ADMINISTRATIVE PROCEEDING
FILE NO. 3-5302

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of :

STEVEN S. MITCHELL :
CLYDE REYNOLDS MAHNKE :
LAWRENCE DENNIS DOUGHERTY :
MICHAEL W. ENGMANN :
NOAM RAND :
RICHARD JAMES FRENCH :
RAINBOW OPTIONS :
GEOFFREY B. HAYNES :
ETHAN ALDRIDGE CO., INC. :
HERBERT C. KURLAN :
JOSE C. PASCUAL :

INITIAL DECISION

Washington, D.C.
March 28, 1979

Irving Schiller
Administrative Law Judge

ADMINISTRATIVE PROCEEDING
FILE NO. 3-5302

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of :

STEVEN S. MITCHELL :
CLYDE REYNOLDS MAHNKE :
LAWRENCE DENNIS DOUGHERTY :
MICHAEL W. ENGMANN :
NOAM RAND : INITIAL DECISION
RICHARD JAMES FRENCH :
RAINBOW OPTIONS :
GEOFFREY B. HAYNES :
ETHAN ALDRIDGE CO., INC. :
HERBERT C. KURLAN :
JOSE C. PASCUAL :

APPEARANCES:

Steven N. Machtinger, Bobby C. Lawyer and Wayne M. Secore for the Division of Enforcement. Leonard H. Rossen, Administrator, Los Angeles Regional Office, on the brief

Allen Barry Witz and Jeffrey R. Liebman of Arvey Hodes, Costello & Burman for Respondents, Lawrence Dennis Dougherty, Richard James French, Rainbow Options, Geoffrey B. Haynes and Jose C. Pascual. John J. Enright and Dolores H. Dohm on the briefs for respondents.

Robert S. Friese of Shartsis, Friese & Niesar for Respondent Steven S. Mitchell.

Michael W. Engmann, Noam Rand, Ethan Aldridge Co., Inc., Herbert C. Kurlan and Clyde Mahnke, *pro se*.

BEFORE:

Irving Schiller
Administrative Law Judge

This public proceeding was instituted by an Order of the Commission dated October 4, 1977 (Order) pursuant to Sections 15(b) and 19(h) of the Securities Exchange Act of 1934 (the Act)[1/] to determine whether the nine individual respondents, Rainbow Options, a partnership and Ethan Aldridge Co., Inc. a corporation, wilfully violated and wilfully aided and abetted violations of Sections 9(a)(1) and (2)[2/] and 10(b) of the Act and Rule 10b-5 thereunder,[3/] and the remedial action, if any, that might be appropriate in the public interest.

In substance the allegations of the Division of Enforcement (Division) included in the Order charge that the respondents wilfully violated and wilfully aided and abetted violations of Section 9(a)(1) of the Act in that for the purpose of creating a false and misleading appearance of active trading in call option contracts respecting the stock of Houston Oil and Minerals Corp. (Houston options) on the Pacific Stock Exchange (PSE), a registered national securities exchange under Section 6(a) of the Act, and for the purpose of creating a false or misleading appearance with respect to the market, they effected transactions in the said call options on November 22, 1976, which involved no change of beneficial ownership. The Order further charges that respondents also

---

1/ 15 U.S.C. § 78o (b); 15 U.S.C. § 78s (h)

2/ 15 U.S.C. § 78i (a)

3/ 15 U.S.C. § 78j; 17 CFR 240. 10b-5

violated the same Section of the Act when, for the purposes noted above, they entered orders for the purchase of Houston options with the knowledge that orders of substantially the same size, at substantially the same time, and at substantially the same price, for the sale of such securities had been or would be entered and by entering orders for the sale of Houston options with similar knowledge that orders for the purchase of such options had been or would be entered. The Order also alleges that respondents wilfully violated and wilfully aided and abetted violations of Section 9(a)(2) of the Act in that they effected with each other a series of transactions in Houston options which created actual or apparent active trading in such securities for the purpose of inducing the purchase or sale of such securities by others. The Order further alleges that the conduct of respondents, with respect to the Houston options described above, constituted wilfull violations and wilfull aiding and abetting violations of Section 10(b) of the Act and Rule 10b-5 thereunder.

After appropriate notice hearings were held in San Francisco, California. Respondents Lawrence Dennis Dougherty (Dougherty), Richard James French (French), Rainbow Options (Rainbow), Geoffrey B. Haynes (Haynes), Jose C. Pascual (Pascual) and Steven S. Mitchell (Mitchell) were represented

by counsel. Respondents Michael W. Engmann (Engmann), Noam Rand (Rand), Ethan Aldridge Co., Inc. (Aldridge Co.), Herbert C. Kurlan (Kurlan) and Clyde Mahnke (Mahnke) appeared pro se. The Division, respondents who appeared by counsel and pro se respondents Engmann and Rand filed proposed findings of fact, conclusions of law and briefs. Pro se respondent Kurlan on his behalf and as president of Aldridge Co. submitted a letter requesting consideration be given to certain matters. Respondent Mahnke did not submit any post-hearing proposed findings or brief.

The findings and conclusions herein are based upon the record and upon observation of the demeanor of the various witnesses. The standard of proof applied is that requiring proof by clear and convincing evidence.[4/]

4/ In Collins Securities Corporation v S.E.C. 562 F 2d 820, decided August 12, 1977, as amended on denial of request for rehearing September 23, 1977, the Court of Appeals for the District of Columbia Circuit held that in an administrative proceeding in which fraud is charged and where the sanction may involve an expulsion or substantial suspension order, the "clear and convincing standard of proof" should be applied. In the instant case, like Collins, the allegations in the Order charge violations of Section 10(b) of the Act and Rule 10b-5. Since the other allegations here are premised on the same conduct which allegedly violated Section 10(b) of the Act and the Rule thereunder, the Collins standard will be applied to all charges.

The Respondents

Respondents Mitchell, Mahnke, Dougherty, Engmann, Rand and French, at all times relevant herein, were sole proprietors registered with the Commission as brokers-dealers pursuant to Section 15(b) of the Act and members of the PSE. In March 1977 Dougherty resigned his membership in PSE and became a member of the Chicago Board of Options Exchange, Inc. (CBOE).

Rainbow of San Mateo, California, is a partnership registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Act. It is a member of the PSE. Haynes is the general partner of Rainbow and has contributed between 10 and 25 percent of the capital of the partnership.

Aldridge Co. of Lynbrook, New York is a Delaware corporation registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Act. It is a member of the PSE. Kurlan is President and a Director of Aldridge Co. and own between 50 and 75 percent of the corporation's common stock.

Pascual was Vice President and Secretary of Harry C. Polonitza & Co., Inc., a California Corporation, which is registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Act. The corporation is a member of the PSE.

All nine of the individual respondents were registered with PSE as option market makers at the relevant times herein.5/

5/ An option market maker is a person who is registered with the PSE for the purpose of effecting transactions as a dealer specialist for his own account on the PSE options trading floor. Transactions by market makers are expected to contribute to the maintenance of fair and orderly markets.

Concern at PSE Prior to Listing of Houston Options

The activities of the various respondents charged with the alleged violations noted above occurred on November 22, 1976, the day the Houston options were listed for trading on the PSE. To fully appreciate the nature of respondents' conduct that day, an examination of certain events preceding the listing of the said options will set the scene for an intelligible understanding of the reasons the respondents engaged in the particular transactions which purportedly constituted violations of the Act.

Prior to 1973, options were traded only in the over-the-counter market. In April of that year the CBOE became the first exchange to list options for floor trading. Thereafter, the American Stock Exchange (Amex), the Philadelphia Stock Exchange (PHLX), the Midwest Stock Exchange and the PSE entered the field. Actual trading of call options on the PSE commenced on April 9, 1976. 6/

6/ As of November 1976 the only type of option trading permitted on the floor of the PSE was in call options which gave the holder of the option a contractual right to purchase (typically) 100 shares of the underlying security at the stated exercise price prior to the fixed expiration time of the option. The underlying securities as to which options are available are determined from time to time by the respective Exchanges, not the issuer, on which the options are to be traded. Each Exchange has established minimum requirements in connection with their selection for option trading designed to assure that underlying securities are widely held and actively traded including, among the standards for listing and maintenance for continued listing, such matters as the number of shares outstanding, trading volume and market price of the underlying security. The Options Clearing Corporation (OCC), whose stock was originally owned by CBOE, was owned as at October 1976, equally by Amex, CBOE, PHLX and PSE, acts as issuer of all listed options and under agreement between it and the exchanges is obligated to perform upon exercise of options. OCC also serves as the clearing house for option transactions on the exchanges.

The PSE option trading is carried on at that exchange's San Francisco option floor. About two weeks prior to November 22, 1976, the PSE determined to list and trade options in Houston Oil and so notified the OCC. At that time it was the only exchange which announced it would trade options on Houston Oil. The record discloses that on or about November 17, 1976, the CBOE, upon application of the OCC, approved the listing application of Houston Oil Options and stated it intended to commence trading in the said options on November 22.

News of the CBOE action spread through the PSE several days before November 22 and was the subject of discussions among the persons involved in option trading on the floor of the PSE. The market makers and brokers in particular expressed "considerable ire, consternation, upset feelings on the floor" at CBOE's decision to begin trading on the same day as the PSE. Their feelings were exacerbated by the knowledge that the OCC, which generally required at least two weeks notice of the desire to commence trading particular options, had shown favoritism to CBOE by making it possible for CBOE to begin trading on about a four day notice. Thus the PSE market makers and brokers were well aware that the CBOE, which in November 1976 was the largest option market in terms of volume whereas the PSE was the smallest in both volume and dollars, would be in competition with PSE for the ultimate designation of the "primary market" for Houston Oil Options. The record discloses PSE had been selected as the "primary market" by Merrill Lynch prior to

November 22nd. Such designation was seriously threatened when CBOE determined to trade Houston Oil Options. Moreover, prior to November 22nd it was generally known by persons involved with option trading at the PSE that the option floor was losing money. Respondents Dougherty and Rand characterized the competitive situation cogently; Dougherty stating " ... Houston oil was kind of looked on as the savior of the Exchange .." and Rand, speaking of CBOE, stated "... they're bigger and they've beaten us every time before. Except that at this particular time, some big companies switched the button our way to start with .... we knew at the time that we will have Merrill Lynch, Dean Witter, which are sizable." Mitchell testified that it was general knowledge in the industry that volume in the Houston options would be a determining factor in the designation of the primary market.

With knowledge that Houston oil options would be dually listed and begin trading at the same time on the PSE and CBOE, the officials at PSE convened a membership meeting on November 17 or 18 on the option trading floor at which time John Allen Brown (Brown), Chairman of the Floor Trading Committee which had responsibility for enforcing option floor rules, informed some 40 market makers, some floor brokers, and others present that Houston options would start trading on the PSE "in competition with CBOE" and that everyone would have to work hard to prove to the investment community that the PSE "was a viable competitive entity in the options area". About ten

or fifteen minutes after the general meeting Brown overheard part of a conversation among some market makers who had gathered about ten feet from the place where the general meeting had been held. Though Brown did not participate in the conversation he overheard "some discussions about volume" and "about what the competitiors, the CBOE, would be doing relative to showing a lot of volume on the first day" of trading. Brown testified that while he was unable to specifically recall the exact statements he heard one of the market makers make some statements about buying and selling options. He was "bothered" by what he heard and recalled particularly telling the market makers in the group "Hey, you can't do that. That this place is really clean. We don't do things like that." Brown could not identify the persons present at this conversation other than Engmann who responded to Brown in substance "Okay, fine. We're going to be broke, but at least we'll be known as the clean exchange."

Before evaluating respondents option trading it is important to appreciate the existing environment on the option floor of the PSE and the mental attitude of the market makers the morning of November 22 when Houston options trading was to commence. There were between 60 and 70 market makers and about 20 or 25 floor brokers in "the pit" where the Houston options were to be traded. The atmosphere in the area was described by Brown as a "feeling of competitiveness." Brown also testified that market makers desired "to be very competitive"; they wanted "to

prove to the investing public, again, this was not a little fledgling, one-horse exchange". He described the market makers as " competitive people" who "were given a challenge in an environment that they felt was not totally fair, this listing of OCC thing, two days, two weeks, and they wanted to prove that regardless of adversity they could still win out over that"; and that "they were the underdogs, the little guys, and they were going to come out on top anyway."

In addition to Brown's description of the prevailing atmosphere on the morning of November 22nd, eight of the individual respondents expressed similar views concerning the importance of volume trading in Houston options. For example Dougherty admitted "It was pretty important that we capture the market" and ".... and it was certainly well known, the importance of volume, because if you don't have volume, there is no reason to list the stock." French stated " ... There was an atmosphere, obviously, that I tried to convey to you of competition .... Obviously we were in competition with CBOE for the market in Houston options." Haynes stated " ... there was a general interest in doing well, competing with the CBOE". He also stated that his own interest in competing with the CBOE was "To have Houston on the Pacific established as the primary market". Mitchell's description of the importance of volume trading was stated as a "common perception" that whoever did the volume was to, in the end, receive most of

the business". It is evident that the respondents as market makers were well aware they would consistently have to keep in mind the competitive factor engendered by the dual listing of the Houston options and that if they were successful in publicly demonstrating that the PSE was capable of generating a larger volume of trading in the said options than CBOE, and the PSE recognized as the "primary market", there was a good likelihood their option business would be substantially increased. This was the blueprint preceding commencement of trading Houston options on the PSE.

The Alleged Violations

As noted earlier the violations respondents are charged with are premised on the transactions they engaged in with respect to the Houstón options. There is no dispute that on November 22, 1976, each of the nine individual respondents effected the following transactions in Houston options in the capacities stated and at the times indicated in the table below:

CONTRACTS	PREMIUM	SELLER	PURCHASER	TIME REPORT OF EXECUTION
50 Jan 40	1 11/16	French	Engmann	10:04:28
50 Jan 40	1 11/16	Engmann	Rand	10:04:58
50 Jan 40	1 11/16	Rand	French	10:05:11
50 Jan 35	4 3/8	Pascual	Haynes	11:11:48
50 Jan 35	4 3/8	Kurlan	Pascual	11:18:31
30 Jan 35	4 3/8	Haynes	Kurlan	11:19:35
20 Jan 35	4 3/8	Haynes	Kurlan	11:21:05
50 Jan 40	1 13/16	Dougherty	Mahnke	10:23:11
25 Jan 40	1 13/16	Mahnke	Mitchell	10:28:31
25 Jan 40	1 13/16	Mahnke	Mitchell	10:33:08
27 Jan 40	1 13/16	Mitchell	Dougherty	10:57:15
23 Jan 40	1 13/16	Mitchell	Dougherty	11:03:22

The Division contends that each of the depicted groups of transactions among the various respondents, to wit: the trades in the first group between French and Engmann, between Engmann and Rand and between Rand and French of 50 Houston option contracts of the January 40 series;[7/] the trades shown in the second set among respondents Pascual, Haynes and Kurlan of 50 Houston option contracts of the January 35 series; and the trades shown in the third set among respondents Dougherty, Mahnke and Mitchell of the January 40 series of Houston option contracts, violated Section 9(a)(1) and (2) and Section 10(b) of the Act and Rule 10b-5 thereunder.

The gist of the alleged violations under Section 9(a)(1) of the Act is that the three respondents involved in each of the groups of transactions, for the purpose of creating a false and misleading appearance of active trading in the Houston options on the PSE and similar appearance with respect to the market for such securities, effected the options transactions among themselves which involved no change of beneficial ownership, and they entered orders for the sale or purchase of the said options with knowledge that orders of substantially the

---

7/ A series of options as used herein relates to options of the same class (written on the same underlying security) having the same exercise price and expiration date and the same unit of trading.

same size at substantially the same time, for the purchase (where the sale occurred first) or the sale (where the purchase occurred first) would be entered. These same transactions, claims the Division, also constituted violations of Section 9(a)(2) of the Act since respondents effected a series of transactions with each other which created actual or apparent active trading in such securities for the purpose of inducing the purchase or sale by others. Section 10(b) of the Act and Rule 10b-5 was also violated, contends the Division, because these same transactions constituted a scheme, device or artifice to defraud and respondents made or omitted to state material facts concerning the trading volume, depth and liquidity and benefits of entering public orders for the Houston options. Each of the groups of transactions will be considered and analyzed separately since each involves a different combination of respondents.

RESPONDENT' TRADING ACTIVITIES

The French to Engmann to Rand to French Transactions.

From a scrutiny of the table above it is obvious that French sold 50 Houston option contracts of the Jan. 40 series at 10:04:28, that Engmann sold such options to Rand 30 seconds later and that Rand sold the options back to French 13 seconds later. The entire process of 3 sales and 3 purchases was ac-

complished in about 43 seconds.[8/]

The Pascual, Haynes, Kurlan Transactions

A perusal of the Jan 35 Houston option trades in the above table shows that Pascual sold 50 such options to Haynes at 11:11:48 a.m., that Kurlan sold Pascual 50 such options 6 minutes and 43 seconds later and that Haynes sold Kurlan 30 such options 1 minute and 7 seconds later and 20 such options in slightly less than 2 minutes later. All the trades were accomplished in less than 9 1/2 minutes.

The Dougherty, Mahnke, Mitchell Transactions

Commencing at 10:23:11, the above table shows that Dougherty sold Mahnke 50 Houston options of the Jan 40 series, that Mahnke sold Mitchell 50 such options in 2 trades between five and ten minutes later and that Mitchell sold 50 such options to Dougherty in two trades within the next 30 minutes. All such trades were accomplished in less than 40 minutes.

8/ In his brief French notes that the time indicated in the table differs from the time stamped on the trade tickets. The time stamped on the tickets shows the transactions effected between 10:03 and 10:05 a.m. The evidence indicates that depending upon the market activity the tickets are time stamped usually within a minute or two after a trade. Each time shown in the table was taken from the PSE Surveillance Report and is considered herein as the "time" of execution. Additionally, it is noted the respondents raised no objection to the accuracy of the times depicted in the said Report.

The PSE,following its usual practice assigned an order book official, Pamela Kolar (Kolar) to the post where the Houston options were to be traded. As such her duties were to maintain a fair and orderly market in the crowd, maintain the limit order book, prepare the unusual activity report and the market maker evaluation sheet. Kolar testified that when trading began there was a certain excitement and enthusiasm about the Houston options and a "general curiosity" among the market makers and floor brokers concerning the trading of Houston options on the CBOE. In response to the request from the "crowd" she checked the Quotron machine located at the post ,obtained the trading volume in the Houston options on the PSE and CBOE and, approximately on an hourly basis, called out the relative trading volume figures on both exchanges. She testified that after she furnished the comparison figures she observed that if the PSE was leading the CBOE in volume of trading the market maker and brokers "were obviously happy. If we weren't they were obviously not happy."

Kolar also testified that during the course of the morning trading she saw three pairs of buy and sell tickets which "looked sort of strange" to her since it appeared to her that "one market maker was buying the other was selling and that a short time later the reversed happened." After bringing the matter to the attention of her assistant they decided to do

something about it. Kolar left her post, found a surveillance official, Stanley Schretter, and told him she suspected the trades. She testified she told Schretter "Stan these trades look funny to me. There are some trades going on that look funny to me." Schretter's response was "you know I was afraid that might happen. I will take care of it." As part of her duties Kolar filed an "Unusual Activity Report" with the Exchange. In response to an item calling for unusual activity Kolar wrote "None". Though she believed the trades which she suspected should have been included in the report she was shocked to see she reported no unusual activity stating there may be an explanation which she could not recall. The explanation was furnished by Curtis Conrad, manager of the surveillance department for options at the PSE, whose functions included review of daily reports including the unusual activity report filed by the order book official. Conrad testified that after the close of trading he talked with Kolar and Schretter, and that Kolar told him she was concerned about the activity that happened in the crowd and asked how she should fill out the Report. Conrad told her he did not know how the Report was to be filled out and told her "Don't put anything on it. Stanley would take care of getting out the reports." 9/

All of the individual respondents urge that they are

9/ There is no evidence in the record that Schretter filed a report. Conrad admitted he told Kolar to file a false report because he did not know how or what Kolar should include in the report and he believed Schretter would take care of filing a report.

"size" traders, to wit that they often trade options of 50 or more contracts, that the trades shown in the table above were within their normal trading patterns, that such trades were not unusual and the trades in question were nothing more than "scratch" trades. They claim such a trade is a common practice among market makers in option trading. Each of the individual respondents vigorously denies that within the meaning of Section 9(a)(1) and (2) his option transactions had a manipulative purpose or that he created a false or misleading appearance of active trading on the PSE or a false or misleading appearance with respect to the market for such security, that the evidence of any alleged violation is based on inferences drawn from the transactions and is not clear and convincing under the Collins doctrine, supra. Consideration is given to each of the series of trades by the three individual respondents involved in each such series in the light of the defenses and contentions by each respondent.

The first series among French, Engmann and Rand, as noted earlier, were executed in less than 1 minute. Each of the three respondents urge their particular trades were not unusual for them because they were size traders. To determine whether the trades were unusual a perusal of the documentary evidence relating to the Jan 40 option on an hourly basis between 7:00 a.m., when floor trading on the PSE began, and 10:00 a.m. will demonstrate the nature of the small lot trading pattern in the said options as it was developing on the floor of the Exchange preceding the trans-

actions in question.

7 to 8:00 a.m.		8 to 9:00 a.m.		9 to 10:00 a.m.	
No. of Contracts Traded	No. of Trans-actions	No. of Contracts Traded	No. of Trans-actions	No. of Contracts Traded	No. of Trans-actions
1	2	1	2	1	4
2	5	2	7	2	2
3	3	3	10	3	3
4	3	5	7	4	1
5	3	20	2	5	3
6	1				
8	1				

Thus, in the space of the first three hours of trading the Jan 40 options, there were a total of 59 trades effected, aggregating 219 contracts of which, as noted, the largest number of contracts traded was 20 with the next largest 8 contracts in one transaction. Of the 219 contracts traded 165 or approximately 72% were in quantites of 5 contracts or less. It is significant to note that in the hour immediately preceding the trades in question there were only 13 trades of which 5 contracts were the largest amount traded. The evidence is clear and convincing that the French, Engmann and Rand transactions involving 150 contracts, effected in less than one minute, did not follow the ordinary or normal trading pattern of these Houston option contracts on November 22, when measured by number of contracts traded in any one transaction in the immediate preceding three hours of trading. The documentary evidence also shows that prior to 10:00 a.m. French had 1 trade of 8 contracts and 9 trades of 5 contracts or less, Rand had 8 trades, none more than 5 contracts and

Engmann had 13 trades of 5 contracts or less and 1 trade of 6 contracts and 2 trades of 20 contracts. The oral evidence lends further support to the unusual nature of the trading described above. Conrad testified that such trades were "out of the ordinary", that he had not seen that type or pattern of trading before and it was unusual because of the time, the people involved and the size of the transaction. He amplified his testimony by stating that what made the trade unusual was that it "was from one market maker to another market maker and back to a third market maker and all three liquidated their positions among themselves." He further testified that after reviewing the sheets for the time involved he had not seen transactions of that size and stated:

> "So they are unusual in the fact that two market makers in an active pit can trade with that size without any other competing, well, without any other competition."

Conrad filed a report with his superiors at the Exchange concluding that the trades in question "were made with the intent of increasing volume."

As noted, French, Engmann and Rand contend that their transactions were merely so-called "scratch" trades and not improper nor prohibited.[10/] It is recognized these are

---

10/ There is conflicting evidence in the record concerning the meaning of the words "scratch trade." The witnesses who testified as to what constitutes such trade agree on one factor, to wit, it is the reversal of a trade at the same price. They differ on whether the reversal must be for all of the options involved and whether it must be reversed on the same day or could be reversed a month or even a year later.

situations in which a market maker may legitimately change his mind and reverse a trade that he has just made (so-called "scratch" trades). But here there is a lack of evidence indicating that their trades were based on any public orders, or any economic difficulties encountered by French, Engmann or Rand which prompted them to reverse their positions, nor was there any change in the prevailing market price of the underlying security[11/] which caused these respondents to reverse their positions, nor any other material circumstances which prompted these three respondents to engage in the triple reverse trades in which their prior positions remained unchanged. In essence, these transactions served no legitimate economic purpose and involved no change in the beneficial ownership in the said options. These were not ordinary scratch trades. In light of the pattern of trading of the options in question on the PSE, 72% of which as noted, were in quantities of 5 contracts or less, it is obvious that the 3 trades, each of 50 contracts, in less than one minute of trading, totalling 150 contracts, was such a significant departure from the trading model of the said options that it lends credence for the finding that, under all of the above circumstances, the motivating factor for the transactions was to show an increased volume of trading on the said Exchange.

11/ The evidence discloses that the market price of the underlying security in the first three hours of trading fluctuated between 36 1/8 at the opening to 37 1/8 and the premium during the same period fluctuated between 1 1/2 at the opening to 1 5/8.

The evidence is clear and convincing that within the meaning of Section 9(a)(1) of the Act French, Engmann and Rand effected transactions in the Jan 40 options which involved no change of beneficial ownerships, for the purpose of creating a false and misleading appearance of active trading in the said options and a false and misleading appearance with respect to the market for such security. Thus these respondents wilfully violated and wilfully aided and abetted violations of Section 9(a)(1) of the Act.

Consideration is next given to the Dougherty, Mahnke, Mitchell, back to Dougherty trades in the same Jan 40 options. It should be noted here that Dougherty, Mahnke and Mitchell admitted their awareness of the fact that trading in the Houston options would begin simultaneously on the CBOE and the PSE and recognized the importance of having the PSE deemed the primary market in the said options. Dougherty's and Mitchell's statements in this connection have been noted earlier. Mahnke admitted he was aware of the competitive factor between the two Exchanges stating "I went in there with the idea of making competitive markets", though he denied any idea of "putting on purposeful scratch trades." It is evident from the table above that the trades in question were effected some twenty minutes after the 3 trades discussed earlier. The evidence discloses that between the 10:05 a.m. transaction between Rand and French, noted above, and the 10:23 a.m.

Dougherty-Mahnke trade of 50 options, the market returned to the 5 share or less pattern of trading. There were 5 trades of which 1 was for 5 contracts, 1 for 2 contracts and 3 trades, each of 1 contract. The first sale from Dougherty to Mahnke took place at 10:23:11, the 2 sales from Mahnke to Mitchell between 5 and 10 minutes later and the 2 sales from Mitchell back to Dougherty between 24 and 30 minutes thereafter. All the foregoing trades were at exactly the same premium of 1 13/16. The evidence further shows that in the 3 hours and 20 minutes of trading in the Jan 40 options preceding the sale to Mahnke, Dougherty effected 6 trades of which 1 was for 20 contracts, 1 for 5 contracts, 1 for 3 contracts, 1 for 2 contracts and 2 for 1 contract each. For the same period Mahnke engaged in 14 trades none of which were in excess of 5 contracts and Mitchell engaged in 6 transactions none of which were in excess of 3 contracts. 12/

A further analysis of the market in the Houston options within the time frame of the 50 contract trades among the three respondents market makers is most revealing. The documentary evidence shows that at the time of the Dougherty-Mahnke

---

12/ It is of interest to note that after the last 2 sales from Mitchell to Dougherty of 50 Houston option contracts, the trading returned to the small lot pattern. The evidence shows there were no trades in excess of 5 contracts in the Jan 40 options for the remaining two hours of floor trading. In that time frame there were a total of 25 transactions of which Dougherty and Mitchell each effected 2 more small transactions, none of which exceeded 5 contracts.

trade of 50 contracts the market price of the underlying security was 37 1/2.[13/] At the time of the Mahnke-Mitchell trade of 25 contracts the market price of the underlying security rose to 37 5/8 but the trade was effected at exactly the same premium of 1 13/16 as the Dougherty-Mahnke trade. Prior to the next Mahnke-Mitchell trade of 25 contracts there were 2 trades of 1 and 3 contracts each at a premium of 1 3/4 and no change in the market price of the underlying security which remained at 37 5/8. It is most significant to note that when the next Mahnke-Mitchell trade of 25 contracts was made, only 2 minutes after the sale of the above noted 3 contracts at a premium of 1 3/4, the premium was again 1 13/16, exactly the same as the prior 25 contract transaction, notwithstanding that the market price remained unchanged at 37 5/8. For the next two Mitchell-Dougherty trades of 50 contracts the premium was also 1 13/16 with the market price of the underlying security at 37 5/8 for the first trade and 37 3/8 for the second trade. Thus, notwithstanding the changes in the market price of the underlying security and the lower premium for the 2 trades effected during the 50 contract transactions among these three market makers, the premium for all of respondents

13/ The record shows that immediately preceeding this trade the market price of the underlying security was 37 1/2 but the premium was 1 3/4. Though there was no change in the market price of the underlying security the premium for the 50 contract transaction was 1 13/16 and remained the same for the succeeding 4 transactions of 50 contracts.

five transactions remained exactly the same.

The conclusion is inescapable that the trades among respondents Dougherty, Mahnke and Mitchell were effected in idential fashion without regard to the fluctuations of the market price of the underlying security or the change in the premium and that the motivating factor for the transactions in question was to show an increased volume of trading on the PSE.

Dougherty and Mitchell also argue that their transactions were merely so-called "scratch" trades and neither improper nor prohibited. The findings made earlier herein with respect to similar contention by French, Engmann and Rand are equally applicable here and no repetition is necessary. With respect to the Dougherty and Mitchell transactions it has been demonstrated above that the changes in the market price of the underlying security and changes in the premium were not the basis for the reversal of their positions. Neither of the respondents claim that such changes were the factors which prompted their so-called "scratches". Nor does the evidence indicate any other material change in circumstances, economic or otherwise, which induced them to reverse their trades. In light of the trading patterns on the PSE in the options in question, the 50 contract trades among these three respondents are found to be out of the ordinary and effected for the purpose of showing trading in volume in the said options. The arguments by both

respondents that their trades were not unusual for them because they were size traders is not supported by the record. Dougherty and Mitchell point to trades they made in other options on various occasions which they claim were "size" transactions. The record however contains no evidence of the circumstances extant at the time such trades were made. Significantly, no evidence was produced by them that such other trades were made in the context of dual trading of the options on the CBOE or any other Exchange. In fact, the evidence shows the contrary to be true. Nor was any effort made to produce evidence that the circumstances relating to the alleged size trades at the time they were made were similar to those existing in the case at bar. The evidence is clear and convincing that the transactions among the three market makers in the Houston options were unusual and out of the normal or ordinary trading model as it then existed on the PSE.

The record lacks evidence that the trades in question were based on any public orders or that they served any legitimate economic purpose. The trades in reality involved no change in beneficial ownership of the said options and, as the evidence demonstrates, were effected primarily to show increased volume on the PSE. In this latter connection it has been noted above that Dougherty admitted "I was trading as much as I could in there to help increase our volume."

Mitchell appears to argue that he was at risk for about 30 minutes and notes that the Houston options were volatile, reflecting the volatility of the underlying securities. However, as noted above, the record fails to establish that Mitchell's trades were determined by the volatility of either market price of the underlying securities or the pattern of premium prices during the time period of his trades. The argument that he was at risk does not negate the fact that he bought 50 contracts and sold exactly the same amount at exactly the same price despite the fluctations in the market price of the underlying security and the premium price.[14/]

Within the meaning of Section 9(a)(1) of the Act the evidence is clear and convincing that the five transactions

---

14/ Mitchell also urges that "shortly after" selling the last block of his Houston options to Dougherty he "reestablished" a substantial spread in Houston options. Mitchell does not point to any specific evidence in the record as to how a spread in these options was "established" in the first instance nor how it was "reestablished." The evidence does show as noted above, that prior to the 50 contract trades he bought 8 contracts in 4 trades and sold 3 contracts in 2 trades and that 10 minutes after his last sale to Dougherty he sold 3 Houston contracts and 2 minutes later bought 5 such contracts. The relevancy of the argument Mitchell makes is obscure. If anything it substantiates the finding that his 50 contract trades in Houston options at the time they were made were far from his normal trading pattern of 5 contracts or less.

effected among Dougherty, Mahnke and Mitchell involved no change in beneficial ownership and were made for the purpose of creating a false or misleading appearance of active trading in the Jan 40 Houston options with a similar appearance of the market for such security. These respondents thus wilfully violated and wilfully aided and abetted violations of Section 9(a)(1) of the Act.

Consideration is now given to the transaction in the Jan 35 Houston options among Pascual, Haynes and Kurlan on November 22, 1976 when trading in the said options began on the PSE. Haynes and Pascual admitted their awareness of the fact that the Houston options would be traded simultaneously on the CBOE. Haynes stated he was interested in having the PSE declared the primary market for the Houston options and that the principal factor in determining whether the PSE would be such a market was volume. Pascual stated that he attended the meeting of market makers and others held prior to November 22 and was made aware that "it would help the PSE tremendously to show people that we have a viable exchange." Kurlan did not testify at the hearing.

The table noted earlier reflects that Pascual sold 50 contracts of the Houston Jan 35 options to Haynes at 11:11:48 a.m. that Pascual bought 50 such options from Kurlan at 11:18:31, that Haynes sold 50 such options to Kurlan in 2 trades of 30 and 20 contracts each at 11:19:35 and 11:21:05.

These 4 transactions, involving an aggregate of 150 contracts, were effected in slightly less than 10 minutes.

An analysis of the trading of the Jan 35 options on the floor of the Exchange shows that from the time the trading commenced until approximately 11:00 a.m. neither Pascual nor Haynes effected any transactions in the said options and Kurlan sold 3 contracts in 1 transaction. In the same time frame there was a total of 25 transactions in the said options. Breaking these transactions down into the number of contracts involved in each trade on an hour to hour basis to show the pattern of trading on the floor of the exchange, the documentary evidence discloses the following:

7:00 to 8:00 a.m.		8:00 to 9:00 a.m.		9:00 to 10:00 a.m.		10:00 to 11:00 a.m.	
No. of Contracts Traded	No. of Transactions	No. of Contracts Traded	No. of Transactions	No. of Contracts Traded	No. of Transactions	No. of Contracts Traded	No. of Transactions
1	5	1	2	3	2	2	1
2	4	2	2	4	1		
3	3	3	2				
5	2	50	1				

The record discloses that the one trade of 50 contracts was at about 9:00 a.m. between Engmann and Rand and was reversed at the close of trading.

Thus the record demonstrates that the pattern of trading the Jan 35 Houston options, prior to the Pascual-Haynes trade, was one of transactions not exceeding a maximum of 5 contracts. In the four hours of trading immediately preceding the Pascual-Haynes trade there were a total of 25 transactions 21 of which

were 3 contracts or less.[15] In the last hour and a half only 1 trade occurred.

A further analysis of the market in the Jan 35 Houston options, within the time frame of the 50 contract trades among these three respondent market makers, reveals the nature of their trading in relation to the movement of the market price of the underlying security and premium prices. Between the opening of trading and a trade immediately prior to the Pascual-Haynes transaction the market price of the underlying security fluctuated between 36 1/8 and 37 3/8 and the premium fluctuated from 3 3/4 to 4 3/8. At the time the Pascual-Haynes trade was effected the market price of the underlying security had dropped to 37 1/4 but the premium remained at 4 3/8. It is most significant that within five minutes after that trade and for a period of six minutes the market price of the underlying security dropped to 37 1/8 and 5 transactions were effected

---

15/ In the case of the Jan 35 options, the pattern of trading after the last trade to Kurlan followed the earlier model of trading small lots. In the approximate remaining hour and a half of trading there were 4 transactions of which 1 was for 3 contracts, 2 were for 2 contracts each and 1 trade of 1 contract. In addition, as noted, the 50 contract reversal of the Engmann-Rand trade was effected at the close.

each of 5 contracts at a lower premium of 4 1/4. Notwithstanding the lower premium in the 5 transactions, Kurlan nevertheless sold 50 option contracts to Pascual at the same premium of 4 3/8 as the earlier Pascual-Haynes trade, and one minute later Haynes sold 30 contracts and two minutes thereafter sold 2 contracts both to Kurlan at exactly the same premium of 4 3/8. In the latter three trades the market price of the underlying security remained at 37 1/8. The evidence further reveals that in general the premiums for the Jan 35 Houston option contracts increased as the market price of the underlying security rose and conversely when the market price decreased so did the premiums for the options. For example, the record shows that when the market price of the underlying security was 36 7/8 the premium in 3 transactions was 4 1/8 and in the following 2 trades when the market price dropped to 36 3/4 the premium also dropped to 4.

In light of the foregoing, the conclusion is inescapable that the trades among respondents Pascual, Haynes and Kurlan were effected in identical fashion without regard to the market price of the underlying security or the changes in the premium and that the motivating factor for the transactions in question was to show an increased volume of trading in the Jan 35 option on the PSE.

Pascual and Haynes, like other respondents argue that their transactions were merely "scratch trades" which are neither prohibited nor improper. As stated earlier herein there are situations in which a market maker may legitimately change his mind and reverse a trade he has just made. But with respect to Jan 35 options there is a lack of evidence indicating any reasons for the reversals. Though Pascual and Haynes point to changes in the market price of the underlying security and the premium between the opening and close of trading they fail to demonstrate that any such changes immediately prior to or at the time of their transactions were the primary reasons for their transactions. The analysis above of the market prices and premiums prior to and at the time of their transactions, as reflected above, illustrates clearly and convincingly that the transactions were effected without regard for the market price or premium and primarily to show volume on the PSE with the hope and expectation the exchange would become the primary market and attract public orders. Neither respondent furnished evidence to establish that their trades were based on any public orders, nor that their transaction covered any short positions nor that there was any change in their own economic condition nor any other material circumstance which directly or indirectly justified the reversal of their trades. Stated differently neither

respondent demonstrated any specific situation which could be said to provide a clear explanation for a legitimate change of mind for a reversal of a trade he had just made. Their positions after the transactions remained unchanged. It is clear that the trades in the Jan 35 options served no legitimate economic purpose and they involved no change in the beneficial ownership of the said options. Considering the nature of the trading in the Jan 35 options on the floor of the Exchange in the four hours prior to the 150 contracts involved in the Pascual-Haynes-Kurlan transactions, which the record shows consisted of 25 transactions 24 of which were 5 contracts or less or approximately 100% of all such trades, the evidence is overwhelming that the trades among these three respondents were far from the ordinary so-called scratch trades effected as a part of normal business by market makers trading in options on the PSE.

The arguments by Pascual and Haynes that they were "size" traders and that these transactions were not unusual for them is rejected as contrary to the evidence. The fact that they may have effected trades in 50 or more contracts on other occasions and under other circumstances does not negate the fact that the trades in question were effected under the particular circumstances described above and were consummated for the purpose of showing large volume on the Exchange. The record lacks evidence to establish that their trades in other options of whatever size were made under

circumstances prevailing in the instant case which relates to the simultaneous commencement of trading in options on both the PSE and CBOE.

Within the meaning of Section 9(a)(1) of the Act, the evidence is clear and convincing that the transactions among Pascual, Haynes and Kurlan were made for the purpose of creating a false or misleading appearance of active trading in the Jan 35 Houston options on the PSE and a similar appearance with respect to the market for such security and their transactions involved no change in beneficial ownership. These respondents thus wilfully violated and wilfully aided and abetted violations of Section 9(a)(1) of the Act.

Respondents Dougherty, French, Haynes and Pascual agree with the Division that clause (A) of Section 9(a)(1) is aimed at prohibiting "wash sales".16/ Clause (A) outlaws any transaction effected for the purpose of creating a false or misleading appearance of active trading or with respect to the market and involves no change in the beneficial ownership of the security. The proscription is directed toward "wash sales." Vol III, Loss, Securities Regulation, (2 Ed. 1961), p. 1547. The above respondents argue that their transactions were not "wash sales" but merely "scratch trades".

16/ A wash sale is the type of transaction described in Clause (A); one which involves no change of beneficial ownership

Though not stated in precisely the same manner, respondents Engmann, Rand and Mitchell make somewhat similar arguments by contending their transactions were not "wash sales". The arguments are rejected. Having found that the trades involved in the three groups of transactions referred to in the above table were effected for the purpose of creating a false or misleading appearance of active trading and with respect to the market for such security and involved no change of beneficial ownership, they constitute the type of wash transactions prohibited by clause (A) of Section 9(a)(1).

Labelling the transactions as "scratch trades" in light of the circumstances under which they were made, as discussed earlier, does not impugn the findings that they were wash transactions within the purview of Section 9(a)(1). The evidence clearly shows that each group of transactions, depicted in the above table, relates to trading 50 Houston options among three market makers, and at the conclusion of such trading, the position of each market maker implicated in each trade with respect to the 50 option contracts he traded, was unchanged. Some of the respondents argue they were either long or short at the time they engaged in the 50 option trades. However, the evidence reflects that such positions did not change

substantially after the completion of the circular trades, but each remained in the same position as they were before such trades were effected. This is manifest by the fact that about 90% of the trading in the Houston options were in lots of 5 contracts or less (excluding the 50 option trades in question) and at the time they engaged in the trades in question none of the individual respondents had acquired an inventory approaching close to 50 options.[17/] Recapitulating all of the transactions in the Jan 35 and Jan 40 Houston options traded on November 22 on the PSE, the evidence establishes that there were no trades exceeding 50 contracts and that even trades of that magnitude were rare or certainly abnormal. Other than the 50 contract trades by the individual respondents and two trades of 50 and two of 20 contracts each (not involved herein) there were no transactions of more than 8 contracts in the said options. Thus the evidence reveals that during that day there was a total of 139 trades in the aforementioned options, of which only ten trades, or 7.2%, were trades of 50 contracts. Nine of such trades were effected by the individual respondents as depicted in the table above. Breaking these down into the respective series of options the

---

17/ The documentary evidence discloses the following positions of the respondents at the time they engaged in their first transaction of 50 Houston options as shown in the table above. French when he sold was long 21 options, Engmann when he bought was long 21 options, Rand when he bought was flat, Dougherty when he sold was long 23 options, (it is noted in the 30 minutes between his sale and repurchase Dougherty did not effect any trades in the Jan 40 options) Mahnke when he bought was long 14 options, Mitchell when he bought was long 2 options, Pascual and Haynes had not effected any trades and Kurlan when he sold was short 3 options.

evidence shows there was a total of 39 trades in the Jan 35 options of which only four or about 10%, were trades of 50 contracts. Three of these four were effected by respondents Pascual, Haynes and Kurlan. There were a total of 100 trades in the Jan 40 options of which only 6 (or 6%) aggregated 50 contracts each and were effected solely among respondents French, Engmann and Rand and respondents Dougherty, Mahnke and Mitchell.

Respondents apparently argue that the word "transaction" in Section 9(a)(1) does not mean "transactions". They state that the legislative drafters [18/] intended that clause (A) be limited to a situation in which one person is both the buyer and seller of the security and is simply buying and selling to himself. Respondents urge that if A sells to B who sells the same security to C who then sells it back to A the trades on their face are "transactions" involving a change of beneficial ownership and cannot constitute a wash "transaction" under Section 9(a)(1). The thrust of that section is to prohibit trading where it is done for an illegal purpose. In the instant case the illegal purpose found was option trading which created a false and misleading appearance of active trading on the PSE and a similar appearance with respect to the market for the Houston options. The fact that the trading was effected among three market makers does not legalize the

---

18/ Respondents' refer to U.S. Senate Committee on Banking and Currency Hearings February 27, 1934.

illegal purpose of the market makers implicated because their trading was not confined to a "transaction." As used in the statute the term transaction is not limited to a purchase and sale by one market maker acting alone, or purchases and sales between two market makers but relates to the entire process by which a prohibited wash sale is accomplished. Thus in the instant case, the three trades among French, Engmann and Rand effected in the time of 43 seconds, without any explanation of a legitimate economic or other purpose served by such trades, is a prime example of the type of "transaction" which the statute was designed to prohibit. The other two groups of trades among the remaining respondents as discussed above, though somewhat longer in time of completion, were found to have been effected for the same illegal purposes and similarly within the term "transaction" as used in the statute.

The Order charges that respondents also violated clauses (B) and (C) of Section 9(a)(1) in that for the purpose of creating false and misleading appearance of active trades, they entered orders for the purchase of Houston options with knowledge that orders of substantially the same size, at substantially the same time and substantially the same price for sale of such options had been or would be entered and entered ordersfor the sale with similar knowledge that orders for the purchase of such options had been or would be entered.

It is evident that clauses (B) and (C) prohibit "matched orders" where it is shown that the purpose was to create a false and misleading appearance with respect to the market for the security. Vol III Loss, Security Regulation (2 Ed. 1961) P. 1547. The Division contends that under the foregoing clauses, each of the individual respondents is chargeable with the requisite knowledge under one or more of four possibilities each of which involves " matched orders". It claims that when each respondent entered an order for the sale or purchase of the option in question he knew that either an offsetting order or orders would later be entered by another respondent or that such an offsetting would later be entered by himself or that an offsetting order had already been entered by another respondent or an offsetting order had already been entered by himself. The respondents, other than Mahnke, who did not submit any post hearing findings or brief, and Kurlan, whose post hearing letter makes no reference to this arguement, agree that clauses (B) and (C) are levelled at forbidding "matched orders". They deny however, that their trades involved matched orders or that the Division proved any of the four possibilities noted above. Moreover, respondents French, Pascaul, Haynes and Dougherty maintained that their trades are not within the purview of the said clauses since as market makers they do not enter "orders" as such when they trade for their own account. Respondents Mitchell, Engmann and to some extent Rand, track the arguments made by the above four respondents.

Consideration is given first to respondents' argument that market makers are not within the scope of clauses (B) and (C). Respondents urge that, as market makers, they do not enter "orders" as such. The argument is contrary to the record and without substance. There is no exception in Section 9(a)(1) for any particular class of traders, whether he be a market maker, floor broker or any other person. The Section prohibits any person from engaging in this type trading for the purpose stated therein in the manner specified by clauses (A), (B) or (C). Respondents' interpretation of clauses (B) and (C) would automatically exclude any market maker, who effected a trade for the purpose of creating a false and misleading appearance of active trading or such appearance with respect to the market, simply because the document evidencing the trade is not an "order ticket form".Respondents' claim in their briefs. "No order form or stationery is filled out to initiate or complete a market maker's trade for his own account; nor does a market maker in any sense enter an order". Such claim is contrary to the record. It is evident from the documentary evidence in the record, that where a market maker executes a trade he fills out a market maker transaction card which requires information as to the number of options contracts traded, the month it expires, the striking price, the amount the option

was trading for and the number of the market makers on the other side of the trade. The words "order" or "orders" as used in clauses (B) and (C) of Section 9(a)(1) obviously relates to any type of document which reflects that a trade was made. Clearly any document which contains the information relating to the sale or purchase of an option is intended to be within the scope of the said clauses irrespective of the label attached to it. In the instant case the transaction card used for recording option trades by market makers falls within the scope of the terms "order" or "orders" as used in clauses (B) or (C).

Consideration is next given to the necessity of proving knowledge to establish a violation under clauses (B) or (C). It is evident that under the two clauses it is essential to demonstrate that when a respondent entered an order to sell an option he knew that a purchase order had been or would be entered to consummate the trade, or the converse if trade originated with a purchase. Of the four possibilities postulated by the Division, noted above, relating to proof that the respondents possessed the requisite knowledge, one depends upon an inference that each respondent knew by observing transactions executed openly in the crowd that his transaction would be offset by a previous transaction by two other market makers. Two other possibilities rest on a conclusion that the respondent, by entering an order, did so with knowledge that he or another respondent, or both, would later reverse the transaction with offsetting orders. The fourth possibility is that each respondent knew when he entered his last order that the transaction

would be offset by an identical transaction he had effected earlier.

The Court in Collins, supra, recognized that in a market manipulation type of case the Commission, in many instances, relies upon inferences to establish a violation of the securities laws and that the use of this inferential mode of reasoning is necessary to prove a violation. In its discussion of the appropriate standard of proof in fraud cases the Court in formulating the "clear and convincing" standard stated " ... it will require the SEC to reach a degree of persuasion higher than mere preponderance of the evidence ...." Applying these concepts to the instant case requires that the inferences that respondents had the requisite knowledge under clauses (B) and (C) be established by clear and convincing evidence.

A perusal of the record fails to demonstrate that any of the four possibilities, relied upon by the Division, furnishes a sufficient foundation for inferences to be drawn that respondents violated clauses (B) and (C) of Section 9(a)(1) of the Act. The record lacks evidence that when a respondent entered an order for the purchase or sale of a Houston option he had knowledge that one or two other respondents had or would enter a matched order of substantially the same size at the same price and at the same amount. The respondents deny, and the record lacks evidence, that the trades were prearranged. Though it has been found that respondents' trades, as depicted

in the above table, resulted in wash transactions, they do not by themselves illustrate clearly and convincingly the knowledge required by clauses (B) and (C). There is no corroborating evidence which would support a finding that respondents possessed knowledge of the type referred to in the above mentioned clauses.[19/] Thus the record falls short of evidence to permit reaching "the higher degree of persuasion" commanded by Collins, supra, in order to conclude that it is clear and convincing that respondents wilfully violated clauses (B) and (C) of Section 9(a)(1). Accordingly those charges will be dismissed.[20/]

Respondents are also charged with violations of Section 9(a)(2) of the Act. In essence, as pertinent here, the section prohibits any person from effecting, alone or with one or more other persons, a series of transactions in any security registered on a national securities exchange creating

---

19/ The only evidence in the record, which conceivably could be considered as corroboration, is the testimony of Brown who overheard a comment made by someone in a group of about ten market makers of the PSE after the general meeting, held the week before trading began, in the Houston options. However, he testified he did not hear the matter being discussed among the market makers and that other than recalling his own statement to the group to the effect "you can't do that", he had no recollection of the reason for his statement. His testimony could not be considered corroborative of any "knowledge" attributed to any of the respondents within the meaning of clauses (B) or (C).

20/ Since Section 9(a)(1) is in the disjunctive the dismissal of charges under Clauses (B) and (C) will have no impact on the findings of violation under clause (A).

actual or apparent active trading in such security, for the purpose of inducing the purchase or sale of such security by others. The respondents are alleged to have effected a series of transactions in the Houston options creating actual or apparent active trading for the prohibited purpose. Respondents French, Pascual, Haynes and Dougherty assert that Section 9 is intended to prohibit manipulation of security prices, that they did not engage in any "series" of transactions, that they did not create actual or apparent active trading and that it was not their purpose to induce the purchase or sale by others. Engmann, though not in the same words, parrots the arguments of the other four respondents.

The argument that Section 9 of the Act is limited to manipulation of security prices is rejected. There is no provision in Section 9(a)(1) which requires proof of price manipulation of the security in question. A violation of that Section may be established absent such proof. Proof of a violation of Section 9(a)(2) may be established by evidence of either a series of transactions creating actual or apparent active trading or by raising or depressing prices where either means is utilized for the purpose of inducing the purchase or sale by others. As early as 1941 the Commission held "Section 9(a) of the Act is a clear indication that illegal manipulative devices and contrivances are not necessarily confined to the

controlling or influencing of movements of prices". Masland, Fernon & Anderson, 9 SEC 338, 346 (1941). The argument by four respondents that there is no proof that any of them had any intent to manipulate the price of the option lacks substance. Moreover, none of the respondents are charged in the Order with manipulating the price of the Houston options.

Respondents also assert that, absent evidence that respondents acted in concert with one or more persons by means of an understanding or arrangement, no "series of transactions" exists under the Section. The argument is rejected. To "effect" a series of transactions, as used in the Section, simply means executing purchases or sales or both. Nothing therein remotely suggests proof of a prior arrangement. As noted by the Division the Commission has held that as few as three purchases constitute a "series". Kidder Peabody & Co., 18 SEC 559, 568 (1945). Professor Loss suggests that perhaps even two transactions would suffice as a series. Loss, Security Regulation, supra, at 1550. The evidence clearly shows that each of the individual respondents, in each group of circular transactions, effected at least two trades in the Houston options in question, and that some of the respondents effected as many as three or four trades.[21/] It is concluded that the individual respondents effected a "series of transactions" within the meaning of Section 9(a)(2) of the Act.

21/ Dougherty and Haynes concede they each effected 3 trades and French and Pascual concede they each effected 2 trades. The evidence shows Engmann effected 2 trades, Rand effected 2 trades, Mahnke effected 3 trades and Mitchell effected 4 trades.

Five of the respondents further urge they did not "create" actual or apparent active trading as that phrase is used in Section 9(a)(2) of the Act. Their contention is that since the Houston class options was already trading at the time each of such respondents effected his trades and, as they claim, "appearing to trade very actively", the trades by the said respondents could not "create" active trading. The argument is rejected. The record shows that there were trades in the Jan 40 options in the first three hours of trading preceding the French, Engmann and Rand trades. The analysis of those trades, as depicted above,[22/] reflects a total of only 219 contracts traded in 59 transactions, and that in that time frame there were only 2 transactions in excess of ten contracts and 2 transactions between 5 and 10 contracts in any one transaction, the balance being 5 contracts or less. The evidence further shows that between 9 and 10:00 a.m., which immediately preceded the French, Engmann and Rand trades, there were only 36 contracts (none exceeding 5) in 13 trades for an average of 2.8 contracts per trade per hour. Thus the trading that morning, particularly in the last hour before the French trade of 50 contracts, appeared to be on the slow side rather than active. When such trading

---

22/ See pages 17-18, *supra*.

is compared with the 150 contracts traded in 43 seconds among the forgoing three respondents, the conclusion is inescapable that the triangular trades started by French gave every appearance of actual and apparent active trading. The same slow trading referred to above followed immediately after the last French trade of 50 contracts. The evidence shows in about the next 30 minutes there were 10 contracts traded (3 of which were for 1 contract each) in 5 trades for an average of 2 contracts per trade. These trades were followed by the first Dougherty contract of 50 contracts.[23/] The total of 150 contracts traded among Dougherty, Mahnke and Mitchell also gives every appearance of actual trading and apparent active trading.

With respect to the Jan 35 options a similar pattern appears. Excluding a trade of 50 options (between Engmann and Rand), which was reversed before the close (last trade of the day), the evidence discloses a paradigm of small lot trading not exceeding 5 contracts. In approximately 4 hours of trading on the PSE a total of 56 contracts were traded in 24 transactions for an average of 2.3 contracts per trade. In fact, in the one and one half hours immediately preceding the Pascual-Haynes trade in the said options, only one trade was effected for 2 contracts. Trading in the Jan 35 options appeared to be slow rather than active. Comparing such trading

---

23/ See table p.10, supra.

with the 150 contracts traded among Pascual, Haynes and Kurlan within a ten minute span, the conclusion is inescapable that their triangular trading gave every appearance of actual and apparent active trading.

"Creating" actual or apparent active trading, as used in the Section, is intended to refer to any activities in the market place which bring about a substantial change from the situation which previously prevailed. It is the nature of the activities which determine whether, at some point, absent any legitimate reason, trading on the exchange becomes so incompatible with the type of trading which preceded such activities that it can be said to create actual or apparent active trading. In the instant case, the evidence is clear and convincing that each group of triangular trades involving a total of 150 contracts, effected by the respondents involved therein, within periods of time from 43 seconds to 30 minutes, were so substantially different from the average of approximately 3 contracts per transaction which preceded their trades, that it is concluded that within the framework of Section 9(a)(2) their trades created actual or, at the very least, apparent active trading in the Houston options in question.

Finally, some of the respondents contend that there is no evidence that their purpose, in effecting their triangular trades, was to induce the purchase or sale of the Houston options by others. In essence, their argument is that the

prohibitive purpose, as stated in Section 9(a)(2), is inducing another to purchase or sell, not inducing brokerage houses to send customer orders to one given exchange rather than another. That narrow view of the Section cannot be accepted. It is well settled that the details of an act will be construed "in conformity with its dominating general purpose" and the Courts "will interpret the text so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy." SEC v C.M. Joiner Leasing Corp., 320 US 344, 350-351 (1943). It is evident that the transactions, which Section 9(a)(2) is designed to prohibit, are those made for the purpose of inducing others to effect transactions in the market place. In the instant case the Houston options began trading in two market places at the same time. The Commission has expressed its concern with floor members of exchanges who increase substantially their proprietary trading in certain dually traded options, where such increased trading is apparently to induce the purchase and sale of such dually traded options on a particular exchange instead of other option exchanges on which the same class of options are traded. In 1977 the Commission issued a release entitled "Option Floor Trading" (Securities Exchange Act Release No. 13433 - April 5, 1977, 11 SEC Docket No. 19, p. 2194), noting that this increased trading by floor members responds to their perception that brokers rely on aggregate reported

trading volume on each exchange in deciding to which market to route their customers orders. The Commission stated that where, for example, increased proprietary trading is for the purpose of inducing the purchase or sale of an option class registered on an exchange such activity would appear to violate Section 9(a)(2) of the Act.

The record in the case at bar demonstrates that the Commission's concern was well founded. The evidence clearly illustrates that on the morning of November 22, all the floor members present at the Houston Oil options post, including all the respondents, were aware that such options were to begin trading on the CBOE simultaneously with trading on the PSE. The "crowd" requested Kolar to keep them informed of the trading volume on the CBOE which she did on an hourly basis.[24/] Respondents French, Engmann, Rand, Haynes, Dougherty, Mahnke and Mitchell were aware and Pascual and Kurlan had sufficient experience to be aware of the fact that if the PSE would become the market place which traded the largest volume it would become the "primary market" and that customers' orders would be routed to that exchange by

---

24/ The argument by respondents that their primary interest in trading the options in question was to make an orderly market is not accepted. If that were their sole interest they would not need to know or request to be kept informed of the CBOE volume.

brokers who rely on aggregate reported trading volume in deciding to which market to route their customers' routine orders. The extraordinary increase in the volume of trading, as illustrated by the number of contracts effected by the respondents, in contrast to the small number theretofore traded, without adequate explanation for the reason for the sudden increase, makes it evident, and the evidence is clear and convincing, that within the meaning of Section 9(a)(2) of the Act respondents' motivation for their increased trading activity was to induce the purchase and sale of the dually traded Houston options by others to be effected on the PSE instead of the CBOE. The individual respondents are therefore found to have wilfully violated and wilfully aided and abetted violations of Section 9(a)(2) of the Act.

The charges of violation of Section 10(b) and Rule 10b-5 thereunder are essentially founded on respondents' activities relating to the triangular trades they executed in the Houston options, as described above. The gist of the charges under Section 10(b) are that respondents employed a device, scheme and artifice to defraud, that they engaged in acts practices and courses of business which would and did operate as a fraud or deceit upon purchasers and sellers of the Houston options and made or omitted to state material facts concerning the trading market in the said options, the depth and liquidity of the market and the benefits of entering orders on the PSE rather than another exchange. Respondents French, Pascual, Haynes, and Dougherty contend the record fails to establish by

clear and convincing evidence any of the elements necessary to prove the Section 10(b) violation. In general Engmann makes a similar argument and Mitchell appears to argue that since there is no manipulation under Section 9(a)(1) or (2) there can be no violation of Section 10(b) for failure to disclose any purported manipulation.

All the arguments are rejected. The evidence is clear and convincing that the activities of the individual respondents, of engaging in the triangular trades for the purposes of increasing the volume of trading in the Houston options, as fully discussed herein, and found to have been manipulative, also constitute a device and scheme to defraud and acts and practices and a course of business which operated as a fraud. Reports of option transactions are carried on various types of ticker tapes and in the newspapers. Investors reading such reports ordinarily assume they reflect legitimate transactions. If, as found in the instant case, such transactions reflect fictitious activity such investors are mislead and deceived as to the market in the options. They are falsely led to believe that bona fide transactions were effected and may be induced by the volume to purchase or sell the option. It is the objective of the anti-manipulative provisions of the Act to outlaw "every ... device used to persuade the public that activity in a security is the reflection of a genuine demand instead of a mirage." Senate Report 1455, 73rd Cong. 2d Sess. (1934) p 54. The same concept is equally true with

respect to any acts, practices or a course of business which achieves the same result. The respondents, were experienced market makers and able to appreciate and evaluate the reactions that increased volume in option trading on the PSE would have on brokers who decide which market to route their customers orders. The respondents knew or should have known that investors who decide for themselves where to trade options would be guided by similar principles.

In its release No. 13433, supra, the Commission stated:

> To the extent public orders are diverted to an exchange because of such proprietary trading, that use of exchange facilities may operate as a fraud upon public customers in connection with their purchase and sale of securities, as well as a fraud upon other markets by depriving them of a fair opportunity to compete for business.

Respondents French, Pascual, Haynes and Dougherty also urge that non disclosure of increased volume does not relate to a material fact. The argument is not accepted. The respondents certainly knew the PSE was reporting the volume of trading on the PSE. They also knew that such report would not reflect that the 150 contract transactions they traded involved no change in beneficial ownership, and knew such trades would not be reported as wash sales. They were thus deceiving both the exchange, by having it report a large volume of trading in Houston options, and brokers and investors into believing their transactions were bona fide. In its Release No. 13433, supra, the Commission pointed out:

> Such increased floor trading may cause exchange reporting of option transactions to omit to state material facts necessary in order to make those reports, in the light of the circumstances under which they were made, not misleading in violation of Section 10(b) of the Act. 25/

In light of the fictitious nature of the trades in question it is found that the non disclosure of the purpose for which the trades were effected constitutes the failure to disclose a material fact.

Some of the respondents also contend that the Order fails to allege and the Division failed to prove scienter, which they urge is essential to establish a Section 10(b) violation. Reliance is placed on Ernst & Ernst v Hochfelder 425 US 185 (1976). The opinion in the Supreme Court in Hochfelder, is silent as to whether the scienter requirement is applicable to the Commission's administrative enforcement

---

25/ Respondents French, Pascual, Haynes and Dougherty are critical of the Commission's Release No. 13433 claiming it is based on assumed facts and that the Commission was unable to conclude that those facts constitute a violation. The criticism is unwarranted. The Commission's views were based upon information obtained in its continuing study of the problems involved in option floor trading on the various exchanges. The Commission, as the expert federal agency in the field of securities laws, has the competency to express an opinion concerning the impact of the various provisions in the Act on the activities, acts and practices of floor members of an exchange. Such views must be, and are, given weight. However, the findings and conclusions herein are based upon the evidence in the record and not upon any facts which these respondents assert were assumed by the Commission.

proceedings.. The Court expressly reserved decision as to the applicability of the requirement to Commission injunctive actions. The Commission in Steadman Securities Corp., et al. Fed. See L. Rep ¶91, 243, appeal pending (5th Cir); 12 SEC Docket No. 1041, July 12, 1977, concluded that proof of specific intent to defraud was not required by Hochfelder in disciplinary enforcement proceedings.[26/] However, assuming arguendo the Hochfelder standard is applicable to SEC disciplinary enforcement proceedings that standard has been met here and, accordingly, it is not necessary to resolve the issue as to whether the scienter requirement of Hochfelder applies under Rule 10b-5. The record and findings herein establish that respondents engaged in transactions which were found to be prohibited under the Act. With respect to each group of transactions in which three respondents both sold and purchased or purchased and sold the Jan 40 or Jan 35 Houston options, the decision by each of the individual respondents to effect the transactions in question was intentional, knowing, and deliberate, not inadvertent or negligent.

Such transactions, in light of the circumstances existing at the time they were effected, and found to be a fraudulent device and a course of business which operated as a fraud and deceit upon purchasers and sellers as well as the exchange constituted wilfull violations of Section 10(b) and Rule 10b-5. The Commission and the Courts have held that wilfull as used in the statute means "intentionally committing the act which constitutes the violation" Tager v S.E.C., 344 F 2d 5, 8 (2d Cir. 1965).

26/ See also Arthur Lipper Corp. v S.E.C., 547 F 2d 171, 180 (2d Cir 1976), rehearing denied 551 F. 2d 915 (1977), cert denied 430 US 1009 (1978) Nassar and Company, Inc., Securities Exchange Act Release No. 15347, 16 SEC Docket. 222, 225-6 (1978).

Other Matters

Respondents French, Pascual, Haynes and Dougherty urge that these proceedings be dismissed on the grounds that they have already been sanctioned by the PSE for the same conduct charged in these proceedings, that the denial of request to call Division counsel and the then Associate Regional Administrator to establish that the staff participated in the disciplinary proceeding by the PSE was erroneous, that the Commission's consideration of the Division's recommendation to institute these proceedings constituted an improper review procedure under Section 19(d)(2) and 19(e)(1) of the Securities Acts Amendments of 1975,[27/] and, that these proceedings are unfair and contrary to due process. The request to dismiss the proceedings is denied. The other arguments are rejected. The Commission's responsibilities under the Securities Acts is to pursue whatever action it deems necessary in the public interest and for the protection of investors. Action taken by a self regulatory body does not prelude the Commission from seeking to take appropriate action in the public interest. Lile & Co., 42 SEC 664, 669-70 (1965); Shearson Hamill & Co., 42 SEC 811, 852, n88 (1965). The Commission's determination to bring proceedings are not, and under the 1975 Amendments, do not constitute an improper review of any action taken by the exchange. It is noted these respondents consented to the sanction imposed by the exchange and the record does not reflect

27/ Pub. L. No. 94-29 (June 4, 1975)

that any of them sought review by the Commission of the exchange's action. Prior to the 1975 Amendments the Commission's oversight powers respecting disciplinary sanctions by a self regulatory organization were limited to review actions taken by the National Association of Securities Dealers. The 1975 Amendments expanded direct oversight jurisdiction to cover disciplinary sanctions by, among other, all national securities exchanges. Securities Exchange Act Release 13726, 12 SEC Docket 1107-1115 (July 8, 1977). These proceedings under Sections 15(b) and 19(h) of the Act are founded on specific allegations of violative conduct in which the imposition of sanctions is to be determined on the basis of a record, not on any consideration of action by the exchange. The denial of respondent's request for staff members to testify was not erroneous. The offer of proof by respondents' counsel related to the action taken by the PSE which they claimed would establish the staff's participation in the initiation, review and approval of the sanctions resulting from the PSE proceedings. None of these matters are considered relevant or material to the issuesin these proceedings which are based on the Order setting forth specific charges of violation. Propriety of the sanctions of the PSE is not an issue here, but the sanction itself will be considered as a factor in determing an appropriate sanction herein. Respondents received due and proper notice of the charges against them, some were represented by counsel, all afforded that right and the right to file briefs, and as the record

demonstrates, received a fair hearing. There is no substance to their claim that the proceedings were unfair or contrary to due process. Other than their arguments relating to the exchange sanction respondents failed to specify the manner in which the proceedings were unfair or the reasons they were not afforded due process.28/

The Order charges Rainbow and Aldridge Co. with the same wilfull violations as those charges against respondents Haynes, who is the general partner of Rainbow, and Kurlan, who is president, a director and owner of between 50 and 75% of the stock of Aldridge Co. The wilfull violations found herein against Haynes and Kurlan are also attributed to their respective firms. It is well settled that a firm can only act through its agents and employees and such firm is accountable for the

---

28/ In this connection it is noted that some of the respondents argue the Division failed to call Schretter, a PSE official, to testify since one or more witnesses testified as to conversations with him. Mitchell urges that somehow the Division prevented access to the witness. These arguments are frivilous. There is no requirement that the Division produce as a witness every person with whom they talked in connection with the investigation of the matters involved herein. Absent any indication the Division was deliberately concealing a witness whose testimony was vital to the defense, and there is no evidence to suggest such fact, there can be no improper motive attributed to the Division. Moreover, the respondents give no reason for their own failure to even request the issuance of a subpoena for his appearance.

actions of its responsible officers. A.J. White & Co. v. S.E.C., 556 F 2d 619, 624 (1st Cir. 1977), Armstrong Jones & Co. v. S.E.C., 421 F 2d 359, 362 (6th Cir 1970), Sutro Bros & Co., 41 S.E.C., 470, 479 (1963). Accordingly, Rainbow and Aldridge are found to have wilfully violated Section 9(a)(1) and 9(a)(2) and Section 10(b) and Rule 10b-5 of the Act.

Public Interest

It remains to determine whether it is in the public interest that a sanction be imposed for the violations found. Consideration must be given to the nature of the trading in options in which the respondents, as market makers engaged in and the impact of their activities on the market place and investors. In 1973, the Commission authorized the CBOE to engage in option trading in order to permit it "to test the market" for standardized call options "within a controlled environment" and the Commission noted at the time it intended to maintain a close surveillance over the CBOE's 'pilot project' which may involve complex problems and special risks to investors and to the integrity of the market place. Since 1973 the Commission approved pilot options trading by various national securities exchanges including the PSE. It expanded these programs to some extent from time to time emphasizing its continued surveillance of options trading programs to assure the maintenance of fair and orderly markets and to prevent

fraudulent, deceptive and manipulative acts, practices, devices and contrivances in securities markets. In 1976, the Commission announced it had learned that widespread fictitous trading by option specialists had occurred and in 1977 it became aware of patterns of trading on options exchanges which suggested that floor members were increasing substantially their proprietary trading in certain dually traded options for the purpose of attracting order flow from major brokerage firms doing business with the public. The Commission also learned of other abusive practices including options transactions which amounted to wash sales, matched orders, or other forms of prearranged trades entered into in order to, among other things, give the appearance of increased trading volume.[29/]

The findings herein demonstrate clearly and convincingly an instance where market makers entered into option transactions which were found to be wash sales and which were effected to give the appearance of trading volume. The record amply reflects that the individual respondents were keenly aware of the situation in which the Houston options would begin trading simultaneously on the PSE and the CBOE, were keenly aware of the benefits which would flow from knowledge that trading on the PSE exceeded the volume of trading on the CBOE and in fact,were part of the so-called crowd which requested hourly reports on the volume of trading on the latter exchange. Respondents, French, Dougherty, Pascual, Rand and

29/ See Securities Exchange Act Release 34-14056, 13 SEC Docket No. 7 pp 366-370 (October, 1977)

Mitchell admitted they knew or were aware of the competitive factors inherent in dually traded options and the advantages to be gained by having the PSE known as the primary market for the Houston options. There is sufficient evidence in the record that such knowledge was possessed by all the respondents and other market makers present at the trading post at the PSE on the morning trading began in the said options.

In light of the nature of the trading in the options in question, preceding respondents transactions, which has been thoroughly detailed above, it is manifest that the transactions entered into by and among the respondents were intended to and did increase the volume substantially. The primary defenses that their trades were nothing more than usual trading and that they were "scratch trades" is contrived to give the appearance of ordinary transactions in the regular course of business. The evidence in the record reflects that in a six week period between November 15 and December 31, 1976, none of the respondents engaged in a single scratch trade containing the characteristics of the purported scratch trades which the respondents effected on November 22, 1976.30/

30/ All the respondents urge that a schedule, prepared by the Division, containing six weeks of all option trading by respondents, which reflects that none of the respondents effected a trade of ten or more contracts and

The manipulation and fraud violations found are of a most serious nature and to the extent they relate to option trading for the purpose of increasing volume on an exchange they cannot be deemed to be inconsequential, as claimed,because they did not, in fact, or would "forseeably harm the public." The discussion above explains the harm caused by respondents' transactions. In mitigation consideration has been given to the sanctions imposed on respondents by the exchange their unblemished records, the number of trades each respondent effected and the dismissal of certain charges. However,

---

Footnote No. 30 continued

30/ reversed that position with the same or another market maker at the same price on the same day, should be rejected. They contend that the schedule contains some errors, that it reflects only trades between market makers on the PSE, not floor brokers and is not probative. Assuming *arguendo* that a few errors appeared in the preparation of the schedule, which involved reviewing thousands of transactions, there is no evidence that such errors were of such substantial nature or that they had any material effect on the entire schedule. None of the respondents established that it is their normal or ordinary trading pattern to enter into trades of fifty or more contracts which they reversed the same day at the same price. The fact that the schedule reflects only trades between market makers and not with floor brokers is significant rather than, as claimed, of limited value, since it shows the trading patterns between market makers, which is what this case is about. Though admittedly the period depicted was selected by the Division, such periods were, in essence, from one week prior to November 22, 1976 through December 31, 1976 and appears representative of respondents trading pattern in options during that general time frame. The exhibit has merit and is given weight.

it is in the public interest that respondents be suspended for the periods stated below for their willful violations as found.

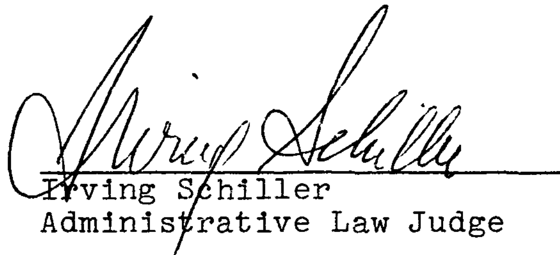
IT IS ORDERED that the registrations, as broker-dealers, of French, Engmann, Rand, Dougherty, Mahnke, Mitchell, Rainbow and Aldridge are hereby suspended for a period of twenty business days and that respondents Pascual, Haynes and Kurlan are suspended from association with a broker or dealer for a period of twenty business days.

IT IS FURTHER ORDERED that the charges of violations as alleged in Section II D(2) and (3) are hereby dismissed.

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

Pursuant to Rule 17(f), this initial decision shall become the final decision of the Commission as to each party that has not, within fifteen (15) days after service of this initial decision upon him or it, filed a petition for review of this initial decision pursuant to Rule 17(b), unless the Commission, pursuant

to Rule 17(c), determines on its own initiative to review this initial decision as to him or it. 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.31/



Irving Schiller
Administrative Law Judge

Washington, D.C.
March 28, 1979

31/ All proposed findings and conclusions or other documents submitted have been considered. To the extent that proposed findings and conclusions submitted are in accordance with the findings, conclusions and views stated herein they have been accepted, and to the extent they are inconsistent therewith they have been rejected. Certain proposed findings and conclusions have been omitted as not relevant or not necessary to a proper determination of the material issues presented.