ADMINISTRATIVE PROCEEDING
FILE NO. 3-6626

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	:
DONALD T. SHELDON, et al.	:
	:

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U.S. SECURITIES AND
EXCHANGE COMMISSION

INITIAL DECISION

December 2, 1988
Washington, D.C.

Max O. Regensteiner
Administrative Law Judge

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DONALD T. SHELDON, et al.	:	INITIAL DECISION
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APPEARANCES: James A. Kidney, Phil Gross, Stephen Webster and Joy Boddie, for the Commission's Division of Enforcement.

Donald T. Sheldon, _pro se_.

Burton H. Finkelstein, Susan B. Bovee and Donald F. O'Connor, of Finkelstein, Thompson & Lewis, for Bruce W. Reid.

Gregory L. Pattison, _pro se_.

BEFORE: Max O. Regensteiner, Administrative Law Judge.

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I. Introduction

In these proceedings pursuant to Sections 15(b), 15B(c) and 19(h) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 14(b) of the Securities Investor Protection Act of 1970 ("SIPA"), the issues remaining for consideration are (1) whether Donald T. Sheldon, Bruce W. Reid and Gregory L. Pattison engaged in misconduct as alleged by the Division of Enforcement; (2) if so, what if any remedial action under the Exchange Act is appropriate in the public interest; and (3) whether Sheldon should be sanctioned because he was an officer, director and controlling person of a broker-dealer for which a trustee was appointed under SIPA. 1/

Following lengthy hearings, 2/ the Division filed proposed findings of fact and conclusions of law and a supporting brief. In response, Sheldon filed a "post-hearing brief," Reid filed proposed findings and conclusions and a supporting brief, and Pattison filed a "final reply." The Division filed a reply brief as well

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1/ Several other persons were also named in the order for proceedings and in a related order for proceedings. The proceedings as to them were concluded on the basis of settlement offers accepted by the Commission or, in one instance, a default. See Exchange Act Release No. 23057 (March 24, 1986), 35 SEC Docket 551; Nos. 23270 and 23271 (May 23, 1986), 35 SEC Docket 1313 and 1315; No. 23266 (June 23, 1986), 35 SEC Docket 1693; No. 23375 (June 26, 1986), 35 SEC Docket 1709 and Nos. 24128 and 24129 (February 24, 1987), 37 SEC Docket 1292 and 1294.

2/ Much of the evidence presented in the course of the hearings related only to the allegations against Sheldon.

as a reply to Reid's proposed findings. The findings and conclusions herein are based on the preponderance of the evidence as determined from the record and upon observation of the witnesses. 3/

The Allegations - An Overview

The allegations in the order for proceedings pertain to respondents' conduct during the years 1982-1985 while they were associated with Donald Sheldon & Co., Inc. ("DSC"), a registered broker-dealer engaged in the municipal securities business, and Donald Sheldon Government Securities, Inc. ("GSI"), a dealer in U.S. Government-backed securities ("government securities"). Both firms were wholly-owned subsidiaries of Donald Sheldon Group Inc. ("DS-Group"). Under then existing law, GSI was not required to be registered with the Commission and was not subject to the other regulatory provisions of the Exchange Act. 4/ As further discussed below, however, transactions in government securities *were* subject to the antifraud provisions of

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3/ Sheldon's brief, while referring to witness names in support of certain contentions, is devoid of transcript page or exhibit citations. Because of Sheldon's *pro se* status, I have made an effort, not always successful, to locate the evidence to which he apparently sought to refer. In making my findings, I have also taken into account some of the many arguments he made during the hearings and evidence presented by him but not covered in his brief.

4/ Legislation enacted in 1986 subjected government securities brokers and dealers to broker-dealer registration and other regulatory provisions of the Exchange Act.

the securities laws. Sheldon was the principal shareholder of DS-Group and was president, board chairman and chief executive officer of that company and its broker-dealer subsidiaries. Reid was manager of the Houston office of DSC and GSI, and Pattison was a salesman in that office.

The allegations invoke a substantial number of statutory and rule provisions, including antifraud provisions of or under the Exchange Act and the Securities Act of 1933, as well as various rules of the Municipal Securities Rulemaking Board ("MSRB"). Sheldon is charged with a broad range of misconduct related to financial difficulties that forced DSC and GSI out of business in July 1985. Among other things, the Division alleges that DSC engaged in business while insolvent and in violation of the net capital rule and special reserve account requirements; that both DSC and GSI failed to segregate customer fully-paid securities and used such securities to collateralize their loans; and that Sheldon was responsible for such conduct and activities. Further, in connection with the offer and sale of various municipal and government securities, Sheldon is charged with certain direct violations as well as aiding and abetting violations by others and failing reasonably to supervise employees of the firms. The alleged violations include misrepresentations of various kinds to customers, misleading advertising and excessive mark-ups.

In connection with the sales activities in the Houston office, Reid is charged with direct misconduct, aiding and abetting misconduct by salesmen in that office and failing reasonably to supervise them. Pattison, who as noted was one of those salesmen, allegedly made misrepresentations to two customers in the sale of a municipal security.

The Respondents

Sheldon, who is 49 years old, entered the securities business in about 1965 in Memphis, Tennessee. From the beginning, his experience was principally in the municipal bond field. In 1972, he established DSC in New York. In 1975, when the Exchange Act was amended to require the registration of municipal securities dealers, DSC became registered with the Commission. It also became a member of the National Association of Securities Dealers, Inc. ("NASD") and the Securities Investor Protection Corporation ("SIPC"). GSI was organized later in the 1970's. At various times prior to the period here under consideration, additional offices were opened in Pompano Beach and Miami Beach, Florida, Houston, Los Angeles and Honolulu. 5/ Each of these offices (except for Honolulu) served as an office both for DSC and GSI. The two companies shared the facilities, and the salespersons were deemed

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5/ For a short time, there was also a branch office in Memphis.

employees of both companies. The trading department, the back office or operations department and the accounting department remained at all times in New York. Sheldon was registered as a principal with the NASD.

Reid, who is about 48, first entered the securities business in 1964, also in the municipal bond field. Beginning in 1976, he was associated with DSC in New York, first as a consultant to organize a government securities department and then as a trader for such securities. In 1980, he opened a branch office for DSC in Memphis. In 1981, that office was closed, and Reid opened the Houston branch office and became its manager. Reid was registered as a principal with the NASD, and he was a vice-president of DSC. Since the demise of DSC and GSI, Reid has been employed by another broker-dealer in a non-supervisory capacity.

Pattison, who had had no prior experience in the securities business, joined the Houston office of DSC and GSI in May 1982 as a salesman. He left in October 1984 and is now a registered investment adviser.

II. Violations Related to Firms' Financial Problems and Demise (Sheldon Only)

The Allegations

DSC and GSI ceased doing business as of the close of business on Friday, July 26, 1985. On July 30, the Commission brought an injunctive action against the

two firms, alleging violations of antifraud and (as to DSC) net capital provisions. It also sought certain ancillary relief, including the appointment of a receiver for the two companies. A temporary receiver was appointed the same day. Subsequently, a SIPA trustee was appointed to liquidate DSC; a trustee was also appointed for GSI. Ultimately, DSC customers were reimbursed by SIPC. Persons who had bought government securities and had claims against GSI, which was not a SIPC member, received less than the amounts of their claims. The record indicates that SIPC made a contribution to help cover their losses.

As noted, the order for proceedings charges DSC and GSI with various violations related to their financial problems and demise and Sheldon with responsibility for such violations. The allegations encompass the various antifraud provisions, which were allegedly violated by the operation of DSC while insolvent;[6/] the failure of both firms to timely segregate customer fully-paid securities and the use of such securities to collateralize loans, including in the case of GSI repurchase transactions; and the failure to

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6/ The Division also asks me to find that GSI and Sheldon violated the antifraud provisions in connection with GSI continuing in business while insolvent without disclosure to customers. However, there is no such allegation in the order for proceedings and hence no basis for a finding of violation.

disclose those practices and attendant risks to customers.[7/] DSC, the regulated broker-dealer, is also charged with violating, and Sheldon with willfully aiding and abetting its violations of, (1) Rule 15c3-1 under the Exchange Act, by failing to have required net capital from at least July 12, 1985; (2) Rule 15c2-2, by hypothecating customer fully-paid securities; and (3) Rule 15c3-3, by failing to obtain and maintain possession or control of such securities and by failing to maintain the required amount of reserves in DSC's Special Reserve Bank Account for the Exclusive Benefit of Customers.

During the hearings and again in his brief, Sheldon strenuously objected to consideration of alleged violations arising out of transactions in government securities, asserting a lack of jurisdiction by the Commission over such transactions. The argument lacks merit. While government securities brokers and dealers were exempt from regulation during the relevant period and government securities were and still are exempt from the registration provisions, transactions in such securities have always been subject to the antifraud provisions of the securities laws. Section 17(c) of the Securities Act states specifically that the

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7/ The order alleged further antifraud violations based on certain large intercompany transfers among DS-Group's subsidiaries. It is not apparent to me, however, nor has the Division explained, how such transfers, though relevant to other alleged violations, would in and of themselves violate the antifraud provisions.

exemptions provided in Section 3, which include government securities, are not applicable to the antifraud provisions of Section 17. While the Exchange Act contains no analogous provision, its general antifraud provisions (Sections 10(b) and 15(c)(1)) are couched in universal terms. Unlike certain other provisions such as Section 15(c)(2), they contain no exclusion for "exempted securities" such as government securities.[8/] The Commission has previously held that transactions in government securities are subject to the provisions of Section 10(b) and Rule 10b-5 thereunder.[9/]

The Violations by DSC and GSI

The financial problems that beset the two broker-dealers can be attributed in substantial part to another subsidiary of GS-Group by the name of Data Station Systems, Inc. ("Systems") that was organized in 1982. Systems was to develop and market certain computer applications. In February 1985, when it was still in the development stage, Systems filed a registration statement with the Commission for an offering of common stock and warrants; that statement never became effective. Systems accumulated a substantial deficit and proved to be a drain on the resources of its broker-dealer affiliates. According to an analysis of intercompany balances at October 31,

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8/ See 3 Loss, Securities Regulation (1961), p. 1429 (The general antifraud provisions apply to exempted securities).

9/ Blyth & Company, Inc., 43 S.E.C. 1037 (1969).

1984 prepared for DSC's SIPA trustee, Systems owed GSI about $1.4 million. The analysis also showed that DSC owed GSI approximately $1.1 million. As of the same date, loans to GSI from Security Pacific Clearing & Services Corp. ("SEPAC"), its clearing agent, totalled about $4.1 million. It is clear that these loans, which were guaranteed by DS-Group, were funding the advances from GSI to its affiliates.

James Neill was a partner in an accounting firm that was the independent public accountant for DSC and was also accountant for DS-Group. On May 9, 1985, he wrote a letter to Sheldon stating that, although his firm had not completed the audit of GSI for the fiscal year ended October 31, 1984, certain important matters had come to its attention. Sheldon admittedly received the letter. Among the matters listed were that GSI's loss for the year would approximate $500,000, resulting in a deficit in stockholders' equity of about $350,000, and that GSI had a receivable from DS-Group of approximately $2 million, the collectibility of which was doubtful. [10/] Neill testified that this money had gone to Systems.

After October 1984, GSI continued to use its SEPAC account to borrow funds and funnel them to DSC. Between

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10/ It is not clear whether this figure reflects the October 31, 1984 situation or that at about the time of Neill's letter.

November 1984 and April 1985 it advanced about $3.3 million to DSC. SEPAC's chief operating officer testified that in early 1985, SEPAC became concerned about the fact that it had not yet received GSI's financial statements or those of DS-Group for the 1984 fiscal year and that when this condition persisted, SEPAC advised Sheldon that it would no longer finance positions for GSI. Sheldon acknowledged that he was informed by SEPAC that it wanted to terminate its credit relationship with GSI. He denied, however, that he was asked for GSI current financial statements. And he testified that SEPAC's concern was with government securities firms generally and not with GSI in particular. In any event, GSI needed to draw on DSC in order to pay off its loan to SEPAC. DSC transferred a total of $4.25 million to GSI's SEPAC account between July 9 and 12, 1985. These transfers substantially exceeded DSC's account payable to GSI and created a significant receivable from GSI.

On or about July 26, 1985, NASD examiners discovered the fund transfers from DSC to GSI and asked DSC for a net capital computation. On July 29, Sheldon provided such a computation as of July 15; it showed a net capital deficiency of over $1 million. [11/] DSC did not open for

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11/ The NASD never completed its own net capital computation. The accountant for DSC's trustee testified that certain book entries that should have been made by July 15 were not made until after that date. These would have increased the amount of the net capital deficiency.

business that day, and, as noted, the following day the Commission obtained the appointment of a receiver.

The record also supports the Division's contention that, as a result of the cash transfers to GSI between July 9 and 12, DSC, as alleged in the order for proceedings, had a net capital deficiency from at least July 12. By engaging in business thereafter until it closed its doors, DSC violated Section 15(c)(3) of the Exchange Act and Rule 15c3-1 thereunder, the Commission's net capital rule. 12/

The Division's contention that DSC was insolvent from at least July 12 and possibly as early as October 1984 is more problematic. While the Division's initial brief characterized this as an undisputed point, Sheldon does dispute it, stressing the distinction between net capital requirements and insolvency. The Commission has held that it is a violation of the antifraud provisions for a firm to do business while insolvent, or (the equivalent) while financially unable to consummate customers' transactions or to meet current

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12/ I am unable to find a violation of Rule 17a-11 under the Exchange Act, as alleged, based on DSC's failure to file a Focus report for the period ended July 31, 1985. By that date, DSC was in the hands of a court-appointed receiver. While a registrant is not relieved of the duty to file financial reports merely because it has ceased doing business (Samson, Roberts & Co., Inc., 42 S.E.C. 612, 613 (1965)), here the registrant and its records had been taken from the control of its owners and managers. Cf. Fox Securities Company, Inc., 45 S.E.C. 377, 381 (1973).

obligations in the ordinary course of business, without making disclosure to customers.[13/] It is true, as Sheldon seems to suggest, that the record does not show that DSC's liabilities exceeded its assets, or that current liabilities exceeded current assets. It does show, however, as further detailed below, that at least during the last few weeks of its existence, DSC lacked the means to consummate transactions with customers other than by hypothecating fully-paid securities.[14/]

In May 1985, Neill discovered that as of October 31, 1984, securities that had been paid for by customers of GSI had not been segregated and were still being used as collateral for loans extended to GSI by SEPAC.[15/] He further discovered that as of the end of April 1985 the situation had become worse. In his May 9 letter

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13/ C.D. Beal & Co., Ltd., 46 S.E.C. 395, 398 (1976); Weston and Company, Inc., 44 S.E.C. 692, 693 (1971).

14/ A related allegation must, however, be dismissed. By DSC's own calculation as of Friday, July 26, 1985, it needed to deposit an additional amount of over $2 million in the Special Reserve Bank Account for the Exclusive Benefit of Customers required to be maintained pursuant to Rule 15c3-3 under the Exchange Act. Under the Rule, the deposit required to be made on the basis of a computation must be made by 10 A.M. on the second business day following the computation. At 10 A.M. on July 30, DSC was no longer engaged in business. Thus, it could not violate Section 15(c)(3), pursuant to which the Rule was promulgated.

15/ Sheldon's contention that segregation by government dealers of customer fully-paid securities is not feasible is contrary to the weight of the evidence. GSI itself did so in most instances.

to Sheldon, Neill advised him that fully-paid government securities on deposit at SEPAC

> are not being delivered to the customers or placed in safekeeping on a timely basis. To the extent that this problem exists, [GSI] is borrowing money against customer fully paid securities. A review of the April 30, 1985 stock record indicates that this condition is worse than at October 31, 1984. We urge you to review this condition immediately. (Div. Exh. 18)

A subsequent review of records as of June 28, 1985 showed that fully-paid customer securities were not only being used by GSI as collateral for SEPAC loans, but were also being used as collateral for repurchase agreements. Specifically, Neill found that as of June 28, about 50 percent of $4.9 million borrowed by GSI from another securities firm through repurchase agreements was collateralized by fully-paid customer securities.

On July 9, 1985, Neill sent a letter to the board of directors of DS-Group, with copy to Sheldon, stating that his firm had resigned as auditors for DS-Group and its subsidiaries.[16/] At a meeting held at Sheldon's request the next day, Neill advised him of his findings regarding the June 28 situation. According to Neill, Sheldon acknowledged that he had not been responsive to

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16/ Rule 17a-5(f) under the Exchange Act requires a broker-dealer to file a notice of its accountant's resignation with the Commission within 15 business days. No such notice was filed by DSC. However, the notice was not due until July 30, the 15th business day after the resignation. On that day, DSC's assets, books and records passed into the hands of a receiver. Under the circumstances I cannot find a violation of Rule 17a-5. See note 12, p. 11, *supra.*

Neill's May 9 letter respecting the failure to segregate fully-paid securities on a timely basis, but stated that he would do so in the future and that new money was coming into the business. Sheldon also asked Neill's firm to continue as auditors, but they refused. Neill testified that this decision reflected the fact that there had been no improvement since early May and the newly discovered use of fully-paid securities as collateral for repurchase agreements. He further testified that while failure to segregate fully-paid customer securities on a timely basis could be due to back office sloppiness, actually delivering such securities to the opposite party to repurchase agreements was something that had to be done "willingly" (Tr. 408).

Further evidence regarding GSI's pledging of fully-paid customer securities was presented through an official of a firm retained by GSI's trustee that provides accounting and consulting services to broker-dealers and to trustees liquidating broker-dealers. He ascertained that as of October 31, 1984, GSI was using about $1.7 million of fully-paid securities to collateralize its loan from SEPAC. As of the time GSI ceased doing business, about $1 million in fully-paid customer securities continued to collateralize a repurchase agreement.

The record also shows that as of July 26, 1985, DSC had pledged a substantial amount of customer fully-paid municipal bonds as collateral for SEPAC loans. The

total par value of those bonds that had been paid for more than three business days earlier was about $1.5 million. The testimony of a former DSC employee who had the responsibility of moving customer securities pledged to SEPAC into a segregated account upon payment shows that this was not a new problem. She testified that at times in the spring and summer of 1985, about twice a week, there was not enough money available to reduce the SEPAC loan so as to be able to move securities from the clearance or loan account to the segregated account. The amount of securities that could not be segregated for lack of funds ranged as high as $2 million.

No disclosure was made to customers that DSC was insolvent or that it and GSI failed to segregate customer fully-paid securities and used such securities to collateralize their loans. Accordingly, I find that DSC and GSI violated the antifraud provisions of Section 17(a) of the Securities Act of 1933 and Sections 10(b) and 15(c)(1) of the Exchange Act and Rules 10b-5 and 15c1-2 thereunder.[17/] DSC also violated Rule G-17 of the MSRB, which requires a broker-dealer, in the conduct of its municipal securities business, to deal fairly with all persons and not to engage in any deceptive, dishonest or unfair practice. In addition, DSC violated Section 15(c)(2) of the Exchange Act and Rule 15c2-1 thereunder

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17/ See Edward C. Jaegerman, 46 S.E.C. 706 (1976); Investment Registry of America, 21 S.E.C. 745, 752 (1946).

by hypothecating customer fully-paid securities under a lien for a loan made by SEPAC to DSC and Section 15(c)(3) of the Exchange Act and Rule 15c3-3 thereunder by failing to promptly obtain and maintain physical possession or control of fully-paid securities carried for the account of customers.

Sheldon's Responsibility

The critical issue remaining for consideration in this part of the decision concerns Sheldon's responsibility for the violations found above. As has been noted, Sheldon was president of DSC and GSI and of their parent company as well as controlling shareholder of the latter. He was also board chairman of Systems. The Commission has repeatedly held that the president of a brokerage firm is responsible for his firm's compliance with applicable requirements, and that he is relieved of that responsibility only when he reasonably delegates a particular function to another person and neither knows nor has reason to know that such person is not properly performing his or her duties.[18/] Mary Schad, a co-founder of DSC, was secretary-treasurer of the two securities firms and was registered with the NASD as a financial and operations principal of DSC. The financial matters discussed in this section of the decision were within the

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18/ See, e.g., Mark James Hankoff, Securities Exchange Act Release No. 24390 (April 24, 1987), 38 SEC Docket 343, 345; Richard C. Spangler, Inc., 46 S.E.C. 238, 250-251 (1976).

areas for which she had responsibility. The record does not indicate that Schad was not qualified for her position or that the delegation of responsibilities to her was unreasonable. Sheldon denied that he was aware of a net capital deficiency respecting DSC before July 29 or that he was ever aware that DSC failed to segregate customer fully-paid securities or used them as collateral for the firm's loans. The record shows, however, that during the period when the violations occurred, Sheldon was aware or at least on notice that the two firms were in serious financial difficulty and that Schad was no longer in a position to avoid violations. I agree with the Division's argument that at the least he was reckless in failing to investigate problems brought to his attention and to keep himself informed of basic financial information concerning the companies in his Group.

Early warning signs of impending problems were conveyed to Sheldon by officials of Chase Manhattan Bank, which provided financing for DSC for a number of years. Beginning in 1983 or 1984 they expressed concern to Sheldon that he was "spreading himself too thin," because he and his firms were expanding both geographically and into fields outside the securities business.[19/] While

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19/ The Division asks me to find that the bank officials also expressed concern to Sheldon about spreading his capital too thinly. However, at the transcript pages cited, the principal bank official dealing with Sheldon testified that while the bank was concerned about the adequacy of capital to support the other fields into which Sheldon was expanding, he could not recall whether he specifically expressed this concern to Sheldon.

bank officials had confidence in the ability of Sheldon and Schad, they lacked confidence in the personnel below them. At a meeting in the summer of 1984 between bank officials and Sheldon and Schad, the bank officials focussed on their perception that Sheldon was spending too much of his time with DS-Systems, the computer company, and neglecting DSC, as well as on the lack of competent second level management. Sheldon and Schad were told that if there were no improvement, the relationship would be terminated. And in fact it was terminated in February 1985. In connection with the termination, the top bank official responsible for the DSC account indicated to Sheldon that he was concerned about Sheldon's "stretching himself personally and the lack of communications that we were able to have with people that we felt comfortable with, and that we were somewhat concerned about his expansions" (Tr. 345).

Sheldon was clearly warned of capital problems by Neill's May 1985 letter which cited GSI's big loss for the 1984 fiscal year, the doubtful collectibility of a large receivable from the DS-Group and the pledging of fully-paid customer securities for GSI's loan. Sheldon testified that when he received the letter, he glanced at it and forwarded it to Schad. He testified that he and Schad discussed the letter and that, although he could not recall what Schad told him, he was satisfied with her explanation.

However, considering that GSI had been providing funds to DSC and Systems, Neill's warning was a "red flag" that the Sheldon companies were in serious financial difficulty which required the closest attention. The financial situation became more critical when SEPAC required GSI to pay off its loan, and substantial transfers of funds from DSC to GSI were necessitated. These circumstances should have prompted Sheldon to make certain that DSC was not staying afloat by borrowing on customer fully-paid securities. Neill's letter put Sheldon on notice of GSI's improper hypothecation of customer securities. And the discussions following his resignation brought home to Sheldon that this problem had become even more serious.

Under the circumstances, I conclude that Sheldon willfully aided and abetted the violations of DSC and GSI found above.

III. Misconduct in Offer and Sale of Municipal Securities [20/]

The sales practice allegations pertaining to municipal securities involve three very different issuers and issues: one issuer, the Washington Public Power Supply System ("WPPSS"), apparently sold more municipal bonds than any other issuer has ever sold; its

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20/ Allegations that excessive markups were taken in the sale of certain municipal securities are discussed in Part V of this decision.

problems leading to the largest municipal bond default in history were (and still are) the subject of extensive coverage in the financial press. The other two issues, a bond issue by the Cheneyville, Louisiana, Westside Habilitation Center and an issue of bond anticipation notes by the City of Vanceburg, Kentucky, were infinitely smaller and their issuers relatively obscure. What the three issues have in common is that they all went into default.

A. WPPSS (All Respondents)

The Allegations

WPPSS, a consortium of Washington State public utility districts and cities, embarked on an ambitious program in the 1970's to build five nuclear power plants to produce electricity for the Pacific Northwest. Construction of the plants was to be financed by revenue bond issues; DSC participated in underwriting a number of these. DSC was also active in the secondary market for WPPSS bonds. In the period from early 1982 to mid-1983, those bonds constituted a major part of its retail sales effort. The alleged misconduct occurred in the offer and sale of project 4 and 5 bonds. In January 1982, construction on project 4 and 5 plants was abandoned. Eventually, in the summer of 1983, WPPSS defaulted on the project 4 and 5 bonds, which had a total face value of $2.25 billion.

The Division alleged that Sheldon and Pattison made misrepresentations in the offer and sale of WPPSS bonds, thereby willfully violating and aiding and abetting violations of the antifraud provisions of the securities laws. The alleged misrepresentations related to such matters as the safety of investments in these securities, financial and other factors affecting their value, the existence of material litigation affecting WPPSS, and the suspension or decline of ratings on the bonds. There is no claim that Sheldon personally sold securities to DSC customers. The charges against him are predicated principally on his radio, television and other advertising of WPPSS bonds without disclosing or making sure that the salespersons disclosed negative information. Sheldon and Pattison are also charged with willfully violating and aiding and abetting violations of MSRB Rules G-17 and G-19(a), the suitability rule.[21/] In addition, Sheldon is charged with willfully violating and aiding and abetting violations of MSRB Rule G-21(c), which prohibits any advertisement concerning municipal securities that the broker-dealer knows or has reason to know is materially misleading. Finally, Sheldon and Reid are alleged to have failed

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21/ Although the order for proceedings refers to the suitability rule as Rule G-19(c), during the period in question the rule was G-19(a). The alleged violations of the Rule will of course be considered with reference to the way it read at that time.

reasonably to supervise DSC employees who committed violations in the sale of WPPSS bonds, with a view to preventing such violations.

In the pages that follow, I deal first with DSC's advertising for WPPSS bonds and then contrast the advertising messages with the actual developments in the WPPSS situation. That comparison leads to the conclusion that Sheldon violated antifraud and related MSRB rule provisions. I then turn to the evidence pertaining to representations made to DSC customers who bought WPPSS bonds. Although those bonds were sold in other DSC offices as well, the WPPSS customer-witnesses were all customers of the Houston office.[22/] Two of them were Pattison's customers; their testimony, together with Pattison's own testimony given during the investigation and at the hearing and certain exhibits, essentially comprises the case against him. Finally, I discuss Reid's alleged supervisory failures in the WPPSS situation.

The Advertising Campaign

Under Sheldon's direction, DSC engaged in extensive

22/ The Division states that it did not call as witnesses "WPPSS customers who were defrauded by New York salesmen," because the two salesmen alleged to have defrauded customers made settlement offers during the hearing that were accepted by the Commission. (Proposed Findings and Conclusions, p. 85, n. 12). However, testimony of those customers would still have been relevant to the issue of Sheldon's supervision. Having failed to adduce it, the Division could not properly refer to customers having been defrauded.

radio, television and other advertising of WPPSS bonds. The Division contends that the advertisements were materially misleading and in and of themselves violated the antifraud provisions. It appears to contend that those provisions were further violated by Sheldon's keeping the bonds in DSC's inventory and promoting them without insuring that the salesmen were informed of WPPSS's problems and disclosed them to customers.

Sometime prior to November 1982, Sheldon was a guest on a radio call-in show. In answer to a caller's question as to the possibility of WPPSS project 4 and 5 bonds going into default, he stated that he owned such bonds himself and that in fact they represented his most recent investments in the tax-exempt market. "Does that answer your question"? Beginning in November 1982, Sheldon used this dialogue in DSC advertisements that were broadcast on a Florida television station and on radio stations in Houston and Los Angeles.[23/] In or about April 1983, the advertisement was amended to add the following:[24/]

23/ The Division asked me to find that the advertisement was also carried by a New York radio station. However, while the tape was sent to a CBS address in New York, it was to be forwarded to a Houston radio station.

24/ According to the then manager of the Pompano Beach office, the television advertisement in the earlier version was still running when the bonds went into default.

Announcer: "April of 1983. Negotiators announce substantial agreement in principle on a plan to bail out WPPSS Projects 4 and 5. Donald Sheldon comments."

Sheldon: "The capacity of these utilities to repay the people that had loaned them this money was never in doubt."

A communication sent to customers in early February 1983 included an "editorial" by Sheldon stating that the news on projects 4 and 5 continued to be encouraging. It went on to state that he felt that "the cases currently before the court concerning this credit will protect the investors and that the utility companies in Washington will pay their just debts." (Div. Exh. 56) In May 1983, Sheldon caused to be distributed to the press, to DSC customers and to the sales force an economic commentary by Dr. Lance Brofman, an economist affiliated with DSC,[25/] that analyzed the potential return from a possible investment in WPPSS bonds. Without differentiating between the different WPPSS projects and bonds, the commentary stated that historically the percentage of municipal bonds making full payment was very high and that therefore even WPPSS bonds had a significant probability of full payment. It stated that in light of current yields, an investment in

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25/ Dr. Brofman, who also has a degree in nuclear engineering, was president of a municipal bond fund's adviser that was acquired by DS-Group in 1982. In his testimony, he referred to himself as DS-Group's "self-appointed" chief economist.

WPPSS bonds could produce a return "comparable to the greatest return obtained on any stock ever available on any stock exchange." (Div. Exh. 50) The commentary concluded that "the mathematics of the situation" suggested that those who did not presently own WPPSS bonds should buy them and those who already owned some should buy more. A press release issued by DSC's public relations agency on the basis of this commentary opened as follows:

> Rejecting dire warnings of possible default and bankruptcy for [WPPSS], Dr. Lance Brofman, chief economist of the Donald Sheldon & Co. investment banking firm, sees the current steep price declines and yield run-ups as a not-to-be-missed opportunity for even the most prudent investor. (Div. Exh. 51)

The Facts About WPPSS; Sheldon's Violations

These advertisements negated or at least minimized the possibility of a default and failed to reflect the increasingly serious risks attendant upon an investment in project 4 and 5 bonds. 26/ Originally, 88 municipal and cooperative utilities ("the participants") in Washington and other western states were to share in the output of the plants and agreed to pay the debt service on the bonds regardless of the cost of the plants,

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26/ My findings regarding the WPPSS situation are based principally on Division Exhibit 57, comprising issues of Standard and Poor's CreditWeek between January 1982 and November 1983, and on a rating history of the bonds admitted as Exhibit 260. Another Division exhibit, #52, consists of assorted news articles about WPPSS. But these were admitted only for the fact of publication, not for the truth of the matters reported.

their need for power, or the plants' completion. As noted, in January 1982 construction on projects 4 and 5 was terminated prior to completion, primarily as a result of cost overruns and a reduction in the projected need for power. In consequence, Standard & Poor's ("S&P") lowered its rating on the bonds from "A" to "BBB+," still an investment grade. Moody's Investors Service had suspended its "Baa" rating a few days before construction was terminated. On October 4, 1982, S&P placed the project 4 and 5 bonds on Credit-Watch surveillance (which signals a potential rating change) as a result of an Oregon court's decision raising doubt as to the enforceability of the participant agreements against the 11 Oregon utility participants. S&P took that action to indicate that the rating would be negatively affected should it determine that the non-Oregon participants could not adequately absorb that portion of the debt service for which the Oregon participants were responsible.

In November 1982, S&P downgraded the bonds again, this time to "B", a speculative grade, and kept them on CreditWatch. S&P stated that the new rating reflected substantial new uncertainties and risk exposure for the bonds and followed events which introduced serious

questions as to whether WPPSS would be able to meet its 1984 debt payments on the project 4 and 5 bonds. Although a lower court in Washington State had held that the Washington participants did have authority to enter into the agreements, some of those participants had indicated that, in light of pending appeals in Oregon and Washington, they might not pay amounts necessary for 1984 debt service into the bond fund until the Washington Supreme Court had ruled on the authority question. At the end of February 1983, S&P furthered lowered its ratings on the project 4 and 5 bonds to "CC," the lowest rating above default, and removed them from CreditWatch. It stated that the downgrade reflected recent developments that created a significant likelihood of an actual payment default by January 1984. S&P noted that, in view of the pending litigation, 86 of the 88 participants had failed to make bond fund payments due on January 25, 1983. The issue of the validity of the Washington participants' agreements was pending before the state's Supreme Court and was not likely to be resolved before the January 1, 1984 payment date. By then, available funds to pay debt service, including funds in the bond reserve account, would be exhausted.

In June 1983, the Washington Court held that the Washington participants lacked the authority to enter into the agreements. In August 1983, S&P lowered its rating to "D" (default), to indicate that WPPSS had failed

to comply with an acceleration notice by the bondholders' trustee demanding immediate payment of principal and accrued interest.

The above is a broad outline of developments. There were occasional bright moments in the increasingly gloomy picture. Thus, Sheldon testified that the addition to the advertisement in April 1983 was prepared the day after the Governor of Washington announced an agreement in principle to resolve the crisis of the project 4 and 5 bonds. That agreement, however, soon fell by the wayside.

Throughout this proceeding (and in the investigation that preceded it), Sheldon has stressed that prior to the Washington Supreme Court's decision he considered a default unthinkable. In his view, the participants had clearly defined contractual obligations and at all times had the capacity to meet their debt service obligations. He testified that it defied logic and was simply incomprehensible to him that creditworthy borrowers would summarily renege on their obligation to repay monies borrowed and that they would be permitted to do so. These views, he testified, led him to the observations expressed in the February 4, 1983 "editorial." He could not recall the nature of the "news" that was stated therein to be "encouraging." Sheldon further testified that to him the economic logic was perhaps even more compelling than the legal logic; that is, that a default has a long-lasting adverse effect on the

credit and borrowing power of a municipality and will therefore be sought to be avoided if at all possible.

While these may be sound observations in the abstract, the objective facts were that by the time the advertisements started running both the legal obligation and willingness of the participants to meet their apparent contractual obligations were in doubt and, as S&P noted, there was serious question as to whether the bond issues could avoid default. From there the situation only deterioriated. Sheldon does not claim that he was unaware of the unfolding story, which was widely publicized. While adverting to the possibility of default, the advertisements gave the impression of safety and security by stressing Sheldon's own investments in the bonds and the capacity of the participants to pay, without pointing out the negative information including the actions of the rating services and the serious risks that an investment in the bonds entailed. As such, the advertisements were materially misleading.[27/] Because he was directly responsible for the advertising campaign, Sheldon willfully violated or willfully aided and abetted violations of the antifraud provisions of Section 17(a) of the Securities Act, Sections 10(b) and 15(c)(1) of the Exchange Act and Rules 10b-5 and 15c1-2 thereunder

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27/ The advertisements were designed to create investor interest in WPPSS project 4 and 5 bonds and were therefore offers to sell. Cf. Carl M. Loeb, Rhoades & Co., 38 S.E.C. 843 (1959).

and MSRB Rule G-21(c). 28/

In view of this finding, I see no need to address the Division's argument that Sheldon further violated the above provisions by failing to make certain that DSC's salespersons were aware of the negative information about WPPSS project 4 and 5 bonds and disclosed such information to their customers or its allegation that Sheldon did not exercise reasonable supervision with a view to preventing violations by the salespersons. 29/ It may be noted,

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28/ While the MSRB rules by their terms only deal with the conduct of brokers, dealers and municipal securities brokers and dealers, the obligations imposed by those rules are also applicable to associated persons. MSRB Rule D-11. See Nicholas A. Codispoti, Securities Exchange Act Release No. 24946 (September 29, 1987), 39 SEC Docket 407, 409, n. 8.

In his brief, Sheldon has presented no defense of his conduct or that of his firm in the WPPSS situation. Instead, he attacks the Commission's staff for allegedly failing to protect WPPSS investors against the default and its consequences while "investigating a few small firms to death." Whatever may be said about the over-all WPPSS situation and the Commission's responsibilities, however, it cannot absolve Sheldon of responsibility for his own misconduct.

29/ Where findings of substantive violations are made against an individual who is an active participant in the misconduct involved, it is unnecessary or even inappropriate and inconsistent to find him responsible for a failure of supervision with respect to the same misconduct. Charles E. Marland & Co., Inc., 45 S.E.C. 632, 636 (1946); R.A. Johnson & Company, Inc., Securities Exchange Act Release No. 25417 (March 3, 1988), 40 SEC Docket 625, 629, n. 14. While here the misconduct in which Sheldon was an active participant (the advertising campaign) was not identical with the conduct (the sales to customers) that was the subject of the alleged failure to supervise, they are closely enough related to make the above doctrine applicable.

however, that there is no claim by Sheldon that he made any efforts to ensure appropriate disclosure by the salespersons with respect to the project 4 and 5 bonds. Indeed, his outlook on the WPPSS situation, as reflected in the advertisements and in his testimony, was inconsistent with any such efforts.

The Salesmen's Representations (Including Pattison's)

I turn now to sales of WPPSS project 4 and 5 bonds by salesmen in DSC's Houston office. Of those salesmen, only Pattison is presently a respondent. The transactions of the others, as well as his, are the basis for the allegation of supervisory failure against Reid. 30/ The essentially undisputed testimony of the customers demonstrates that the salesmen recommended the bonds, citing the asserted safety of the investment, and failed to disclose material facts reflecting the substantial risks involved. Moreover, the salesmen were or should have been aware that the bonds, at least after they had been downgraded to a speculative rating, were not suitable for these investors who wanted secure, non-speculative investments.

Mr. G. testified that in April 1983 salesman Steets importuned him to swap certain bonds he had bought about two months previously into other, unnamed, but higher-yielding bonds. According to Mr. G., Steets "wore [him] down" (Tr. 3577), and he finally agreed. The new bonds

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30/ The findings made herein with respect to salesmen other than Pattison are made solely on that issue and are in no way binding on those salesmen.

turned out to be WPPSS #s 4 and 5. When he received the confirmation, Mr. G noted that the S&P rating was "CC." Mr. G. testified that he had stressed to Steets that he did not want to speculate. He complained to Steets about the WPPSS purchase, demanding that those bonds be replaced with "good" bonds. Steets assured him the bonds would be paid. He never informed Mr. G. that construction had been abandoned on projects 4 and 5 or of the litigation surrounding payment of the bonds. Mr. G. also complained to Reid, but to no avail.

In August 1982, Mrs. D. advised salesman Wood that she sought a non-speculative investment that would generate better income than CDs. On Wood's recommendation, she bought different bonds, including WPPSS projects 1 and 2 bonds which were rated "AAA" by S&P. In October 1982, again on Wood's recommendation, she bought WPPSS project 4 and 5 bonds. Wood represented that these were similar to the #1 and 2 bonds, when in fact the bonds had entirely different characteristics. Mrs. D. ordered additional #4 and 5 bonds the next month. However, after she learned from another source that there was significant litigation in progress, she refused to accept delivery of a further purchase of #4 and 5 bonds.

In or about November 1982, Mr. S. told salesman Evans that he wanted to buy the same issue of bonds as a friend. The friend had bought WPPSS #1 and 2 bonds.

However, Evans sold #4 and 5 bonds to Mr. S. on November 16. In the conversation preceding the sale, responding to Mr. S.'s statement that he was primarily concerned with security because he "was wanting this for retirement" (Tr. 3704), 31/ Evans said that for these bonds to fail the State of Washington would have to "go broke." (Tr. 3704) Evans also said that the bonds were rated "BBB," but would go to "AAA" or "AA" and increase in value because he felt that the U.S. Government was "going to pick . . . [them] up right away." (Ibid) Evans did not mention that construction had been abandoned on projects 4 and 5, or that there was litigation concerning the participants' obligation to back the bonds. As noted, on November 18, two days after the sale to Mr. S., S&P downgraded the bonds to "B." 32/

Mrs. H. bought several bonds through Evans in 1982. She specified that she wanted only investment grade bonds. Among the bonds she bought were WPPSS project 1 bonds, which were rated "AAA." In April 1983, Evans urged her to take her profit in other bonds and get a higher yield through putting her account entirely into WPPSS project 1

31/ The hearing transcript at the page noted has Mr. S. testifying that he was primarily concerned with "securities." In context, it is clear that Mr. S. actually testified about a concern with "security."

32/ In February 1983, DSC repurchased the bonds from Mr. S. By that time, the price per bond had gone down from almost $500 to about $320.

bonds. She authorized him to do what he thought best. He placed her entire portfolio into the #1 bonds, then urged her to switch to project 4 and 5 bonds as an even better issue. At that point, those bonds were rated "CC" by S&P. Knowing of problems with projects 4 and 5, Mrs. H. refused, but Evans made the switch anyway. Mrs. H. protested to the Houston and New York offices that she had not authorized the transaction, but to no avail.

Mr. J. bought WPPSS project 4 and 5 bonds through salesman Jennings on November 11, 1982. He was interested because a friend had previously bought WPPSS bonds, although he did not know which series. Mr. J. told Jennings that he wanted a secure investment. Jennings gave him the impression that the bonds were backed by the State of Washington and specifically said that they were "good bonds." (Tr. 4022) Jennings said nothing about litigation or that construction had been terminated on projects 4 and 5.

Turning now to Pattison's customers, Mr. M., an engineer, bought WPPSS project 4 and 5 bonds in October 1982, when the bonds still had an S&P rating of "BBB+." According to Mr. M.'s testimony, Pattison said that the bonds were a secure investment backed by the State of Washington and that the Federal government would back them up if necessary. Pattison referred to the bonds as being of investment grade. Mr. M. testified that he did not know the bonds' specific rating. He further testified that

Pattison did not tell him that construction on the plants had been terminated, that there was litigation concerning the backing for the bonds or that there was any risk involved in the investment. Apparently after the bonds were downgraded to "B" in November 1982 and had radically declined in price, Mr. M. learned the negative information about the bonds. After his complaint to Reid went unanswered, Mr. M. called Sheldon who said that he would cancel the sale if there was any impropriety. In a later conversation, in about February 1983, Sheldon said he had found no impropriety and that Mr. M. would just have to take his loss. Sheldon said that the bonds were a good investment, that he had just bought some for his own account and that it was his company's policy to recommend them.

The other customer of Pattison's whom the Division called was Mr. R., who bought WPPSS project 4 and 5 bonds in May 1983. By that time S&P had downgraded the bonds to "CC," its lowest rating above default. Mr. R. testified that Pattison indicated to him that the bonds had a good return and that, while the project 4 and 5 plants would not be completed and there was a lawsuit pending, other power plants in the area would be responsible for paying the interest. According to Mr. R., Pattison also said that the bonds were backed by the Bonneville Power Administration and that the State of Washington would not

allow them to lapse. Pattison did not tell him that courts in Oregon and Idaho had already held that local utilities were not legally bound to back the bonds. Mr. R. testified that Pattison did not discuss the rating of the bonds with him and that he was not aware of the "CC" rating, but would have bought the bonds anyway because they had "the backing" (Tr. 3732).

Pattison testified that after he had recommended various other municipal bonds to Mr. M., the latter called him in response to a DSC "blind" newspaper advertisement for a bond rated "BBB+" with a good yield, which turned out to be WPPSS project 4 and 5 bonds. This testimony, which I credit, demonstrates that Mr. M. was in fact aware of the bonds' rating. Pattison admitted, however, that he failed to disclose to Mr. M. the fact that the construction of projects 4 and 5 had been abandoned, that there was ongoing litigation regarding the participants' backing for the bonds, that Moody's had suspended its rating or that S&P had just placed the bonds on CreditWatch. He testified that he did not disclose these matters, which he conceded were material, because he was not aware of them. He denied, however, that he told Mr. M. that the bonds were backed by the State of Washington. With reference to the sale to Mr. R., Pattison denied that he failed to inform the customer of the ongoing litigation or made misstatements of any kind. But the thrust of Mr. R.'s testimony was not that Pattison

did not advise him of pending litigation, but that he reassured him that notwithstanding the litigation, the backing of the bonds was not in doubt.

Conclusions as to Pattison's Violations

Pattison admittedly failed to disclose material information to Mr. M. And he led Mr. R. to believe that the backing of the bonds was assured, when, in fact, court decisions had already imperiled such backing. His basic defense is that his failure to disclose material information to Mr. M. was attributable to DSC's failure to provide its salespersons with accurate and current information about bonds that were in inventory and its failure to supervise novice salespersons such as he was when he made the sale to Mr. M. He also contends, presumably with particular reference to the sale to Mr. M., that no one could have predicted at that time that the utility participants would renege on their contracts.

As discussed below, there were in fact serious deficiencies in the supervisory and compliance practices and procedures of the Houston office and, indeed, those of DSC as a whole. But these deficiencies, while warranting consideration in determining what, if any, sanction should be imposed, do not excuse the conduct of Pattison, who had responsibilities of his own to live up to. As the Court of Appeals for the Second Circuit pointed out in an

oft-quoted statement, a securities salesman

> . . . cannot recommend a security unless there is an adequate and reasonable basis for such recommendation. He must disclose facts which he knows and those which are reasonably ascertainable. By his recommendation he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation. Where the salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information. 33/

Information concerning WPPSS was widely publicized and was readily available. If Pattison felt unable to obtain up-to-date information, however, he had the option of not selling the WPPSS bonds.

Based on the above, I find that Pattison willfully violated or willfully aided and abetted violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Section 15(c)(1) of the Exchange Act and Rule 15cl-2 thereunder, and Rule G-17 of the MSRB. 34/

33/ Hanly v. S.E.C., 415 F.2d 589, 597 (2nd. Cir. 1969).

34/ Pattison's conduct, if not knowing or intended to defraud, was at least reckless. It follows that he acted with scienter and that his violations were willful. See First Pittsburgh Securities Corporation, Securities Exchange Act Release No. 16897 (June 16, 1980), 20 SEC Docket 401, 405, n.19.

The Division did not brief its proposed finding that Pattison also violated the MSRB's suitability rule, Rule G-19(a). Such a finding is not self-evident here. And I decline to make it. See Rule 16(d) of the Commission's Rules of Practice.

Failure of Supervision by Reid

The findings previously made reflect violations of the antifraud provisions and MSRB rules by five different salesmen in the Houston office in the sale of WPPSS project 4 and 5 bonds. Reid concedes that in at least some instances the salesmen's activities were fraudulent because they recommended the bonds without making proper disclosures. The issue now to be addressed is whether Reid failed reasonably to supervise the salesmen with a view to preventing such violations.

The Division contends that Reid exercised no supervision to speak of. Rather, it asserts, he discouraged the salesmen, most of whom were inexperienced, from taking time off from their telephone selling to learn about the bonds they were offering, including the WPPSS bonds; failed to ensure that the salesmen had up-to-date information about those bonds; and did nothing to ascertain that salesmen were making adequate disclosure to prospective investors or that sales were suitable for customers. Reid, on the other hand, claims that he made published information about bonds, including WPPSS bonds, available to the salesmen; that the salesmen also received economic commentaries about the WPPSS situation from DSC's New York office; and that he cannot be faulted as a supervisor for failing to prevent oral misrepresentations or nondisclosures.

The record contains extensive evidence, including testimony of a number of salesmen and Reid himself, concerning the manner in which business was conducted in the Houston office, generally, and with respect to the sale of WPPSS project 4 and 5 bonds in particular. Although there are many conflicts in the testimony, certain facts are clear. As previously noted, Reid was registered as a principal with the NASD. DSC's Standard Operating Procedures Manual stated that Reid, as manager of the Houston office, was responsible for supervising the activities of the registered representatives in that office. Reid's principal activities were as a retail salesman with a substantial following and, apparently beginning in 1983, as a trader of certain municipal securities, mostly Texas securities, that were not handled by the traders in New York. In addition to commissions on his own transactions, he received an override on the production of the salesmen. Reid considered that, as branch manager, he was responsible for the hiring and training of salesmen and for their general supervision. He testified that he sought to make sure that no salesman gave incorrect information, and that, if he overheard a salesman doing so, he would stop him and correct him. At another point he testified that his supervisory duties were to train the salesmen and to make sure that "the best I could tell nobody made any gross misstatements of fact" (Tr. 5672). Reid also testified that since Houston was not an office of supervisory jurisdiction and

every transaction therefore had to be approved in New York, he did not consider that he had a responsibility to monitor transactions for suitability. 35/

The sales force at any one time ranged from about 10 to 20 salesmen. The turnover rate was high, with the average tenure of a salesman being a year to one and a half years. According to Reid, the high turnover rate was due to Sheldon's unwillingness to pay salesmen as much as other firms did and his unusual policy of not paying commission on a transaction until the securities had actually been delivered to the customer. A majority of the salesmen that were hired were new to the business.

When the Houston office first opened and a group of new and inexperienced salesmen was hired, it appears that they received substantial training. Later groups of salesmen hired without prior experience received less extensive training. They were sent to commercial training courses and studied training materials in preparation for the NASD examination. These included material relating to the rules of the MSRB. In addition, Reid held occasional after-work training sessions for the new and inexperienced employees, discussing municipal and government securities and the markets for them and the research sources.

35/ Section 27(f) of Article III of the NASD's Rules of Fair Practice in part defines an "Office of Supervisory Jurisdiction" as any office designated as directly responsible for the review of the activities of registered representatives in such office.

New salesmen were directed to learn sales techniques by listening to those who were already engaged in selling.

During the period from 1982 to mid-1983, the WPPSS project 4 and 5 bonds presented a highly uncertain, volatile and generally deteriorating situation in which full disclosure of the current material facts and over-all picture was of particular importance. The record indicates that Reid occasionally conveyed certain information orally to the salesmen concerning the WPPSS 4 and 5 bonds, and that at times he caused articles about WPPSS in the Bond Buyer and other publications as well as pertinent items appearing on the Munifacts wire to be distributed to the salesmen.[36/] Any oral communication from Reid, however, must have been colored by the optimistic view he shared with Sheldon that there would be no default because the participants would not be permitted to escape their contractual obligations. Reid maintained that view until the ruling of the Washington Supreme Court in June 1983. He testified that he conveyed his optimism to the salesmen and bought $100,000

36/ As noted by the Division, Reid testified at one point that as long as a salesman knew the rating on a bond, he had no obligation to ascertain additional information about the bond. However, the fact that he did distribute articles pertaining to developments in the WPPSS situation suggests that the Division gives that testimony too literal a reading. Moreover, Reid testified at another point that he expected a salesman to disclose to a prospective buyer any pertinent information, good or bad, that he had about the security (Tr. 5851).

par value of the bonds himself. Moreover, Reid professed to see no distinction between bonds that had never been rated and bonds like WPPSS project 4 and 5 bonds, whose rating had been suspended.

In addition, there was no filing system in effect so that previously distributed articles and other information would be readily available to the salesmen employed subsequent to such distribution. Pattison's experience provides a good illustration of the consequences. As noted, when he sold WPPSS bonds to Mr. M. in October 1982, about two months after he had first begun selling, he was unaware of the fact that construction on projects 4 and 5 had been terminated nine months earlier or that even before that Moody's had suspended its rating. Reid's comment on this matter was that the new salesmen typically would ask more senior salesmen or him "what the story was on a given offering" (Tr. 5854).

In connection with his argument that the Houston sales force was kept informed about WPPSS, Reid also points to Dr. Brofman's economic commentaries regarding WPPSS that were distributed by DSC to customers, the press and salesmen. However, the only such commentaries in the record post-dated the WPPSS Project 4 and 5 bond sales here under consideration. Moreover, the commentaries did not even purport to be a comprehensive analysis of the WPPSS situation. Dr. Brofman testified that he viewed the WPPSS situation wholly from an economic point of view, made no

attempt to determine what the legal issues were and "totally disregarded the legal aspects" in his analyses (Tr. 6116). Yet the legal aspects were of critical importance.

Sheldon testified that Reid, consistent with DSC policy, required his salesmen to do their own research. The testimony of several salesmen confirms that in fact they were to a large extent left to their own devices in obtaining reliable and current information about WPPSS. The record shows that at least some of the salesmen had a perception that current research material including the S&P and Moody's reports, which was located on or behind Reid's desk, was not readily accessible because Reid did not look favorably on salesmen taking time away from their telephone solicitations. Others testified that they had ready access to research material.

In any event, in light of the highly complex and uncertain situation of the WPPSS project 4 and 5 bonds, the fact that they were the subject of extensive advertising and were a major item in DSC's inventory, and the inexperience of much of the sales staff, it was not sufficient to have the sales personnel do their own research. The situation was one that cried out for firm-wide guidance to its sales staff. Absent that, however, it was incumbent on Reid, as branch manager, to be certain that the salesmen had at their fingertips up-to-date and reliable information. Even if the salesmen did have the latest S&P rating, and

even if, as Reid argues, ratings are "the most important ingredient in the bond business" (Brief, p.6), prospective purchasers were entitled to other material and reasonably ascertainable information pertaining to the bonds. In this respect, Reid's supervision was deficient. While there can be no assurance that salesmen, even when armed with complete information, will make the appropriate disclosure to their customers, it is likely that salesmen not so armed will fail to do so.

Finally, Reid cannot escape responsibility for supervisory failure with respect to suitability simply because Houston was not an office of supervisory jurisdiction. At least when S&P in November 1982 downgraded the project 4 and 5 bonds to "B," a speculative rating, he had a responsibility to impress on his sales force that henceforth they were no longer suitable for persons who wanted a non-speculative investment as well as to review the sales tickets that he was required to initial to monitor compliance with his instructions. He makes no claim, and there is no evidence, that he did so.

Based on the above findings, I conclude that within the terms of Section 15(b)(6) of the Exchange Act, Reid failed reasonably to supervise salesmen subject to his supervision who violated the antifraud provisions as well

as Rules G-17 and 19 of the MSRB, with a view to preventing such violations. His failure to provide reasonable supervision also violated Rule G-27 of the MSRB.

B. Cheneyville Westside Habilitation Center (Reid and Sheldon)

The Division alleges that in connection with the offer and sale of Cheneyville bonds by the Houston office of DSC, Reid violated or aided and abetted violations of antifraud provisions and MSRB rules, including the suitability rule.[37/] He and Sheldon are also charged with supervisory failures.

Reid

Cheneyville was a $13.55 million revenue bond issue that was offered to the public in April 1982. The issue included bonds with interest rates ranging from 14% to 16 1/2%. The proceeds were to be used to construct a facility for mentally retarded persons. Over the next two and half years the issuer and the bonds had a troubled history; in October 1984 the issuer defaulted by non-payment of interest then due. The Division contends that Reid knew of the bonds' problems by October 1983, but nevertheless bought the bonds for the firm's inventory,

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37/ The Division also sought to hold Reid responsible for sales by the New York office. However, the testimony of New York customers who bought Cheneyville bonds was offered only against Sheldon and therefore is not evidence against Reid.

failed to obtain current financial information or to inform the salespersons that the bonds were a risky investment and personally recommended the bonds to customers and put them into accounts he controlled. Reid, on the other hand, disclaims knowledge of serious problems prior to default. He does not address his asserted obligation to obtain reliable current information.

Seven customers of the Houston office testified to purchases of 16 1/2% Cheneyville bonds between September 1983 and September 1984 through Reid and three of his salesmen. All but one of the purchases were between April and September, 1984. In six instances Reid or the salesman recommended the purchase of the bonds, which were not rated, without disclosing ongoing litigation or other material negative factors. The seventh customer, Dr. L., had given Reid de facto discretionary authority over his account; in May 1984, Reid bought $15,000 in Cheneyville bonds for the account without discussing the transaction with Dr. L. or giving him any information concerning Cheneyville.

The essentially undisputed facts concerning Cheneyville reflect a series of problems that made the unqualified recommendation of the bonds improper. At the outset, there was a fiasco when Bossier Bank & Trust Co., the indenture trustee, deposited over $8 million of the

offering proceeds in a bank that subsequently failed. In settlement of litigation, Bossier made good most of the loss. Partly as a result of the shortfall, however, the debt service reserve fund, consisting of a portion of the proceeds designed as an emergency fund, had to be invaded to pay the April 1983 coupon. As of October 1, 1983, the construction fund had a balance of about $1.3 million and the reserve fund a balance of about $1.1 million, enough in total to make the October 1983 and April 1984 payments. After that the issuer would be wholly dependent on operating revenues consisting principally of Medicaid payments by the State of Louisiana. And the occupancy rate of the facility was far below projected levels.

In further litigation beginning in 1983, involving Bossier, the developer, an attorney appointed to represent the bondholders and the principal underwriter, the developer, who was to receive the balance in the construction fund upon completion of the project, sought a ruling that the October 1983 payment be charged against the reserve fund. Bossier, which had resigned but continued to act as trustee because no successor could be found, wanted the construction fund to be charged. Within the same action, there was litigation concerning the developer's claim that he had completed the facility. According to counsel for

Bossier, the difficulty in finding a trustee was attributable to the extensive litigation and the realization that the project would not be financially viable.

The last coupon paid prior to bankruptcy reorganization was April 1984. At that point, the court had not yet determined to which fund the October 1983 payment should be charged. Ultimately the court held that it should be charged to the construction fund. That meant that most of the April 1984 payment had to come from the reserve fund. There was not enough left in both funds combined to make another payment, and not enough funds were available from the facility's revenues. And so the October 1984 interest payment was not made. In 1985 Cheneyville filed for Chapter XI bankruptcy; as a result of the proceeding the interest rate on the bonds was reduced to 10 percent.

Reid testified that prior to the default he was not aware of the litigation concerning the issue of which fund was to bear the interest payments. However, I find that in the fall of 1983 his customer Dr. G. informed him of problems with the project and in particular of that litigation. Beginning with the issue of October 17, 1983, Dr. G. received a few of the Cheneyville "Updates" sent by Swink & Co., which had been principal underwriter of the Cheneyville offering, to bondholders and dealers on its mailing list.

The Updates tracked the progress of the litigation and other developments, and Dr. G. shared the information with Reid. 38/ Salesman Denton testified about getting information from the president of the facility that he passed on to Reid. The record is less than clear, however, as to the information he received or conveyed to Reid.

There is another factor that indicates that Reid was at least on notice of serious problems in the Cheneyville situation. That factor is that in 1984, when inflation was at a low level, the 16 1/2 percent bonds were selling at a discount and at declining prices rather than at a premium.

Aside from what he actually knew or must have known, Reid had an obligation to know. Reid testified that in 1983, when certain salesmen learned of large purchases of Cheneyville bonds by Dr. G., they approached Reid to add such bonds to the inventory so they could sell them to customers. In Reid's words,

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38/ I reject Reid's attack on Dr. G.'s credibility based on the fact that Reid, at an unspecified time, had fired Dr. G.'s son-in-law from an unspecified position with DSC.

While the Updates were sent to DSC's New York office, the record does not warrant a finding that they were also sent to the Houston office.

> I told them if they wanted to sell them, get on the phone [to obtain information]. Here is the trustee bank. Here is the paying agent. Here is the name of the facility. Call them. Do [your] own research. I stressed to all of them [on] more than one occasion. . . . I was not a research analyst. I was not paid to do that. (Tr. 5739) 39/

Reid further testified that some of the salesmen did make inquiries of people connected with Cheneyville. He asserts that he received sporadic information from them, most of which was "generally positive" and "reasonably optimistic" in nature (Brief, p. 22).

Reid's testimony and arguments reflect the view that he had no affirmative responsibility to obtain reliable information, including financial information, about Cheneyville. The Division takes the position that as DSC's sole trader in Cheneyville bonds, an obscure unrated issue, Reid had precisely such a responsibility and that by failing to carry it out he was a direct violator in every sale, whether by him or by another salesman, in which investors were not properly informed or to investors for whom the bonds were not suited.

The Division has cited no authority for this proposition. However, whether or not Reid, _qua_ trader,

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39/ In investigative testimony, Reid was asked why he did not personally call the facility to check. His answer: "The biggest reason was that I stayed on the phone all day long, and these men seemed to enjoy doing a little research" (Div. Exh. 1064, p. 433).

had a responsibility as urged by the Division, he was not simply a trader, but also branch manager. Having brought the Cheneyville bonds into inventory, he then had an obligation to see to it that they were sold only on the basis of reliable and current financial and other information. That does not mean that he himself had to do the necessary research. He could have delegated that task to a responsible and reliable subordinate. By his own admission, however, Reid (and presumably the other salesmen) received only episodic and sporadic information about Cheneyville from salesmen who made inquiries. I recognize that it may often be difficult or even impossible to obtain reliable current information about unrated municipal bonds trading in the secondary market. But if such information cannot be obtained, the dealer cannot properly recommend and sell the bonds to customers, at least not without full disclosure of the lack of information.

Reid's arguments also overlook the sales of Cheneyville bonds to his own customers. The undisputed testimony of one of these, Mr. B., was as follows: In June 1984, Reid recommended an investment in Cheneyville bonds to him, stating that it was a good bond paying 16 1/2 percent. In view of the high interest rate, Mr. B. expressed concern about safety. Reid assured him that he had nothing to worry about and did not tell him of the litigation or of any other problems. The next interest payment was due October 1, 1984. However, when Mr. B.

deposited the coupon with his bank, it came back unpaid. He called Reid who stated that there were problems with the trustee, that "they" were changing trustees and that everything would be all right. Reid did not tell Mr. B. that the bonds were in default. Instead, he told Mr. B. to send the coupon to DSC's office, and soon thereafter Mr. B. received payment from DSC. In April 1985 Mr. B. deposited his coupon for the interest payment which he thought was then due. Again it came back unpaid. At this point Reid told Mr. B. that the facility had financial difficulties. It was only after that that Mr. B. learned of the litigation.

In Edward J. Blumenfeld, Securities Exchange Act Release No. 16437 (December 19, 1979), 18 SEC Docket 1379, involving a municipal bond salesman, the Commission said that every salesman who recommends securities, particularly those of little known issuers, is under a duty to investigate in order to make sure that his recommendations have a reasonable basis. Quoting from its earlier decision in Willard G. Berge, Securities Exchange Act Release No. 12846 (September 30, 1976), 10 SEC Docket 600, 602, aff'd sub nom. Feeney v. S.E.C., 564 F.2d 260 (8th Cir. 1977), the Commission went on to state that every salesman has an obligation to deal fairly with his customers. "Hence no salesman can recommend an unknown or

little known security unless he has himself seen reliable financial data that supply him with a reasonable basis for his recommendation. This is especially true of debt securities." The Commission concluded that Blumenfeld, lacking current financial information, had no reasonable basis for the recommendations and representations that he made and therefore had violated the antifraud provisions. Like Blumenfeld, Reid had no reasonable basis for his recommendation. 40/

With respect to Dr. L., another customer, Reid from time to time executed transactions for his account without first consulting him. Dr. L. did not object; he testified that Reid had *de facto* discretionary authority over the account. In May 1984, Reid purchased Cheneyville bonds for Dr. L.'s account without discussing the investment with Dr. L. Thus, Dr. L. received no information prior to the purchase about the litigation pertaining to Cheneyville. He eventually learned of the default, but not until after the demise of DSC in July 1985. When Reid bought the Cheneyville bonds for Dr.

40/ In 1980, Sheldon had distributed a memorandum to the sales staff, reflecting DSC's attorney's advice based on the *Blumenfeld* decision. As quoted in the memorandum, the attorney paraphrased the decision as follows: "[A] salesman who recommends speculative or little known debt securities without reviewing current financial information is guilty of a willful violation of the antifraud provisions of the securities laws" (Div. Exh. 259). This statement was subsequently incorporated into DSC's Standard Operating Procedures Manual.

L.'s account, it was the equivalent of a recommendation to Dr. L. As found above, Reid had no reasonable basis for such a recommendation. In addition, both Mr. B. and Dr. L. had advised Reid that while they were looking for high yields, this was subject to the limitation that investments for their accounts be safe. Under the circumstances, Reid's recommendations, which occurred only a few months before the default and at a time when a default was clearly to be anticipated, were not suitable for them.

Based on the above findings, I conclude that Reid willfully violated or willfully aided and abetted violations of Section 17(a) of the Securities Act, Sections 10(b) and 15(c)(1) of the Exchange Act and Rules 10b-5 and 15c1-2 thereunder and MSRB Rules G-17 and G-19. 41/

Sheldon

In addition to the sales by the Houston office as described above, evidence regarding sales of Cheneyville bonds by salesmen in the New York office was presented on the issue of Sheldon's alleged supervisory failure. Mel Feldman, sales manager of that office, recommended and sold those bonds to several persons as late as July 1984 without disclosing anything regarding the ongoing litigation or other negative information. Salesman Himber

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41/ In view of these findings, a further finding of supervisory failure is not warranted. See note 29, p. 30, *supra*.

also recommended and sold Cheneyville bonds to several of his customers as late as September 1984 without disclosing negative information. Feldman and Himber obtained the information on which they based their sales presentations largely from Reid, who was the firm's trader in this issue, and from salesman Stafford in the Houston office. 42/ Prior to the default, they were unaware of the ongoing litigation.

Sheldon testified that he probably did not become aware of Cheneyville until after the default. The Division does not claim otherwise. It contends, however, that he was derelict in his supervisory responsibilities because he failed to establish any compliance procedures for insuring that information about obscure, little-known bonds would be obtained before they were sold, that negative information would be conveyed to the sales force and subsequently to customers, and that sales would be suitable for investors.

Sheldon testified that it was DSC policy that each salesperson was required to do his or her own research and to investigate the facts relating to any security that he or she wanted to offer for sale. He further testified that most of the bonds that the firm's traders acquired for DSC's inventory were investment grade securities that were

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42/ Findings with respect to Feldman and Himber are based on their investigative testimony, which was received against Sheldon, but not against Reid. Hence such findings are made only against Sheldon.

suitable for virtually all customers, and that as to those bonds that were not investment grade, they were "openly discussed" (Tr. 9511) and the degree of risk was known to the salespersons who were then responsible for describing it to their customers.

The policy of relying on salespersons to do their own research, to which Reid also subscribed, may not have been inappropriate with respect to bonds that were rated and had no unusual characteristics. In such cases, the information in S&P's and Moody's was likely to be both adequate and easily comprehended. Even accounting for the fact that the sales personnel would exchange information, it was not an acceptable policy, however, for unrated bonds or those involving complex legal issues or litigation. In those situations, including Cheneyville, it would be impossible for the branch manager (in this case Reid) to monitor sales presentations based on information obtained by one or more salespersons with varying degrees of experience and perceptiveness.

Moreover, the record shows that in the area of sales practices, Sheldon failed to provide or implement a structure of effective procedures for supervision and compliance. It is reasonably clear that under DSC's structure, managers of the various offices had the responsibility for supervising the activities of the salespersons

under them. But the record does not reveal the existence of a system of internal control subjecting the branch managers to effective supervision. Mary Schad, DSC's secretary-treasurer and registered financial and operations principal, was the firm's designated compliance officer. In investigative testimony,[43/] Schad referred among other things to the fact that, in order to make branch managers' supervision more effective, the physical arrangement of the offices was such that "everyone pretty much knows what everybody else is doing. . ." (ALJ Exh. 3, p. 129). However, Sheldon acknowledged that he was responsible for the sales aspects of the firm and for supervision of the branches. With reference to the Houston office, Sheldon testified that Reid, as a principal of the firm in charge of the office, was responsible for the proper representation of securities by the sales personnel in that office and for insuring that they properly informed themselves about speculative or little known securities. In response to the question what he did to supervise the Houston office, Sheldon, aside from about five visits to that office in the approximately four years of its

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43/ Schad invoked her privilege against self-incrimination when deposed by the Commission in September 1985 in its injunctive action against DSC and GSI. Apparently on the assumption or expectation that she would do so again if called to testify in this proceeding, she was not called as a witness. Investigative testimony that she gave in 1984 and earlier in 1985 was received in evidence.

existence, could point only to his participation in the initial training program for salespersons and to the fact that, as a result of Reid's similar background in the industry and their having worked together, he "felt very comfortable with [Reid's] direction and control of that office" (Tr. 9720).

Having been given ample opportunity to testify about any established procedures for supervising the branch managers generally and Reid in particular, Sheldon was unable to refer to any such procedures. The only conclusion to be drawn is that there were none and that Reid was essentially left to his own devices. In a recent decision, the Commission pointed out that it had long recognized that it is not sufficient for a broker-dealer to establish a system of supervisory procedures which rely solely on supervision by branch managers.[44/] Under the circumstances, I find that Sheldon failed reasonably to supervise persons subject to his supervision who violated the antifraud provisions and MSRB Rules G-17 and G-19, with a view to preventing such violations, and that he also violated Rule G-27 of the MSRB.

44/ Dean Witter Reynolds, Inc., Securities Exchange Act Release No. 26144 (September 30, 1988), 41 SEC Docket 1680, 1685, citing Shearson, Hamill & Co., 42 S.E.C. 811 (1965).

C. Vanceburg Bond Anticipation Notes (Reid and Sheldon)

The Division alleges that Reid further willfully violated and aided and abetted violations of the designated antifraud provisions and MSRB rules in connection with the offer and sale of Vanceburg bond anticipation notes. Again, Sheldon is charged with a failure reasonably to supervise.

Reid

In 1979, the city of Vanceburg, Kentucky, floated a $110 million revenue bond issue to finance construction of an electric power plant. The city of Hamilton, Ohio, contracted to purchase the major portion of the output and to pay 90 percent of the bond debt. The project was to be completed in August 1982, but it ran out of funds. To raise funds for completion of the project, Vanceburg in June 1982 sold a $14 million issue of 10 1/2 percent revenue bond anticipation notes. The notes were to mature in two years; at maturity, they were to be "rolled over" into long-term bonds. Hamilton was not responsible for any portion of the debt service on the notes. Moody's assigned the notes a rating of MIG (Moody's Investment Grade) 2 when they were issued. This is the second highest rating; as defined by Moody's, loans bearing this designation are of "high quality." S&P did not rate the notes, but rated the bond issue "BBB+."

In January 1984, Hamilton sued Vanceburg, claiming that it had been induced to enter into the contract by fraud and also claiming mismanagement. It asked the court to void the contract or to award Hamilton $10 million in damages. Had the contract been voided, it would have affected not only the debt service on the 1979 bond issue, but the contemplated 1984 bond offering on which Hamilton was again to be responsible for 90 percent of the debt service. As a result of the suit, Moody's suspended its rating on both the notes and the bonds, pending clarification of the suit's impact on the credit quality of the system's debt. S&P put the bonds on CreditWatch "with negative implications." In March 1984, it lowered the rating to "BB," a speculative rating. These actions were reported in the municipal bond publications.

As a result of the suit and the rating changes, it became necessary for the principal underwriter of the notes to seek alternative sources of financing to refund the notes. Those efforts, continuing until just before the maturity date of the notes, proved unavailing. On June 1, 1984, the maturity date, a partial payment, slightly in excess of interest due, was made. However, Vanceburg defaulted in payment of the principal of the notes. Eventually, in December 1984, the notes were paid in full from the proceeds of a bond sale.

According to its reply to Reid's proposed findings, the Division's case respecting the notes pertains only to transactions by the Houston office subsequent to the cancellation, at the end of April 1984, of the sale of a large quantity of notes to a Mr. E., in connection with which certain information concerning the refunding of the notes came to Reid's attention. In the weeks prior to this event, several of the salesmen in the Houston office, who had developed interest in the notes as a sales item, had contacted the bank that was fiscal agent for the notes and had been told that the notes were "fully funded." They failed to ask what was meant by this, but apparently took it to mean that funds were already on deposit in the bank to pay off the notes and accrued interest on maturity. That, however, was not the case. Reid testified that when the salesmen told him what they had learned, he took it to mean that on or before the maturity date of the notes, "a bond issue would be sold or was in the process of being sold" (Tr. 5771).

On April 27, 1984, salesman Stafford sold $450,000 of the notes to Mr. E., representing that the funds to pay the notes were in the bank and that there was therefore no risk in buying the notes. However, when Mr. E. made his own inquiries from the bank, he was told that the funds were not there. He was also informed for the first time

that there was ongoing litigation. Mr. E. thereupon cancelled the transaction.[45/] Stafford confirmed with the bank that the money was not there. Reid was advised of this, either by Mr. E. or Stafford or both. And it was common knowledge in the office. Reid told Stafford he would give him a few days to dispose of the notes to other customers rather than reselling them in the wholesale market at some loss, which Stafford would have to bear. He instructed Stafford to find out the true situation before offering the notes to anyone. According to Reid, Stafford contacted various sources and then assured him that, although the money was not on deposit, the notes would be paid at maturity from the proceeds of a bond issue. Reid further testified that he himself called the bank and was told that the notes were "funded" (Tr. 5780). A memorandum written by Stafford to Sheldon regarding the notes indicates, however, that his inquiries in early May from bond counsel and the prospective underwriter of the bonds disclosed that there were possible problems in paying off the notes at maturity (Div. Exh. 1046).

45/ Stafford testified that the sale was conditional on Mr. E.'s verifying that the funds had been deposited, and that he so advised Reid. According to Reid, Stafford never advised him that this was a conditional sale.

Stafford thought he could sell most of the notes to Mr. B. When he had opened his account with DSC, Mr. B. told Stafford that his investment goals were "retirement income, interest income and I wanted a good safe bond" (Tr. 3561). In early May 1984, Stafford called and said he had a "good deal" for him, namely Vanceburg notes totalling $400,000, on which he could earn good interest in a "real short transaction" (Tr. 3562). Stafford mentioned no litigation or other problem and did not discuss anything about ratings. By his own admission, Stafford did not advise Mr. B. that, as he had just learned, the funds to pay the principal and interest were not on deposit with the fiscal agent. Ultimately, Mr. B. did not buy the bonds because the bank from which he wanted to borrow the purchase price would not accept the notes as collateral.

Salesman Frazier, however, managed to sell a portion of the notes. When Mr. H. had opened an account with DSC, he told Frazier that he did not want to speculate and wanted the best yield consistent with safety. In selling Vanceburg notes to Mr. H. prior to Mr. E.'s cancellation, Frazier assured Mr. H. that money to pay the principal and interest was already on deposit in a bank. He also told Mr. H. that the notes were rated "BBB." On May 17, 1984, after Mr. E.'s cancellation, Frazier induced Mr. H. to buy another $100,000 of the notes. He stated

that Reid had double-checked with the "trustee," who had assured Reid that the money was on deposit. Frazier did not tell Mr. H. about the litigation or other problems with the notes or about Moody's rating suspension. He testified that he was not aware of the rating suspension and thought the notes were still rated "BBB" by S&P.

Reid himself also managed to dispose of some of the "cancelled" notes. As noted in the discussion of the Cheneyville bonds, Reid's customer Dr. L. had given him de facto discretionary authority over his account. On May 11, 1984, Reid caused the account to purchase $50,000 in Vanceburg notes; these were part of the notes that Mr. E. had decided not to buy. In mid-June, after the default had already occurred, Reid placed an additional $25,000 in Dr. L.'s account. It appears that another customer who had bought Vanceburg notes brought them to the DSC office at or about the maturity date and was inadvertently paid for them by DSC. Reid testified that when he learned of the default, he asked Dr. L. to take those notes as a favor to him, telling Dr. L. that sooner or later they would be paid in full, and that Dr. L. agreed. However, I credit Dr. L.'s testimony that, consistent with the manner in which his account was normally handled, Reid did not consult with him before effecting the transaction in his account. Dr. L. did not learn of the litigation or the default until several months later.

As stated in connection with the Cheneyville bonds, Reid, as trader and branch manager, had an obligation to be reasonably certain that the Vanceburg notes he brought into DSC's inventory were sold on the basis of current and reliable information. By failing to carry out that obligation, Reid has to accept responsibility for the consequences.

Reid claimed that when he made his first purchase of Vanceburg notes in March 1984, the trader on the other side told him that the notes were rated "MIG-2" and "BBB," respectively, and that he reasonably relied on this representation and passed the information on to his salesmen. At that time, however, Moody's had already suspended its rating, and the S&P "BBB+" rating was for the bonds, not the notes. Moreover, S&P had put the bonds on CreditWatch. While I do not agree with the Division that Reid's reliance on the other trader for rating information was _per se_ unreasonable, it was reckless for Reid not to consider that ratings can and do change. Had he looked into the matter, he would have discovered not only the true rating situation, but the litigation that had first caused the rating agencies to take cautionary steps in January 1984.

After Mr. E.'s cancellation, when he learned that funds to pay the notes were not on deposit, Reid was obligated to determine exactly what the situation was.

It was clearly not reasonable for him to rely on Stafford, whom he himself characterizes as inexperienced, and particularly not since Stafford had a financial stake in disposing of the notes to customers. And if, as appears was the case, it was uncertain whether arrangements could be worked out to pay the notes at maturity, Reid was obligated to see to it that those uncertainties and risks, together with all other reasonably ascertainable facts, were explained to any customers to whom the notes were offered. With respect to his conduct toward Dr. L., Reid characterizes the purchase of the notes by Dr. L.'s account after the default as "a professional courtesy performed by a long-standing customer" (Brief, p. 19), and he stresses Dr. L.'s testimony that he did not believe that Reid had defrauded him and that he was still doing business with Reid. As previously noted, however, I credit Dr. L.'s testimony to the effect that Reid did not communicate with him in advance of the purchase. For the same reasons as discussed in connection with the Cheneyville bonds, Reid's conduct in purchasing both batches of Vanceburg notes for Dr. L.'s account was improper.

Based on the above findings, I find that Reid willfully violated and willfully aided and abetted violations of

the same provisions refered to in the Cheneyville section of this decision.

Sheldon

Sheldon testified that he became aware of the Vanceburg notes about a week before they matured when Schad advised him that a Houston customer had "reneged" on the purchase of a sizeable number of notes (Tr. 9164). He thereupon instructed Reid to sell the notes in the wholesale market. According to Sheldon, Reid requested permission to delay the sale; when the notes were subsequently sold, the market price had declined and DSC had to absorb a significant loss. In his brief, Sheldon contends that he instructed Reid not to sell the notes in question to customers.

The Division, citing Reid's investigative testimony, asserts that Sheldon instructed him to sell the notes either to customers or to the street (Div. Exh. 1064, p. 163). I do not read that testimony to differ from that of Sheldon.

In any event, however, I find that in the Vanceburg situation, as with the Cheneyville bonds and for the reasons stated there, Sheldon failed in his supervisory responsibilities.

IV. Misconduct in Sale of Government Securities [46/]

The order for proceedings (as fleshed out in "more definite statements" submitted by the Division) alleges that Sheldon willfully violated the antifraud provisions in connection with representations by GSI salesmen and in advertisements regarding anticipated yield on investments in government securities. Reid is charged with responsibility for practices in Houston that allegedly led investors in government securities to believe that their investments were insured by SIPC, in violation of the antifraud provisions. Sheldon is also charged with failure reasonably to supervise with a view to preventing these practices both in Houston and in the Los Angeles office. Additionally, he is charged with supervisory failure in connection with representations by salesmen in Los Angeles and Houston that certain government securities would be delivered to investors, when in fact delivery was precluded by the "book entry" system. [47/]

46/ Allegations that excessive markups were taken in the sale of certain government securities are considered in Part V of this decision.

47/ The Division contends that Sheldon is also charged with violations of the antifraud provisions in this "book entry" matter. However, the portion of the order for proceedings to which it points (Section IIK (2)(j)) does not name Sheldon.

A. Anticipated Yields (Sheldon)

GSI advertised "Ginnie Mae" (Government National Mortgage Association or GNMA) and "Freddie Mac" (Federal Home Loan Mortgage Corporation or FHLMC) certificates in various newspapers. Each advertisement featured a large print percentage figure accompanied by the legend "or more anticipated yield" (as, for example, "14% or more anticipated yield"). The legend was followed by an asterisk. A footnote in small print near the bottom of the advertisement read as follows: "This is our estimated anticipated yield which is formulated based on our analysis of this particular pool's past performance and which, in our opinion while not guaranteed, offers such attractive potential. The yield based on a 12 year average life using GNMA (Freddie Mac) standard bond yield tables is [here the note cited a significantly lower percentage figure]." The term "pool" referred to a group of mortgages against which securities were issued by Ginny Mae or Freddie Mac.

Freddie Mac and Ginnie Mae certificates were the main sales items of Sheldon's Los Angeles office and were sold in other offices as well. For each pool in inventory, the sales personnel were provided with various information, including an anticipated yield figure. The anticipated yield figures supplied to the sales force and used in the

advertisements were compiled by Douglas Ebbitt, GSI's trader of government securities. Those figures also appeared on confirmations of transactions.

The Division contends that in many instances the anticipated yields were overstated, and that customers were misled into believing that the anticipated yield was what they could actually expect to receive. Sheldon denies that there was any impropriety in the way his firm used the anticipated yield concept.

The Division called as an expert witness Dexter Senft, a managing director of First Boston Corporation with responsibility for research and product development on the fixed income side, including mortgage-backed securities. Senft has written and lectured extensively regarding such securities. Sheldon acknowledged that Senft was well known in the industry, and he did not question Senft's expertise. Senft explained that the interest rate on a Ginny Mae or Freddie Mac certificate is normally fixed, so that the monthly interest to be received by the investor can be predicted with certainty. The amortization of the principal, which is also a component of the monthly payment, is also known. The other component of principal payment, however, derives from mortgagors' prepayment of their loans; that item is not predictable

with certainty. Typically, the certificates in GSI's inventory were available at discounts. Where a certificate is bought at discount, the yield will increase as the prepayment rate goes up. This is, of course, because principal is repaid without discount; thus, the faster it is paid the better is the return.

Senft analyzed a group of more than 60 GSI confirmations of sales of Freddie Mac certificates showing in each instance the anticipated yield. Using an experience model called SMM (single monthly mortality) that measures the rate of prepayment of a particular pool of mortgages, Senft calculated that most of the yields were overstated by GSI. I find his testimony and accompanying statistical exhibits (Div. Exhs. 77 and 81) persuasive. Ebbitt, called as a witness by Sheldon, testified that his calculations of anticipated yield were based on tables published by Financial Publishing Co. However, neither he nor Sheldon produced such tables, and without them Ebbitt was unable to replicate his computations.[48/] Ebbitt testified that his only

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48/ A former attorney for the Sheldon firms testified that he corresponded with Commission staff regarding the formulas for computing yields, resulting in agreement on use of a new formula. While he further testified that the agreement was reflected in a letter from GSI to the Commission, no such letter was produced at the hearing.

disagreement with Senft, whom he characterized as a highly respected expert on "mortgage backed" calculations, was that he relied more on recent "paydown" than Senft would deem prudent (Tr. 8239). Accepting, however, that in many cases the anticipated yield used by GSI was inaccurate, it does not follow that Sheldon is responsible. Ebbitt was an experienced trader in mortgage-backed securities. Sheldon testified that he had confidence in Ebbitt and relied on his judgment and the accuracy of his calculations. There is nothing in the record indicating that Sheldon must or even should have been aware that the yield figures were overstated.[49/]

On the other hand, I do hold Sheldon responsible for customers being misled as to the meaning of anticipated yield. The concept relies on a projection based on past prepayment record of the particular pool. As Senft pointed out, for an individual pool, as distinguished from a large group of pools, the ability to predict future prepayment on the basis of past prepayment

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49/ The anticipated yield representations that Senft found to be overstated preceded a letter from FHLMC to Sheldon in February 1985, expressing concern about GSI's aggressive advertising of high anticipated yields. The letter referred to complaints by purchasers when yields "your salesmen promised them prove to be illusory" (Div. Exh. 79).

behavior is very poor.[50/] Ebbitt testified that in buying mortgage-backed securities for GSI's inventory, he looked for pools that had "some remarkable paydowns" recently, and that customers could be told that there was a "possibility" they could get the anticipated yield based on past prepayments (Tr. 8235). At another point, he acknowledged that anticipated yield was strictly speculative in nature. Under the circumstances, it was critical that the true character of the projection be clearly explained so as not to mislead potential investors. The small-print caveat in the advertisements was not sufficient to dissipate the prominently featured anticipated yield rate.[51/] And, contrary to Sheldon's

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50/ Senft testified that in large numbers prepayments occur according to patterns that can be described in economic terms, but on any one pool they occur more or less at random.

51/ Ebbitt testified that the NASD approved the form of the advertisements. The Division, citing its exhibit 282, an NASD advertising review form containing comments on a proposed advertisement by DSC and GSI in a Honolulu newspaper, asserts that the NASD does not "approve" broker-dealer advertising. It is true that the form includes caveats that the views expressed are solely advisory and do not constitute findings of compliance with NASD rules. However, the exhibit shows NASD comments regarding an anticipated yield advertisement, among them a statement that the advertisement "should include the usual footnote giving the basis for the yield computation." Presumably this was a reference to the footnote previously quoted in the text.

argument that anticipated yield was never claimed to be precise or guaranteed, GSI personnel, in their sales presentations, stressed the anticipated yield as the return customers could expect to receive or at least failed to explain the limitations of that concept. Such presentations were materially misleading.

The Division presented the testimony of a number of customers of the Los Angeles office on this issue. Sheldon's argument that the record does not show the actual returns received by those investors is to some extent accurate. Some of the customers, such as Mr. J. and Mr. V., in testifying about the returns they received, referred only to the interest portion of their payments. That, of course, was not the total yield. However, as stated above, their testimony and that of others shows that they were misled as to what they could expect to receive on a monthly basis.

As noted, sales of Freddie Macs and Ginny Maes on the basis of anticipated yield were a mainstay of the Los Angeles office. In his testimony, Sheldon insisted that anticipated yield was the only way to correctly present the potential return on mortgage-backed securities sold at a discount. He must have known that customers would be likely to be misled unless the concept were carefully explained. As New York salesman Calabrese correctly noted,

this was a very difficult thing to do. Ebbitt testified that customers should be advised that the anticipated yield was "strictly speculation" and that he may well receive "a more modest yield" (Tr. 8282). There is no evidence, however, that there was any systematic effort to train the sales personnel in proper sales presentations when the anticipated yield concept was used. In his brief, Sheldon, without giving a transcript reference, claims that Ebbitt testified that he had taught classes to the sales personnel on that concept. I have been unable to locate any such testimony. Indeed, Ebbitt testified that he was "never really involved in the training of the employees. . ." (Tr. 8255). Under all the circumstances, Sheldon must be held responsible for misuse of the anticipated yield concept. I conclude that he willfully violated or aided and abetted violations of the previously cited antifraud provisions.

B. Deliverability of Freddie Mac Certificates (Sheldon)

The Division further alleges that in 1985, after Freddie Mac had gone to a so-called book-entry system, customers were misled into believing that they would receive certificates evidencing their interests, when in fact that was no longer the case, and that Sheldon failed

reasonably to supervise the sales force to prevent such conduct.

From January 2, 1985 on, new Freddie Mac participation certificates were offered in book-entry form only. Paper certificates were no longer available on these, being replaced by an electronic system. Under the new set-up, certificates were registered in the name of a member bank of the Federal Reserve System, in GSI's case SEPAC. SEPAC had a record of GSI's ownership, but only GSI had a record of which of its clients had purchased portions of a pool. The advent of the book-entry system was widely publicized.

The record shows that from April to July 1985, a number of customers, most of them customers of the Los Angeles office, were expressly advised in connection with purchases of Freddie Mac certificates that were subject to book entry, that they would receive certificates of ownership. Various salesmen made oral representations to this effect. In addition, despite the change in the system, GSI continued to use as a sales tool, until its demise, a Freddie Mac brochure produced by it that included the following question and answer:

Q. Do I actually hold the certificate?

> A. Yes. Your PC (participation certificate) is registered in your name . . . and delivered to you via registered, insured mail. Your PC arrives about four weeks after you invest... 52/ (Div. Exh. 76)

Sheldon's brief asserts that the inventory positions posted on a blackboard in each office designated those pools that were book-entry pools, and that Ebbitt held meetings with all sales personnel where he discussed book-entry versus deliverable securities. There is partial support for these assertions in the record. Dennis Riggi, one of a three-man informal management committee in the Los Angeles office who took responsibility for posting information on the blackboard, testified that from about April 1985, when he first became aware that certain Freddie Mac pools in GSI's inventory were on the book-entry system, he put that information on the board where appropriate. He also testified that Ebbitt came from New York around late March or early April, held a sales meeting and explained that henceforth most of the Freddie Mac inventory would be available only in book-entry form. Ebbitt himself testified that he was aware of the changeover from about the beginning of 1985; that

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52/ Confirmations for the purchase of these Freddie Mac certificates, like those for other securities, contained the notation "deliver direct." I am not persuaded that the Division is correct in viewing this notation as misleading in the context of book-entry pools.

he was in the Los Angeles office from the end of February 1985 to the end of April or May; and that during his sojourn there he held a sales meeting to explain the changes to the sales personnel. The testimony concerning the inventory board and the meeting conducted by Ebbitt was corroborated by other former salesmen in the Los Angeles office.

The fact remains that even though the book-entry pools were designated on the inventory board and even though Ebbitt explained the new system to some extent at least to the Los Angeles sales force, some of the salesmen continued to assure their customers that they would receive certificates. And the brochure with its now false material (in relation to 1985 pools) continued to be used. [53/] These practices violated the antifraud provisions.

On the issue of whether Sheldon failed to exercise reasonable supervision, I do not subscribe to the Division's argument that he "surely was aware" of the representation regarding delivery that was included in the brochure concerning Freddie Mac (Div. Brief, p. 35). No doubt Sheldon

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53/ One of the Los Angeles salesmen testified that an advertising committee consisting of salesmen in the Los Angeles office had formulated a plan to "sticker" the Freddie Mac brochure to reflect the book-entry system, but had not gotten around to doing so by the time of GSI's demise.

was familiar with the brochure and its general contents; to assume that he must have been familiar with every statement in it is unwarranted. However, Sheldon was admittedly aware by March 1985 that a new Freddie Mac system was in effect and that it represented a problem that needed to be addressed. He should have made it his business to determine whether the brochure needed correction and, if so, to have it corrected, as well as to seek to assure that the salespersons represented the situation accurately. However, particularly with respect to the Los Angeles office where most of the misrepresentations occurred, there were no adequate supervisory procedures in place. The record shows that Sheldon completely relied on Ebbitt for the running of GSI, but did not consider Ebbitt a compliance officer. Testifying during the investigation in January 1985, Sheldon stated that there were no compliance procedures or policies specifically applicable to GSI, and that he had never felt that it was necessary to have a compliance officer for GSI, since it was an unregulated company. Ebbitt's own testimony clearly indicates that he considered his responsibility to be "on the telephone doing my own job" (Tr. 8291), i.e., trading government securities, and not to be a compliance person.

Moreover, during the period in question there was no branch manager in charge of the Los Angeles office.

Until he was fired in about June 1983, a man named Taffel was more or less manager of that office. I put it that way because Taffel himself testified that he was not a "real" manager, in that his authority was limited and he was not a principal. Yet, at least toward the end of his career with the Sheldon firms, he did have authority to hire salesmen, received additional compensation and was flown to several management meetings. After Taffel's departure, it appears that, with Sheldon's blessing, a group of three salesmen informally evolved into a management committee which undertook day-to-day responsibility for the smooth running of the office and the training of new salesmen. Important or unusual matters had to be referred to Sheldon for decision, although during the last few months of GSI's existence one of the three was given the title vice-president and he and a second committee member given the authority to hire and fire. None of the three received added compensation. Sheldon's attempt, in his brief, to portray this informal committee as part of "a participatory management structure [installed by him] patterned after the employee participatory concept so effectively used by the Japanese" and as a management structure designed "to better serve the needs of both our investors and our employees" (Brief, unnumbered page titled California Office Management) is disingenuous. It does not reflect the facts in the record.

A more accurate portrayal of the situation is that of the Division: The committee was created spontaneously by three salesmen to fill a vacuum left by the departure of a manager, which Sheldon did not take steps to fill (Reply Brief, p. 12).

Based on the above findings, I find that, within the terms of Section 15(b)(6) of the Exchange Act, Sheldon failed in his supervisory responsibilities.

C. SIPC Coverage of GSI (Reid and Sheldon)

Unlike DSC, GSI was not a member of SIPC. The Division alleges that customers in Los Angeles and Houston were led to believe that their purchases of government securities were insured by SIPC. Sheldon is charged with failure of supervision in this respect. Reid is charged with willfully violating and aiding and abetting violations of the antifraud provisions through the Houston office's use of material relating to DSC and its SIPC membership in communications with customers interested in or buying government securities. He is also charged with supervisory failure.

As previously noted, DSC and GSI shared the same offices and used the same sales force. The telephone was usually answered simply "Donald Sheldon." A form letter introducing prospective Houston customers to the firms used DSC stationery which referred to SIPC membership. It

opened with the statement that information was being submitted regarding DSC; went on to refer to DSC as a municipal bond specialist and to GSI as a government securities specialist; and then went on to state that "we are members" of SIPC, among other organizations. One such letter in the record bears Reid's signature. Reid testified that he instructed the secretarial help, at the time the Houston office opened, that "responses to government advertisements" (presumably the reference is to responses to persons who answered GSI advertisements) should use GSI stationery and "municipal information" should go out on DSC stationery (Tr. 5924), and that after that he did not recall giving the matter further thought. Asked as to whether he had instructed the secretaries to use separate letterheads in correspondence beyond the form responses, he testified that he could not recall doing that and that it did not seem that important.

Five Houston office customers who purchased government securities testified that they were led to believe that their accounts were insured by SIPC. Mr. A.D., who responded to a GSI advertisement, received the form letter described above, signed by Reid, and with it Reid's business card showing him as vice-president of DSC. Mr. D. also received a Freddie Mac brochure and a SIPC brochure. In response to Mr. D.'s request to the salesman to whom he spoke for a financial statement of the firm, he received

a DSC financial statement. Mr. D. bought a Freddie Mac certificate. He testified that when he made his investment, he understood that it was covered by SIPC. It was only after the firm's demise that he learned that there were two companies, one of them not a SIPC member. Mr. W.J.C. also received the form letter when he responded to a government securities advertisement. He subsequently bought a Freddie Mac certificate. He did not realize until after the demise of the firms that there were two different firms. Mr. J.P.C., who had expressed interest in government securities, received among other things the form letter and a SIPC brochure. Mr. R.D. originally bought a Freddie Mac certificate from salesman Samples in the Los Angeles office. Samples sent him a business card showing his company's name as DSC and DSC's membership in SIPC. After moving to Texas, he bought another Freddie Mac certificate through the Houston office. Subsequently he received a DSC business card, noting SIPC membership, from the salesperson with whom he dealt. Dr. G. dealt with Reid himself. Between 1983 and 1985 he bought municipal bonds. He was told that his account in DSC was insured by SIPC. In 1985 he bought a Ginnie Mae certificate. Since Reid said nothing to the contrary, Dr. G. believed that that account was insured as well. Dr. G. testified that Reid instructed him to endorse a check that he used for payment to "Donald Sheldon Co. Securities, Inc." Reid's letter confirming the transaction was on DSC stationery

and showed SIPC membership. While an account statement Dr. G. received had GSI at the top, it came in a DSC envelope. Dr. G. testified that prior to the firms' demise he understood he was dealing only with DSC and had no knowledge that there was a company such as GSI.

The Los Angeles office did not use an introductory form letter like the one used by Houston. In other respects, the testimony of a number of customers of that office who purchased government securities is similar to that of the Houston customers. The distinction between DSC and GSI was not explained or was blurred, and they were led to believe that their accounts were insured by SIPC. Practices included salesmen sending their DSC business cards showing SIPC membership along with information about government securities; using DSC letterhead in correspondence with government securities customers; and giving or sending SIPC brochures to customers interested in government securities.

Reid contends that there is no basis for the charge that he or his salesmen deliberately misled customers regarding SIPC insurance, urging that the most he can be charged with is "sloppy procedure" (Brief, p. 40). He points out that no customer-witness testified to an affirmative representation that his government securities purchase was insured by SIPC, and he asserts that Dr. G., the only Reid customer to testify on this issue, stated that Reid had made no such representation. Reid further urges that the

introductory form letter was generated in New York and that he inadvertently failed to catch the problem. He claims that he always responded to customer inquiries on the subject by stating that government securities transactions were not SIPC-insured, and that he told the salesmen that this was the case.

Sheldon also contends that there was no intent to deceive any customers, and he asserts that the distinction between the two firms, in terms of SIPC insurance, was covered in training sessions and made clear to the salesmen.

As a result of the manner in which DSC and GSI were operated, with common facilities and sales personnel, there was a considerable potential for confusing and misleading customers as to the identity of the firm they were dealing with. Precisely because of the lack of SIPC coverage for GSI customers, it was critical that in all communications the distinction between the two firms be clearly maintained. It appears that dual sets of material, including letterheads and business cards, were in fact provided for each office. And, as far as the record shows, confirmations for sales of government securities and account statements for GSI customers were always on the GSI letterhead. But, as found above, in other types of communications the distinction was not always maintained. The introductory form letter used in Houston conveyed the

impression that there was only one company, covered by SIPC, or at best that there were two companies, both covered by SIPC. In either reading, when sent to persons who responded to a government securities advertisement, it was materially misleading and Reid must take responsibility for it. With respect to Reid's customer, Dr. G., while it is true that Dr. G. did not testify that Reid told him that government securities were SIPC-insured, his testimony was that they never discussed the subject. But Dr. G. was under the impression that he was still dealing with DSC, which he had been told was covered by SIPC. And Reid, by using DSC stationery in correspondence with Dr. G., only reinforced that impression. 54/

I accept Reid's contention that there was no deliberate deception. And I do not believe that the record warrants a finding of "recklessness in office management" (Reply Brief, p. 29), which the Division asks me to make and which could provide the scienter required to find violations of certain of the antifraud provisions. However, even negligently made material misrepresentations violate Sections 17(a)(2) and 17(a)(3) of the Securities Act. 55/

54/ Although Dr. G. rejected the suggestion that he might have misunderstood the name of the entity to which Reid told him to endorse the check, I consider that more likely than not.

55/ See Aaron v. S.E.C., 446 U.S. 680 (1980).

I find that Reid willfully violated those provisions.[56/]

As for Sheldon, the record warrants a finding that he failed to exercise reasonable supervision. Because of the potential for deception, Sheldon should have systematically and periodically instructed the sales personnel regarding the distinction between the two companies. DSC's Standard Operating Procedures Manual (Div. Exh. 2) included a statement that each new customer was to be informed by the salesman of the difference between DSC and GSI. However, the record shows that many of the salesmen did not receive a copy of the Manual. And there is no indication that there was any follow-up to assure compliance with the instruction. Sheldon cites former salesman Rosenblum's testimony (but without page references) for the proposition that Ebbitt held meetings to discuss the distinction in terms of SIPC coverage. However, I find nothing to that effect in Rosenblum's testimony nor in Ebbitt's testimony. On the other hand, several of the Los Angeles salesmen testified that they knew that GSI was not a member of SIPC, but had learned this in informal discussion with other salesmen and not from any memorandum or formal

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56/ For purposes of Sections 17(a)(2) and 17(a)(3), willfullness means no more than intentionally committing the act which constitutes the violation. First Pittsburgh Securities Corporation, Securities Exchange Act Release No. 16897 (June 16, 1980), 20 SEC Docket 401, 405, n. 19.

presentation. Some salesmen were not even aware that GSI was not covered by SIPC. The office administrator testified that she and her staff, with responsibility for mailing literature to customers, were well aware of the distinction between DSC and GSI and sought to send out only the appropriate material. But this was obviously not enough to prevent the violations. Moreover, the absence of a real manager in the Los Angeles office, as previously described, made it all the more imperative that Sheldon himself take appropriate measures.

V. Excessive Markups

A. Municipal Securities (Reid and Sheldon)

The Division charges that Sheldon and Reid willfully violated and aided and abetted violations of the antifraud provisions in connection with undisclosed excessive markups in the sale of WPPSS and Cheneyville bonds. They are also charged with willfully violating MSRB Rules G-17 and G-30. The latter provision prohibits a dealer from selling municipal securities to a customer except at a fair and reasonable price, "taking into consideration all relevant factors." 57/ In addition,

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57/ The factors referred to in the rule include the best judgment of the dealer as to the fair market value of the securities, the expense involved in effecting the transaction, the fact that the dealer is entitled to a profit and the total dollar amount of the transaction.

Sheldon and Reid are alleged to have failed reasonably to supervise with a view to preventing excessive markups.

In support of its allegations, the Division presented schedules (Div. Exhs. 85 and 86) prepared by a staff member showing certain transactions in WPPSS project 4 and 5 bonds between October 1982 and June 1983, certain transactions in Cheneyville bonds in 1983 and 1984, and markup computations reflecting the difference between the retail sales price and DSC's cost. The schedules were limited to same day or next day transactions and to instances where the markups so computed exceeded 5 percent.[58/] The Division also presented as an expert witness on municipal bond markups Peter Trent, a former Chairman of the MSRB with many years of experience in the municipal bond business. During his tenure as Chairman, the Board engaged in an extensive dialogue with the industry, culminating in a Report on Pricing that is further discussed below. Trent's expertise was conceded by Sheldon and Reid. His analyses and testimony related to compliance with the MSRB rules, and not to the antifraud provisions.

58/ Sheldon argued that during 1984, DSC's overall markups were only about eight-tenths of one percent. He based this on a Division Exhibit (No. 58) which ranked DSC salesmen by gross sales made and gross profit earned. However, the exhibit has no bearing on the findings regarding the markups alleged to have been excessive, all based on specific DSC records. And those findings make it highly unlikely that Exhibit 58 reflects an average markup taken by DSC.

Examining Division Exhibit 85, the WPPSS schedule, Trent counted 122 sales with markups exceeding 5 percent, including 109 with markups of at least 6 percent.[59/] In the first few months of the period covered, markups were mostly in the 6-9 percent range. However, by June 1983, when the market prices for various series of the bonds had dropped to the 20's, markups were mostly in the 10-15 percent range. Trent deemed all of the markups over 5 percent to be excessive, in violation of Rules G-17 and G-30. He explained that even though he considered 5 percent to be too liberal, he used a 5 percent "benchmark" because that was the limit implied in DSC's own Standard Operating Procedures Manual. The manual, under the heading "Fraudulent Devices," included a paragraph on mark-ups drawn from the Commission's decision in Edward J. Blumenfeld.[60/] The paragraph picked up a sentence quoted by the Commission from a court decision that it is the practice in the municipal bond industry to charge retail prices no more than one-quarter of one percent to five percent over the current market price.[61/] The Cheneyville schedule

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59/ When Exhibit 85 was received in evidence, a few of these transactions were excluded because the backup data was not available.

60/ Securities Exchange Act Release No. 16437 (December 19, 1979), 18 SEC Docket 1379.

61/ Preceding that sentence, the paragraph stated: "Excessive markups are considered willful violations
(CONTINUED ON NEXT PAGE)

for 1984 transactions (Div. Exh. 86) reflected markups mostly in the 5-7 percent range, with a few at 8 or 9 percent. Trent concluded that 79 transactions, with a par value of $915,000, were marked up excessively. 62/ He applied a somewhat different standard here, although a 5 percent standard would have yielded essentially the same result. Under Trent's standard, markups of more than 3 1/2 percent were excessive on transactions of 10 bonds or more, markups of more than 4 1/2 percent excessive on 5-bond transactions. 63/ Trent indicated that he considered this standard also as liberal, but commented that the Cheneyville bonds were in the category of non-rated, higher-risk obligations, the markups for which were usually higher than "general market municipal bonds" (Div. Exh. 108-A). As to why he applied an even more liberal standard to the WPPSS transactions,

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61/ (CONTINUED FROM PREVIOUS PAGE) of anti-fraud provisions. Dealers are only entitled to charge a fair markup over current market prices. Markups of more than 10% are always considered fraudulent in the sale of equity securities, and markups in excess of 7% have been found fraudulent. Markups on municipal bonds are generally lower than those for equity securities."

62/ As noted, the Division's schedule also presented evidence regarding markups on Cheneyville bond sales in 1983. However, in its first "More Definite Statement," the Division limited the time period for the alleged excessive markups in Cheneyville bonds to the period January - November 1984.

63/ In the course of his testimony, Trent expressed these standards both in terms of "points" and percentages. He made it clear, however, that in the case of discount bonds it was percentages (3 1/2 and 4 1/2, respectively) he would apply, not points.

Trent explained that WPPSS was a more volatile situation and that somewhat larger percentage markups could be justified for discount bonds such as the WPPSS 4 and 5 bonds than for bonds selling around par. 64/

Reid contends, among other things, that Trent failed to consider factors that the MSRB had declared relevant to the determination of a fair and reasonable price, and that Trent was not in a position to express a reasoned conclusion because he did not trade

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64/ Trent also prepared schedules based on DSC records regarding sales by Reid and Feldman of WPPSS project 1, 2 and 3 bonds in 1983, which were received in evidence as part of Exhibit 108-B (the Feldman schedule was received against Sheldon only). Again using 5 percent as a benchmark, Trent found that the markups were excessive in 18 sales by Reid and 71 sales by Feldman. Reid raised a number of questions about Trent's methodology, which in this instance was different from the ordinary markup methodology. More significantly, however, John Gibson, a former trader for DSC, testified without contradiction that during the relevant period DSC was a market maker in WPPSS 1, 2 and 3 bonds. In the case of a market maker, contemporaneous cost may not be an appropriate basis for calculating markups. Peter J. Kisch, Securities Exchange Act Release No. 19005 (August 24, 1982), 25 SEC Docket 1533, 1540. Whether it is or not requires examination of the nature of the inter-dealer market to determine whether it may legitimately serve as the basis for findings of prevailing market price. Alstead, Dempsey & Company, Incorporated, Securities Exchange Act Rel. No. 20825 (April 5, 1984), 30 SEC Docket 259, 261. In my view, the burden was on the Division to produce the evidence necessary to permit that examination to be made.

While two traders for other firms testified that DSC was also a market maker in WPPSS 4 and 5 bonds, Gibson, who was in a better position to know, testified that it was not considered "a real market maker" in those bonds (Tr. 7746).

the bonds in question during the period under consideration and, aside from the information in the schedules, was not familiar with the market for them.

Rule G-30 contains no numerical guidelines to be used in determining whether a particular markup is excessive. In 1980, the MSRB issued a notice indicating its concern that additional guidance under the rule might be necessary and suggested the development of specific numerical guidelines as one possible course. It solicited the views of interested persons on the desirability of such action and as a point of departure for discussion suggested a "band" of 1 - 2 1/2 points as a possible guideline. After considering the extensive response, the Board, in a Report on Pricing issued in September 1980, rejected the concept as not feasible in view of the heterogeneous nature of municipal securities transactions and dealers and reiterated that all relevant factors should be considered. Trent testified that all board members considered 5 percent, the figure used in the NASD's pricing policy for corporate securities, to be too liberal. The Board reiterated a previously expressed position that of the possible relevant factors, the most important one was yield to the customer, i.e., that the yield should be comparable to that on comparable securities. Trent testified that in arriving at his opinion, he considered the factors cited in the Report, to the extent he found them to be relevant to the securities in question.

As noted, Trent's conclusions regarding the ma reflected his interpretation of Rule G-30. He was not asked about, and did not address himself to, Commission decisions interpreting that rule or applying the antifraud provisions. In my view, those decisions lead to the same conclusion as that reached by Trent as well as to the conclusion that many of the markups violated the antifraud provisions. First of all, Commission decisions have consistently held that, absent countervailing evidence, a dealer's contemporaneous cost is the best evidence of the current market. [65/] As the Division points out, the burden is on the respondent to establish the contrary. [66/] That has not been done here. Further, the Commission has consistently held markups exceeding 10 percent not only excessive but fraudulent in the sale of equity securities; has found markups exceeding 7 percent fraudulent in such sales; and has stated that markups on debt securities, including municipal bonds, are generally lower than those for equity securities. [67/] In connection with the last point, the Commission has referred to the statement of a

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65/ See, e.g., First Pittsburgh Securities Corporation, Securities Exchange Act Release No. 16897 (June 16, 1980), 20 SEC Docket 401, 406. This standard has received judicial approval. Barnett v. U.S., 319 F.2d 340, 344 (8th Cir. 1963).

66/ See, e.g., Charles M. West, Securities Exchange Act Release No. 15454 (January 2, 1979), 16 SEC Docket 592, 594.

67/ See e.g., Edward J. Blumenfeld, Securities Exchange Act Release No. 16437 (December 19, 1979), 18 SEC Docket 1379, 1381-82.

court (previously noted) that it is the practice in the municipal bond industry to charge a retail customer a price which is no more than one-quarter of one percent to five percent over the then current market price for a bond. 68/ The Commission has twice dealt with Rule G-30, in each instance on review of NASD decisions finding that respondents had charged customers unfair or excessive prices in violation of that Rule as well as Rule G-17. In both cases the Commission affirmed the NASD's findings. In the first case, involving Staten Securities Corporation, markups ranged from 5.1 to 6.7 percent. 69/ In the second case, they ranged from 6.1 to 32.7 percent. 70/ The Commission stated in each case that it had taken all relevant factors into account. In the second case, it did not indicate what factors had been considered. In the Staten case, the Commission referred to various factors, including the availability of the securities, the size and price of the transactions, the amount of gross profit and the apparently riskless nature of the transactions. Neither decision referred to the yield factor or certain other factors discussed in the MSRB Report.

68/ S.E.C. v. Charles A. Morris & Associates, Inc., 386 F. Supp. 1327, 1334 n. 5 (W.D. Tenn. 1973).

69/ Securities Exchange Act Release No. 18628 (April 9, 1982), 25 SEC Docket 2006.

70/ Nicholas A. Codispoti, Securities Exchange Act Release No. 24946 (September 29, 1987), 39 SEC Docket 407.

Based on these standards and on Trent's expert opinion, I find that the markups on the WPPSS and Cheneyville bonds exceeding 5 percent were excessive and that the resulting prices were not fair and reasonable and violated Rules G-30 and G-17. Moreover, at least to the extent that the markups, which were undisclosed, exceeded 8 percent, they violated the antifraud provisions.[71]

Particularly egregious was a series of transactions in which Reid in effect interposed certain trading accounts which he controlled between the dealer market and regular, or what the Division characterizes as "non-favored," customer accounts. In effect, Reid sold Cheneyville bonds to the trading accounts at prices reasonably related to DSC's contemporaneous cost, well below par, then sold bonds short to non-favored customers at or near par and covered the short position by buying the bonds from trading accounts at a profit to those accounts but still well below par. The second markup was in itself excessive. For example, on September 13, 1984 Reid bought 135 bonds for DSC from another dealer or a broker at 89 1/8. On the same day, DSC sold 135 bonds to three trading accounts at 91 1/8 and another 10 bonds at 93. Also the same day,

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71/ See Edward J. Blumenfeld, Securities Exchange Act Release No. 16437 (December 19, 1979), 18 SEC Docket 1379, 1382; Crosby & Elkin, Inc., Securities Exchange Act Release No. 17709 (April 13, 1981), 22 SEC Docket 772, 775.

DSC bought 30 bonds from the trading accounts at 94 and the following day another 30 at 94 and 95. Two business days after that, on September 18, DSC sold bonds to three non-favored customers at par.

Reid asserts that the markup computations in Exhibit 85, the WPPSS bond schedule, are flawed because the staff member who prepared it did not know the actual time of each transaction and therefore whether sales to customers followed or preceded purchases from dealers or brokers, the nature of the quoted dealer market at the time or why DSC paid different prices to brokers on the same day. 72/ I agree with the Division that the quoted dealer market and precise transaction times are not necessary for the markup analysis. And it is clear that contemporaneous cost may properly be based on a transaction following the retail sale. 73/ Finally, the record shows that with the exception of about three transactions, including one where the markup computation was based on the lower rather than the higher cost of two same-day purchases, the schedule appears to be properly constructed. The required modifications do not materially affect the conclusions drawn from

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72/ Reid also claimed that Exhibit 86, the Cheneyville schedule, was flawed. The points he raises, however, relate to the 1983 transactions. As stated above, I have excluded these from consideration.

73/ See, e.g., Alstead, Dempsey & Company, Incorporated, Securities Exchange Act Release No. 20825 (April 5, 1984), 30 SEC Docket 259, 264, n. 16.

the schedule.

Reid admittedly traded the Cheneyville bonds for DSC and set the reoffering price to customers. He asserts, however, that he did not set the retail price on the sale of WPPSS bonds. The record shows that many of the WPPSS bond purchases reflected on Exhibit 85 were made by Reid and that, with one or two exceptions, the sales were all effected by Houston salesmen. Accepting Reid's testimony that the retail sales price was set by DSC's New York traders, he admittedly knew what the markups were when he had effected the purchase, particularly since purchase and sale were almost invariably effected on the same day. Accordingly, he is responsible for the violations. I also find that he had the scienter that is requisite for adverse findings under certain of the antifraud provisions. Reid's testimony, both during the investigation and at the hearing, reflects considerable confusion as to markup standards. He acknowledged that he had read the material in DSC's Standard Operating Procedures Manual, which at least implied a 5 percent upper limit, but further testified that until about 1984 he was under the impression that normally 5 points ($50 per bond) was the normal markup. According to his testimony, he then was told by Schad that the guideline was 5 percent, not 5 points, but he did not know whether this was to be applied to DSC's purchase or sale price. At another point, Reid testified that Sheldon had told him to stay within the NASD's

5 percent guideline. During the investigation, he also testified to unfamiliarity with Rule G-30.[74/] Reid was reckless in not informing himself of the pertinent regulatory requirements. I conclude that he willfully violated or willfully aided and abetted violations of the antifraud provisions previously referred to and MSRB Rules G-17 and G-30.

With respect to Sheldon, the Division asserts that he overruled attempts by the trading desk to limit markups taken by Reid and Feldman and that he is therefore "culpable of willful fraud" (Brief, p. 44). However, the anecdotal evidence cited is simply inadequate to support a finding that Sheldon authorized markups that were violative of MSRB rules or antifraud provisions. On the other hand, a finding that he failed reasonably to supervise is warranted. In his testimony on markups, Sheldon reiterated the theme that DSC's traders set the retail sales prices, that they were well-qualified professionals, and that they used their best judgment in light of current market conditions. He testified that

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74/ Unfortunately, the questioner referred to this as an NASD rather than as an MSRB rule (Div. Exh. 244, p. 103).

Reid was not alone in his confusion. In October 1984, the MSRB, in republishing its 1980 Report on Pricing, stated that it was doing so in response to inquiries indicating confusion whether there were pricing guidelines in effect for the municipal securities industry.

he relied on them and did not get personally involved in the pricing process. Sheldon was not aware whether the traders were familiar with the material on markups in DSC's Standard Operating Procedures Manual. Yet he had a duty to make reasonably certain that the traders knew the applicable regulatory requirements and abided by them. That he failed in this duty is clear from his own testimony. I therefore find that Sheldon failed reasonably to supervise traders with a view to preventing violations of the antifraud provisions and MSRB Rules G-17 and G-30 and that he violated Rule G-27.[75/]

B. Government Securities (Sheldon)

Sheldon is charged with antifraud violations as a result of GSI's alleged taking of undisclosed excessive markups in the sale of government securities from 1982 on. Both Sheldon and Ebbitt, GSI's trader, testified that it was the policy and practice of GSI to take a 5 point

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75/ The Division also charges Sheldon with violations and failure to supervise in connection with sales by Feldman of municipal bonds through one Richard Knox, who added his own 3 percent fee on top of DSC's markup to customers. However, the Division has proposed no findings regarding specific transactions. Moreover, the only Sheldon testimony it cites assertedly showing his awareness of the Knox transactions reflects merely his awareness that Knox, an accountant, had given DSC a lot of business from various of his clients. Under all the circumstances, I make no adverse findings on this point.

markup on the sale of discount mortgage-backed government securities.[76/] Translated into percentage terms, this meant that markups were invariably in excess of 5 percent. Where the cost of the security was around $60, as was the case in a number of instances, a 5 point markup was equivalent to an 8 percent markup. At the $70 level the markup was 7 percent.

The Division contends that GSI's policy produced excessive markups. Sheldon, on the other hand, contends that during the relevant period there was no rule in effect governing markups on mortgage-backed securities; that the NASD's regulations for equities (presumably referring to its 5 percent policy) are irrelevant on this issue; and that industry practice is not law. It is true that markups on government securities, including mortgage-backed securities, have not been the subject of any rule. However, they have always been subject to the antifraud provisions.[77/] And the Commission, through its decisions, has provided guidance regarding the interpretation of those provisions in relation to markups. As noted, the Commission has found markups exceeding 7 percent

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76/ In addition, GSI normally took a 2-point "purchase credit" (markdown) on purchases from individual customers.

77/ Sheldon's argument that the Commission lacked jurisdiction over transactions in government securities has already been discussed and rejected, *supra*, pp. 7-8.

in the sale of equity securities to be fraudulent, and it has pointed out that markups on debt securities are generally lower than those for equity securities. In the Blumenfeld case, municipal bond sales with markups of 8 percent or more were held fraudulent. Sheldon acknowledged that within the universe of debt securities, government securities are even less risky and volatile than municipal securities. As he put it, municipal securities "have a credit as well as market potential for fluctuation," whereas government securities "have only a market potential" for fluctuation in response to interest rate changes (Tr. 9772). Gary Peters, the Division's expert witness on government securities pricing, testified that 5 points on discount Ginnie Maes was an excessive markup and that a maximum markup of 4 percent or up to 3 1/2 points was the industry practice. 78/ Peters' conclusions were recently corroborated when the Commission, in a release dealing with markups on zero-coupon securities, stated that industry practice in sales of conventional Treasuries is to charge markups over the

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78/ Sheldon, who acknowledged Peters' expertise, nevertheless wants me to disregard Peters' testimony because of alleged bias against Sheldon. The record reflects a long history of conflict between Sheldon and Peters, who were at one time business associates. But, based on my observation of Peters during his testimony and the nature of that testimony, I do not believe his testimony was tainted by bias.

prevailing inter-dealer market price of between 1/32 to 3 1/2 percent. 79/ The Commission concluded that markups on government securities, like markups on corporate and municipal debt securities, are usually smaller than those on equity securities.

Based on the above, GSI's 5 point practice resulted in excessive markups. 80/ As with municipal securities, there was no markup disclosure to customers. Sheldon, who was admittedly aware of the practice, must be held responsible. Sheldon simply assumed that transactions in government securities were completely unregulated. In this, he acted recklessly. Moreover, he had been apprised of the Blumenfeld decision by counsel and had himself communicated to his staff the Commission's statements in that case regarding markups that have been previously noted. He was thus on notice that in the case of debt securities, markups exceeding 5 percent would at least be suspect. I conclude that in connection with GSI's excessive markups, Sheldon willfully violated or aided and abetted violations of the antifraud provisions.

79/ Securities Exchange Act Release No. 24368 (April 21, 1987), 38 SEC Docket 234, 235.

80/ A firm's practice of charging customers a particular markup without regard to price or number of units demonstrates a pricing pattern which precludes any attempt to justify the markups on the basis of the particular circumstances of each sale. J.A. Winston & Co., Inc., 42 S.E.C. 62, 69-70 (1964).

VI. Miscellaneous Alleged Violations

A. Salesman Smith's Conversion of Customer Funds (Sheldon)

Jonathan Smith was a salesman in the New York office of DSC and GSI. The Division alleges that in 1982 he misused customer securities; that Sheldon failed to report this to the authorities and failed reasonably to supervise him to prevent a repetition; and that Smith then repeated his misconduct. Sheldon is charged with willfully violating and aiding and abetting violations of MSRB Rule G-25 which prohibits improper use of municipal securities or funds held on behalf of another person. He is also charged with failure reasonably to supervise.

The pertinent facts are as follows: In 1982, for reasons not clear on the record, Smith opened accounts with DSC in fictitious names and placed large numbers of bonds in those accounts. Payment was not made, and in November 1982 Smith's scheme was discovered. It appears from Sheldon's testimony that one actual customer account was involved; he was made whole. The market value of the bonds had declined, and DSC sustained a loss of about $60,000 on sale of the bonds. The firm determined not to terminate Smith's employment. According to Schad's investigative testimony, it had had no prior problem with Smith since employing him in 1976; he admitted his misdeeds and showed remorse; and he agreed to repay DSC's loss. It was decided

to put him under stricter supervision, by seating him next to Feldman, the sales manager, who was aware of the situation. In addition, according to Schad, procedures were instituted to preclude Smith from making deposits into customer accounts, or taking funds or securities out of customer accounts, without the approval of the operations manager. However, in October 1984 Smith confessed to DSC officials that he had been misappropriating customer funds and securities, beginning in December 1982. A critical part of the scheme was his ability to take posession of customer securities held in safekeeping. Smith was terminated, and the authorities were notified.

The Division's case rests essentially on the grounds that Sheldon failed to report Smith's first malfeasance to the authorities or to dismiss him, and that he failed to assure that Smith would be properly supervised thereafter. The failure to fire Smith in November 1982 and to report him was not violative of any provision of law or rule. However, Smith's elaborate scheme put Sheldon on notice that Smith could not be trusted and at the least required the closest kind of supervision. Sheldon testified that he delegated this responsibility to Jack Manion, a vice president and registered principal with primary responsibility for DSC's trading and sales until his death in the spring of 1983. Sheldon acknowledged that he did not know whether Manion placed any restrictions or instituted any procedures with

respect to Smith's activities. In answer to the question whether he inquired of Manion about this, Sheldon responded that "Manion was a very tough individual, and I didn't feel it necessary to inquire as to what his procedures were in this matter. It just . . . never entered my mind to do so" (Div. Exh. 246, p. 96). However, the matter was of such an extraordinary nature that Sheldon could not simply walk away from it. Moreover, there is no indication in the record as to whom or what he relied on to keep a close watch on Smith after Manion's death. Accordingly, I find that Sheldon failed reasonably to supervise Smith with a view to preventing the latter's misappropriations extending over a period of almost two years. 81/

B. False Quotations (Sheldon)

The so-called Blue List is a printed and electronic medium used by municipal bond dealers to advertise quotations on municipal bond offerings. The Blue List printed issues for November 7 and 8, 1984, showed DSC quoting Cheneyville bonds at 86. On November 7, DSC bought Cheneyville bonds at prices of 59 and 51, and it sold Cheneyville bonds at 64 and 56 on November 8. The Division contends that the quotations were obviously far

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81/ There is no legal substance to the Division's contention that the "utter absence of supervision" was "sufficiently reckless to constitute aiding and abetting liability on Sheldon's part" (Brief, p. 46).

above the market and thus violated MSRB Rule G-13(b)(ii). That rule prohibits a municipal securities dealer from publishing a quotation unless the stated price is based on its best judgment of the fair market value of the securities quoted.

It appears that DSC's quotations did violate the Rule. In asking me to find that Sheldon failed reasonably to supervise to prevent such violations, however, the Division has presented no evidence to indicate that Sheldon was on notice that improper quotations might be submitted. Sheldon testified that offering prices for the Blue List were submitted by a trader, and that he had no information about the quotations in question. On the record before me, there is simply no basis for imposing responsibility on him with respect to these isolated violations.

C. Books and Records (Sheldon and Reid)

Sheldon and Reid are charged with willfully aiding and abetting DSC's violations of Rule 17a-3 under the Exchange Act involving books and records deficiencies. By their conduct, they also allegedly violated certain MSRB rules.[82/] Failure of reasonable supervision with a view

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82/ One of the MSRB rules cited in the order for proceedings is Rule G-19(a). However, the provisions of that rule relied on by the Division were not adopted by the MSRB until April 1985, almost at the end of the period here under consideration.

to preventing violations is also alleged. I turn to the specific conduct and transactions cited in the Division's Proposed Findings in support of the allegations.

1. NASD staff members found as a result of an examination that DSC failed to prepare and maintain a reconciliation of a cash account for four months in 1984; failed to prepare an accurate reconciliation of a bank account in October 1984; and failed to accurately compute its net capital as of October 31, 1984. In addition, customer new account cards omitted various required information and, of 99 order tickets for a two-week period in November 1984 reviewed by the NASD staff, 65 had execution dates that appeared to be wrong. 83/ The NASD staff deemed all the above deficiencies to involve noncompliance with MSRB Rule G-8, which requires certain books and records to be maintained by municipal securities dealers. It appears that they also violated Rule 17a-3. It does not automatically follow, however, that Sheldon should be held responsible. The matters in question fell within Schad's area of responsibility. As to Sheldon, the Division simply states that the facts speak for themselves. It also states that Sheldon was warned of problems by the NASD and by DSC's bankers and did nothing. However, it is not clear that he

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83/ The Division independently presented evidence of order tickets not being stamped on a timely basis or at all.

was in fact warned by the NASD of problems of the nature described above prior to the violations. I am not aware of evidence that the bankers warned Sheldon of those types of problems. They clearly were concerned about DSC's recordkeeping, but the record does not show that they conveyed their concern to Sheldon. Under all the circumstances, the evidence does not warrant a finding that he aided and abetted DSC's violations or failed to provide reasonable supervision.

2. According to an accountant whose firm was retained on July 31, 1985 by the receiver and later SIPC trustee for DSC, the firm's accounting records, in particular the financial records, were in a state of "fairly significant disarray " (Tr. 611). The only specific item that he cited, however, was an inability since October 1984 to reconcile certain cash accounts. I do not find this an adequate basis for making adverse findings against Sheldon.

3. Reid caused DSC's records to be falsified by showing a purchase by Dr. L. of Vanceburg notes to have been made in May 1984 when in fact Reid placed the notes in Dr. L.'s account in June, subsequent to the default. In so doing he willfully aided and abetted violations by DSC of Rule 17a-3 and MSRB Rule G-8.

4. According to the Division's Proposed Findings, Reid bought and sold Cheneyville bonds for Dr. G.'s account

without authorization. Reid also executed transactions in Dr. L.'s account without having been given discretionary authority in writing; as has been noted, he had _de facto_ discretionary authority. With respect to Dr. G., the record shows that he acquiesced in the way Reid handled his account, complaining only as to transactions on which he lost money but not about transactions being unauthorized. In any event, the Division has not explained how Reid's handling of the two accounts violated the recordkeeping requirements. Perhaps it had in mind MSRB Rule G-8 (xi)(H), which requires that if a customer has a discretionary account, the account record must include his written authorization and a principal's written approval. Arguably, the exercise of _de facto_ discretionary authority automatically violates this provision. Absent briefing of the point, I am not prepared so to rule.

D. Use of Non-Qualified and Unlicensed Managers and Salesmen (Sheldon and Reid)

The order for proceedings includes allegations that Sheldon and Reid violated or aided and abetted violations of the antifraud provisions by using non-qualified and unlicensed managers and inexperienced and unlicensed salesmen. In addition, Sheldon is charged with violating MSRB Rules G-2 and G-3 by having DSC engage in the municipal securities business while non-qualified managers and salespersons were associated with it. And both he and Reid are charged with failure reasonably to supervise.

The record shows that several individuals identified in DSC's Standard Operating Procedures Manual as branch office managers with supervisory responsibilities were not registered principals. Sheldon and Schad testified to their understanding that only an office of supervisory jurisdiction was required to have a registered principal. The only such office in DSC's structure was the New York office. The Division urges, however, that under MSRB rules all the managers were required to have principal registrations. Neither Rule G-2 nor Rule G-3 seems to so require. G-2 requires every person associated with a municipal securities dealer to be "qualified in accordance with the rules of the Board." G-3 specifies the required qualifications for various categories of associated persons from "municipal securities representative" to different types of principals. However, Rule G-27(c) appears to require that the person responsible for supervising salesmen in a branch office be a qualified principal.[84/] Sheldon knew that most of the branch managers were not registered principals and is therefore responsible for violations of the MSRB rules. I am not prepared to hold, however, that such violations are *per se* translatable into

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84/ It is not clear, however, that Paul Steets, who apparently was an assistant manager of the Houston office, was required to be qualified as a principal.

Unfortunately, the parties did not brief the proper interpretation of the MSRB rules, with the exception of Rule G-30.

violations of the antifraud provisions.

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The record shows that at least seven salespersons in New York sold municipal bonds before they were properly licensed by the NASD and before expiration of the 90-day apprenticeship prescribed by MSRB Rule G-3 for municipal securities salesmen who are new to the business. Since these persons had not yet been assigned their own representative numbers, they used numbers assigned to Schad or Feldman, the New York sales manager. Sheldon admitted that at some time he became aware of "the possibility that such a practice may have occurred. . ." (Div. Exh. 247, p. 425). He could not recall, however, when he became so aware. The responsibility within the firm for compliance with the regulatory qualification requirements rested with Schad. Under the circumstances, while violations clearly occurred, there is insufficient evidence to hold Sheldon responsible, either as violator or aider and abettor or on a failure to supervise basis. 85/

85/ Two salesmen in the Houston office sold in states in which they were not licensed. The Division seeks to hold Reid responsible. Reid argues that the Commission cannot hold a broker-dealer or its employees liable for violating state licensing provisions. The Division responds that absence of a state license is a lack of a necessary qualification under MSRB rules G-2 and G-3. That, however, is simply not the case.

E. Failure to Obtain Required Information About an Associated Person (Sheldon)

MSRB Rule G-7 requires a municipal securities dealer to obtain from each associated person a questionnaire containing specified information concerning that person. The order for proceedings alleged that Feldman violated the rule by failing to obtain such information concerning one Richard Knox and that Sheldon failed reasonably to supervise Feldman in this regard. As here pertinent, Rule G-7 defines the term "associated person" to mean a "municipal securities representative." Rule G-3, in pertinent part, defines a municipal securities representative as a person associated with a municipal securities dealer in other than a principal capacity, whose activities include sales of municipal securities or sales-related communications with public investors in municipal securities.

Knox is an accountant. During the relevant period (from 1982 on), he was registered with the NASD as representative of a broker-dealer but did no business for that firm. He was not registered with DSC in any capacity. Beginning in 1982, Knox had an arrangement with Feldman under which he became an intermediary for the purchase of municipal bonds by his clients from DSC. Typically, he told Feldman that he had an accounting client who wanted to invest a certain amount. Feldman then told him what was available, and Knox placed an order on the client's behalf. He also

gave information to Feldman regarding the client for use on the new account card. As compensation, he charged the client three percent of the amount invested. DSC's confirmation was in the name of the client, but was mailed to Knox, as were the bonds purchased. Usually the client made out a check payable to DSC, which included Knox's fee. The checks were deposited in an account maintained for Knox by DSC; when the bonds were delivered, DSC withdrew the purchase price from that account.

Sheldon, citing Knox's testimony that he was not an employee or agent of DSC, contends that Knox was not an "affiliated person" of DSC. However, Knox's conclusory opinions do not put an end to the matter. It is possible to view him as agent for his clients rather than as representative of DSC. However, it is more consistent with the MSRB rules' objective of customer protection to view him as an associated person of DSC within the meaning of Rules G-7 and G-3. Feldman should have but did not obtain from Knox the information specified in Rule G-7.

The remaining and critical question, however, is whether Sheldon can be found to have failed in his supervisory responsibilities. The Division contends that he was aware of Knox's work for DSC. There is no evidence, however, that he was aware of the arrangement between Knox and Feldman. The only evidence cited by the Division is Sheldon's investigative testimony that

he knew that Knox was an accountant who had given DSC a lot of business for various of his clients. Sheldon further testified that he had no other information about Knox or his transactions with DSC. There is not sufficient evidence here to warrant an adverse finding with respect to Sheldon.

VII. Alleged Staff Misconduct

Repeatedly in the course of the hearings and again in his brief, Sheldon accused Division counsel of threatening and intimidating his prospective witnesses.[86/] Considering the power the Commission wields over persons engaged in the securities industry, the staff must of course be particularly sensitive in interviewing prospective defense witnesses who are so engaged, to avoid giving the impression that adverse consequences may attach to testimony favorable to a respondent. With one possible exception, however, there is no evidence to indicate that Division counsel did not act in accordance with that precept vis-a-vis prospective securities industry witnesses or that they acted in any improper fashion in their contacts with

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86/ Sheldon also repeatedly sought to present evidence in support of his argument that his firms were intentionally destroyed by the Division through unduly extensive and heavy-handed investigations. I rejected such evidence on the ground that, with possible limited exceptions not shown to be applicable, the scope of the investigations was not properly an issue before me. When Sheldon raised this argument again in his brief, I granted the Division's motion to strike it as "impertinent."

other prospective defense witnesses. The one possible exception involved Donald Wheeler, owner and principal of a municipal securities firm, who testified that he felt threatened by a conversation he had with Division counsel prior to his appearance as a witness. Whether or not that feeling was warranted, however, Wheeler, who is also an attorney, was clearly not intimidated and acknowledged that his substantive testimony was not affected by that conversation. Viewing the proceeding as a whole, Sheldon was clearly given every opportunity to present his defense case to the fullest extent.

Sheldon also complains of the fact that when the Division offered certain investigative testimony against him, it offered only portions of that testimony and excised the remainder. As the Division notes, however, in doing so it was acting in accordance with my instructions to designate the pages being offered. Moreover, upon Sheldon's request and without objection from the Division, I received the remaining pages into evidence as Sheldon exhibits.

VIII. Public Interest

A. Sheldon

In light of the findings that Sheldon willfully violated and willfully aided and abetted violations of provisions of the securities laws, Commission rules thereunder and MSRB rules and the findings of supervisory

dereliction, it must now be determined what if any remedial sanction should be imposed on him pursuant to Sections 15(b)(6) and 15B(c) of the Exchange Act. In addition, under Section 14(b) of SIPA, Sheldon, as an officer, director and controlling person of a broker-dealer (DSC) for which a trustee was appointed under that Act, may be barred or suspended from association with a broker-dealer if such action is determined to be in the public interest. The Commission has construed this provision as not imposing strict liability on individuals merely on the basis of their status in a firm for which a SIPC trustee has been appointed. However, there is a clear basis for imposition of a sanction where, as here, the individual is found to have violated or aided and abetted violations of securities law provisions related to the broker-dealer's financial collapse. 87/

The Division urges that only an unqualified bar of Sheldon from association with a broker-dealer or municipal

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87/ See Carroll P. Teig, 46 S.E.C. 615, 622 (1976); Raymond L. Dirks, Securities Investor Protection Act Release No. 123 (July 5, 1985), 33 SEC Docket 1079, 1083, aff'd 802 F.2d 1468 (D.C. Cir., 1986). Moreover, in Teig and again in Dirks, the Commission held that a finding of violation or aiding and abetting of a violation was not even necessary to imposition of a sanction under Section 14(b). Since persons within the specified categories could reasonably be expected to be aware of the broker-dealer's practices and financial condition and to take or demand action to avoid the financial collapse that leads to SIPC trusteeship, failure to act responsibly -- simple neglect or nonfeasance -- can provide an adequate basis for a sanction.

securities dealer will meet the public interest.[88/] Sheldon, persisting in his claim that he engaged in no misconduct, insists that the case against him must be dismissed.

Although I have rejected certain of the Division's allegations against Sheldon, the extensive findings that I have made against him cover a broad range of misconduct. At least in substantial part through the diversion to the computer venture of funds borrowed by GSI and other intra-Group fund transfers of which he must or should have been aware, he permitted his securities firms to get into a situation where customer securities and funds were placed at risk, resulting in violations of various customer protection rules, including the net capital rule, and of the antifraud provisions and ultimately leading to the appointment of a SIPC trustee. DSC customers, although eventually paid by SIPC, suffered at least inconvenience and very likely losses in some cases as well. Many GSI customers clearly sustained losses. Among them were customers who had been misled about SIPC coverage of their investments.

88/ The Division also asks me to bar Sheldon from association with an investment adviser. However, the Exchange Act provisions under which these proceedings were instituted do not expressly provide for imposition of such a sanction. Even if they could be construed to authorize it, respondents were not on notice that such a novel construction (novel at least in the context of a litigated proceeding) would be urged. Hence, it would not be fair to impose a sanction involving association with an investment adviser.

In the WPPSS situation, Sheldon set the tone for DSC's sales campaign by his misguided and irresponsible advertisements, which presented an optimistic picture and failed to disclose the dark clouds on the horizon and attendant risks. The Cheneyville and Vanceburg debacles and the misrepresentations made by sales personnel regarding deliverability of Freddie Mac certificates and SIPC coverage of GSI highlight the fact that in the area of sales practices, Sheldon failed to provide or implement a structure of effective procedures for supervision and compliance. Sheldon's contention that DSC had a well-defined compliance structure is simply not supported by the record, particularly in relation to sales practices. And Sheldon acknowledged that with respect to GSI, there were no compliance procedures or policies, reflecting his dogged assertion that GSI's transactions were not subject to regulation. The mark-up violations in the sale of municipal securities demonstrate that supervision over traders was also inadequate.

The above recital is obviously not exhaustive; it is only a capsule summary of some of the most serious misconduct. In addition to the violations found herein, the Division notes that in 1978, the NASD, with their consent, censured DSC, Sheldon and Schad and fined the individuals $400 jointly and severally for violating the Commission's net capital and books and records rules.

Sheldon, as noted, maintains that he and his securities firms engaged in no misconduct and, on the contrary, that they did a good job for their customers. He testified that all salespersons were consistently instructed to research the facts about any securities they offered and to offer them only to those persons for whom they determined those securities were a suitable investment. He asserts that the alleged misconduct involved only a relatively small number of customers, when compared to some 10,000 active accounts carried by the firms at the time of their demise, and that former Sheldon salespersons now employed by other firms are still doing business with most of the customers they had when employed by DSC/GSI. Sheldon also testified at some length about DSC's achievements during the New York City financial crisis of 1975, when it was apparently almost alone for a time in maintaining a market for the city's bonds and notes. On the occasion of the firm's tenth anniversary in 1982, the Governor of the State of New York issued a citation noting DSC's "extraordinary efforts" to maintain a secondary market for the city's bonds during the crisis and the firm's great contribution to New York's "financial sector and community at large" (Sheldon Exh. C). Several municipal bond traders testified in Sheldon's behalf that DSC and he, in their trading and market-making activities, had operated in an ethical and professional manner.

Upon careful consideration of all the factors presented, I have concluded that an unqualified bar of Sheldon from association with a broker-dealer or municipal securities dealer is required in the public interest. I am primarily influenced, of course, by the extensive, serious and protracted nature of Sheldon's misconduct. Additionally, however, his failure to recognize that he and those under him engaged in wrongful conduct adds to the concern that he would again engage in misconduct if given an opportunity to do so. Of course, I recognize the serious effect of this sanction on a man who has spent most of his adult life in the securities business. But I believe that it is necessary in the public interest and with a view to deterring others who might be tempted to engage in similar misconduct. [89/]

B. Reid

As with Sheldon, the Division contends that the public interest requires an unqualified bar of Reid from association with a broker-dealer or municipal securities dealer. Among other factors, it stresses Reid's conduct in putting the rather obscure Cheneyville bonds and Vanceburg notes into his office's inventory without obtaining current and reliable financial and other information

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89/ See Arthur Lipper Corporation v. SEC, 547 F.2d 171, 184 (2d Cir. 1976).

about them. It asserts that no effort was made to be certain that the salespersons made full disclosure in selling those securities and the WPPSS bonds and sold them only to persons for whom they were suitable. The Division also points to the excessive markups for which Reid was responsible. And it points out that this is not the first proceeding against Reid. In a 1979 proceeding, the Division alleged that Reid and others violated antifraud provisions of the securities laws in 1974-75 by engaging in bond trading transactions with an institutional account at prices not reasonably related to the market prices. At the time Reid was associated with another firm. Reid submitted an offer of settlement in which, without admitting or denying the alleged violations, he consented to a suspension from assocation with a broker, dealer or investment adviser for 30 days and a suspension from such association in any supervisory capacity for one year.[90/]

Reid asserts that the sales of Cheneyville bonds and Vanceburg notes accounted for only a very small percentage of business done in the Houston office and that the sales of WPPSS bonds were directed from New York. He contends that if there were failures on his part, they were in the area of supervision and should be viewed in

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90/ UMIC, Inc., et al., Securities Exchange Act Release No. 16110 (August 16, 1979), 18 SEC Docket 103.

the context of the supervisory activities that he carried out, such as after-hours training, providing adequate research facilities and encouraging salesmen to do necessary research. Reid claims that his conduct with his own customers was entirely proper. He points out that he has been in the securities business almost uninterruptedly since 1964. And he urges that the prior Commission proceeding should not be given much weight, as it involved limited trades some 14 years ago for which he was sanctioned by consent.

As my findings demonstrate, Reid's misconduct with respect to the Cheneyville and Vanceburg securities went beyond supervisory deficiencies. It was highly irresponsible on his part to introduce those relatively obscure securities into DSC's inventory without making reasonably certain that they were sold only on the basis of reliable and current financial and other material information. This required systematic research by an experienced person such as Reid or under his direct supervision. Moreover, in both instances Reid was on notice of problems well before the default occurred. I have also taken into account Reid's failure to provide adequate supervision respecting the sale of WPPSS project 4 and 5 bonds and his selling of WPPSS and Cheneyville bonds with excessive markups. [91/] Moreover,

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91/ However, the Division's argument that the Houston office had the characteristics of a "boiler room" is not supported by the record.

Reid's apparent pride in the way he conducted himself with his own customers is not well-founded.[92/] As has been noted, Reid sold Cheneyville bonds to Mr. B. only a few months before the default, without having a reasonable basis for his recommendation. And even after the default Reid misled Mr. B. as to the true situation. Reid also took advantage of the fact that he had _de facto_ discretionary authority over Dr. L.'s account to defraud him with respect to both Cheneyville bonds and Vanceburg notes. Particularly egregious is the fact that Reid, without Dr. L.'s knowledge, placed Vanceburg notes in Dr. L.'s account _after_ the default. The fact that, for whatever reason, Dr. L. and Mr. B. continued to do business with Reid cannot mitigate his misconduct toward them.

A severe sanction is clearly called for. Considering all the factors and circumstances, exclusion of Reid from the securities business for a substantial period, but not indefinitely, with any return to the business thereafter to be in a non-supervisory position subject to adequate

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92/ In view of my rulings during the hearings rejecting the Division's attempts to prove misconduct by Reid and Sheldon with respect to municipal bonds other than those specified in the order for proceedings and the Division's More Definite Statements, I have of course given no consideration to the Division's argument that had I admitted such evidence, it "might have disclosed more unhappy Reid customers" (Reply Brief, p. 21, n. 13). It made that argument in response to Reid's arguments concerning his relationship with his own customers.

supervision, will meet the requirements of the public interest. Such a sanction should serve to impress on Reid (and others) the need for scrupulous propriety in the offer and sale of securities. Accordingly, I conclude that Reid should be barred from association with a broker, dealer or municipal securities dealer, with the proviso that after two years he may apply to become so associated in a non-supervisory and non-proprietary capacity, upon a satisfactory showing of adequate supervision.

C. Pattison

The Division recommends that, in view of Pattison's misrepresentation or omission of material information in the sale of WPPSS project 4 and 5 bonds to two customers, he be suspended from association with a broker-dealer or municipal securities dealer for a period of 60 days. Its recommendation relies on a comparison with sanctions imposed by the Commission, with their consent, on settling salesmen-respondents in this proceeding for assertedly similar conduct. These ranged from 30-45 day suspensions. The Division urges that unlike those respondents, Pattison cannot "mitigate his sanction" by claiming that hearing was avoided, and that he should therefore be sanctioned more severely (Brief, p. 59).

As previously noted, Pattison stresses that his failure to inform Mr. M. of material information was due

to DSC's failure to provide him with such information and to supervise him properly. He also points to the testimony of another customer that Pattison warned him about the speculative nature of the WPPSS bonds and to testimony of Reid and fellow salesmen attesting to a low-key sales approach by Pattison.

The Division's argument based on comparisons with sanctions imposed on a settlement basis is unsound. The Commission has repeatedly pointed out that a sanction in a litigated proceeding cannot be compared with sanctions imposed pursuant to settlement offers, because in settlement cases the Commission takes into account pragmatic considerations such as the avoidance of time-and-manpower-consuming adversary proceedings. 33/ Thus, a respondent cannot gain a lessened sanction by citing sanctions imposed in settlement cases. On the other hand, the Division cannot gain an increased sanction through such comparisons. In a litigated context such as this, the sanction must be based on the record made through hearings; settlement sanctions even in the same proceeding are simply irrelevant.

On the record before me, and on the basis of my observation of Pattison during his testimony, I conclude that a 45-day suspension from association with a broker-

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93/ See, e.g., Butcher & Singer Inc., Securities Exchange Act Release No. 23990 (January 13, 1987), 37 SEC Docket 790, 800.

dealer or municipal securities dealer is necessary and appropriate in the public interest.

IX. ORDER

Based on the findings and conclusions made above,[94/] IT IS ORDERED that:

1. Donald T. Sheldon is hereby barred from being associated with a broker, dealer or municipal securities dealer;

2. Bruce W. Reid is hereby barred from being associated with a broker, dealer or municipal securities dealer, provided that after two years he may apply to become so associated in a non-supervisory and non-proprietary capacity, upon a satisfactory showing of adequate supervision; and

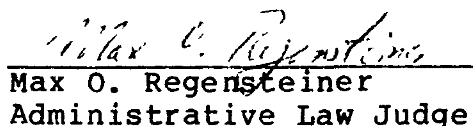
3. Gregory L. Pattison is hereby suspended from being associated with a broker, dealer or municipal securities dealer for a period of 45 days.

This order shall become effective in accordance with and subject to the provisions of Rule 17(f) of the Commission's Rules of Practice.

Pursuant to that rule, this initial decision shall

94/ All proposed findings and conclusions and all contentions have been considered. They are accepted to the extent they are consistent with this decision.

become the final decision of the Commission as to each party who has not filed a petition for review pursuant to Rule 17(b) within fifteen days after service of the initial decision upon him, unless the Commission, pursuant to Rule 17(c), determines on its own initiative to review that initial decision as to him. If a party timely files a petition for review, or the Commission takes action to review as to a party, the initial decision shall not become final with respect to that party.



Max O. Regensteiner
Administrative Law Judge

Washington, D.C.
December 2, 1988