MUNICIPAL SECURITIES
Cases and Materials

Supplemental Text
(2001 – 2003 Cases)

Office of Municipal Securities[1]
Division of Market Regulation

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This compilation was prepared by the Office of Municipal Securities in the Division of Market Regulation of the Securities and Exchange Commission and supplements the Municipal Securities Cases and Materials Text that was issued in January 2001. It contains the full text of certain Commission orders/opinions, administrative law judge decisions, and litigation releases, as well as federal court decisions, involving participants in municipal securities transactions. In some instances, the document is a determination of fact and law following a hearing; in others, findings made by the Commission in a settled proceeding in which the named party has neither admitted nor denied the findings, but consented to entry of the order. In still other instances, such as a complaint, the document may consist of allegations.

The compilation organizes enforcement actions by relevant participants to municipal securities transactions or topics. However, inclusion under a particular heading does not limit in any manner the relevance of the document to other participants or topics.

While this compilation provides an extensive review of Commission activity in the municipal securities market, it does not purport to be exhaustive. It also does not include actions by private parties under the federal securities laws arising from municipal securities transactions, or Commission and private actions under the antifraud and other sections of the federal securities law arising from transactions not involving municipal securities. Such materials may also be useful to the reader.

The reader is encouraged to consult the web site maintained by the Commission at http://www.sec.gov for future releases.

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In the Matter of the City of Miami, Florida, Cesar Odio and Manohar Surana, A.P. File No. 3-10022, Initial Decision Release No. 185 (June 22, 2001) (initial decision of administrative law judge).

APPEARANCES:	Mitchell E. Herr for the Division of Enforcement, Securities and Exchange Commission
	Thomas Tew and Daniel S. Newman for Respondent City of Miami, Florida, with co-counsel Alex Villarella, City Attorney
	Steven E. Chaykin and Glen Widom for Respondent Manohar Surana
BEFORE:	Brenda P. Murray, Chief Administrative Law Judge

On September 22, 1999, the Securities and Exchange Commission ("Commission") issued an Order Instituting Proceedings ("OIP") pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), which authorize the issuance of cease and desist orders where appropriate. The OIP, amended on November 1, 1999,[1] charges that in 1995: (1) the City of Miami, Florida ("City") violated Sections 17(a)(1), 17(a)(2), and 17(a)(3) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, in connection with the offer, purchase, and sale of municipal bonds, and (2) Cesar Odio, the City Manager, and Manohar Surana, the City's Director of Finance and Management and Budget, committed or caused the City's violations.

I held hearings for three days in Miami, Florida, on March 6 through 8, 2000. The hearing record consists of testimony from six witnesses, including two experts, sponsored by the Commission's Division of Enforcement ("Division"), 118 exhibits sponsored by the Division, and twenty-three exhibits sponsored by the City.[2] Four of the Division's exhibits were transcripts of investigative testimony with additional exhibits. The Division called Respondent Odio to testify. He did not participate in the hearing on his own behalf because the Commission accepted his Offer of Settlement. See Cesar Odio, Order Making Findings and Imposing a Cease-and-Desist Order, 72 SEC Docket 614 (Apr. 14, 2000). Mr. Surnana was represented by counsel at the first day of the hearing. His participation then ended because he too agreed to settle the allegations. See Manohar Surana, Order Making Findings and Imposing a Cease-and-Desist Order, 73 SEC Docket 1110 (Sept. 22, 2000). Messrs. Odio and Surnana, without admitting or denying liability, agreed to cease and desist from committing or causing any violation and any future violation of Sections 17(a)(1), 17(a)(2), and 17(a)(3) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

The Division's Post-Hearing Brief is dated May 15, 2000. The City served its Post-Hearing Brief on July 17, 2000. The Division filed its Post-Hearing Reply Brief on August 8, 2000.[3]

On September 28, 2000, the Division moved to reopen the record to take official notice of news from the September 28, 2000, issue of The Miami Herald that Donald Warshaw, a former City Manager, had been indicted by a federal grand jury on one count of conspiracy and four counts of mail fraud for allegedly stealing $86,563 from the Miami Police Relief and Pension Fund and the Do The Right Thing charity from 1993 to 1999. Mr. Warshaw was the City Manager at the time of the hearing. (Tr. 732.) The Division wants the record to contain this material to refute testimony in the record of Mr. Warshaw's integrity, and to demonstrate that the City has not shaken its "legacy of public corruption." (Division's Motion To Reopen Record at 3.) The City filed its opposition on October 12, 2000, noting that Mr. Warshaw was dismissed as City Manager in April 2000 and that the charges in the indictment are unconnected to the allegations in the OIP. The City argues that Mr. Warshaw's situation is unrelated to whether or not there is a likelihood that the allegations in the OIP, if proven, will reoccur. (Respondent, The City of Miami, Florida's Opposition to the Division's Motion To Reopen Record at 2.)

Rule 323 of the Commission's Rules of Practice provides that I may take official notice of any material fact if it is a matter which might be judicially noticed by a district court. Rule 323 also provides that if official notice is taken of a material fact not in evidence, the parties shall be afforded an opportunity to establish "the contrary." 17 C.F.R. § 201.323. While district courts do on occasion take judicial notice of newspaper articles, I deny the Division's request that I do so here. The proposed exhibit consists of unresolved allegations against Mr. Warshaw. These allegations are entitled to no probative value. To grant the motion would likely result in further evidentiary submissions and this material does not merit reopening the record that was closed at the conclusion of the evidentiary hearing fourteen months ago. See, e.g., Cities of Campbell v. FERC, 770 F.2d 1180, 1191 (D.C. Cir. 1985).

I. ISSUES

The Division alleges that the City violated the antifraud provisions by distributing false and misleading information and omitting material information about its financial status in the City's 1994 Comprehensive Annual Financial Report ("CAFR") and in the Official Statements[4] for three bond offerings. Specifically, the Division alleges that the City violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, by making materially false and misleading representations and omitting material information in its Official Statements, in the offer and sale of three bond issues. It also alleges that the City violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, by making materially false and misleading representations and omitting material information in its 1994 CAFR in connection with its outstanding bonds. (Div. Br. 1, 6-9, 20-25, 39-40; Div. Reply 1-3, 5-6, 17-19.)

The 1994 CAFR and the Official Statements both contained the City's 1994 audited General Purpose Financial Statements ("Financial Statements"). However, the 1994 CAFR and the Official Statements differ in that: (1) the 1994 CAFR was not used in the offer and sale of securities and, unlike the Official Statements, it disclosed that the City's bonds had been downgraded after fiscal year ("FY") 1994 closed; and (2) the Official Statements contained a summary of the City's 1995 budget, which the 1994 CAFR did not. These differences caused slightly different allegations by the Division.

The Division alleges that:

1. Both the 1994 CAFR and the Official Statements omit that the City experienced a serious cash decline after the City's 1994 Financial Statements closed;

2. Both the 1994 CAFR and the Official Statements misrepresent "Operation Right Size," portraying it as a positive measure that would strengthen the City's financial position; and

3. In the Official Statements, the City falsely represented that it had a balanced budget for FY 1995, and it omitted to report that Standard & Poor's, Inc. ("S&P") had downgraded the City's bonds. Also, in the Official Statement for the pension bonds, the City did not make sufficient disclosure about the pension bond proceeds being used to bail the City out of the cash deficit in the prior fiscal year.

II. FINDINGS OF FACT

I base my findings and conclusions on the record and on the demeanor of the witnesses who testified at the hearing. I applied "preponderance of the evidence" as the applicable standard of proof. Steadman v. SEC, 450 U.S. 91, 97-104 (1981). I have considered and rejected all arguments and proposed findings and conclusions that are inconsistent with this decision.

Miami is the largest of the thirty or thirty-one cities in Miami-Dade County. The county government has a budget of $4.5 billion and 28,000 employees. (Tr. 589.) In contrast, the City has a budget of about $250 million and about 3,300 employees. (Tr. 589.) The City government serves one of the country's poorest urban populations, and as of 1994 and 1995 it had been struggling with a deteriorating financial situation for a number of years. (Tr. 234-36, 254, 736.) The City has a City Commissioner-City Manager form of government. The City Commission, an elected body consisting of a Mayor, a Vice-Mayor and three City Commissioners, was responsible for the conduct of the City government.[5] The City Commissioners delegated responsibility of day-to-day management to an appointed official, the City Manager, who was responsible for all City departments and who was the ultimate superior of every City employee. (Tr. 102-03; Div. Ex. 190, Tab 10 at 1.)

Cesar Odio was City Manager from November 1985 until he retired on September 11, 1996. (Tr. 256.) Soon after his retirement, Mr. Odio pled guilty to felony charges of obstruction of justice under a negotiated plea agreement with federal authorities and served a twelve-month sentence in prison. (Tr. 91-93, 256.) Mr. Odio's arrest and plea came about as the result of "Operation Green Palm," an undercover federal law enforcement action, which brought to light many of the facts in this record. (Tr. 99-100.)

Manohar Surana was the City's Director of Management and Budget when Mr. Odio became City Manager. Mr. Odio appointed Mr. Surana to Assistant City Manager in 1991. In February 1995, when Mr. Garcia, the Finance Director, retired, Mr. Odio consolidated the Departments of Finance and Management and Budget ("Department of Finance"), and named Mr. Surana Director.[6] (Tr. 250-52, 550.) Mr. Surana was responsible for preparation of the City's financial statements from February 1995 until he left City employment in August 1996. He was also responsible for the Official Statements in the three bond offerings. (Tr. 93, 263-64.)

Howard Gary & Company ("Howard Gary"), a full-service investment banking and underwriting firm, and Raymond James & Associates, Inc. ("Raymond James") (collectively, "Financial Advisor"), acting jointly, became the City's Financial Advisor in 1989, and served in that capacity in 1994 and 1995. (Tr. 91, 235-38, 291-96; Div. Exs. 181B, 181E.) Mr. Howard Gary, the president, CEO, and principal of Howard Gary, was the City Manager before Mr. Odio. (Tr. 90-91, 290.) The City did not renew its contract with Howard Gary in late 1996. (Tr. 302.) The Financial Advisor's contract called for a wide range of duties, but the Financial Advisor played a limited advisory role, and its primary source of payment from the City was from participating in City bond offerings.[7] (Tr. 340-41, 348-53, 559; Div. Ex. 181B.) Kishor M. Parekh ("K. Parekh"), the Financial Advisor's key contact with the City, had a strained relationship with Mr. Surana.[8] (Tr. 295, 549-550.) K. Parekh found out about financial actions of the City after they occurred. (Tr. 337-38, 343-45.)

To understand these allegations of fraud involving the bond offerings of 1995 and the dissemination of materially misleading financial information, it is necessary to understand the City's compilation of financial data. The City's balance sheet shows assets under various fund headings. The general fund is the largest component of the City's operating budget and funds most of the City's core activities, such as the largest City departments, including the fire and police services. (Tr. 193-94, 209-10; Div. Ex. 178 at 61-62.) Rating agencies and bond insurers give primary attention to the condition of the general fund in assessing the City's financial condition. (Tr. 303; Div. Ex. 103 at 20, Div. Ex. 175 at 20-21.) The general fund "is the general operating fund. It is used to account for all financial resources except those required to be accounted for in another fund." (Div. Ex. 18 at 30.) It is "to account for resources traditionally associated with government which are not required legally or by sound financial management to be accounted for in another fund." (Div. Ex. 18 at 59.)

A significant general fund expense of the City during the period at issue was the Gates Judgment, a designation used for the result of a March 23, 1985, consent decree in a court action that alleged that the City had mishandled pension funds over an extended period. (Tr. 106, 298-99, 311-12; Div. Ex. 103, Div. Ex. 133 at 101-02, Div. Ex. 181F.) The City's liability was $213 million. (Div. Ex. 103 at 19.) Payments totaled about $17 million annually to the Fire Fighters' and Police Officers' Retirement Trust and the General Employees' and Sanitation Employees' Retirement Trust until they were fully funded.[9] (Tr. 298-00; Div. Ex. 103 at 27, Div. Ex. 178 at 174-75.) The City's mandatory payment toward the Gates Judgment was reduced in the early 1990s but it remained a "significant drain on the general fund." (Tr. 311-12; Div. Ex. 181F.)

Another balance sheet item was the enterprise funds, which consisted of self-supporting operations where the cost of providing goods or services is financed through the collection of user charges. (Div. Ex. 18 at 39, Div. Ex. 192 at 68.) For example, the marina, the Orange Bowl, and solid waste collection were supposed to be self-sufficient operations. Collected fees were set aside to pay those costs. (Tr. 178.) The City's enterprise funds experienced the following operating deficits:

FY 1992 close to ($4 million)
FY 1993 ($6.5 million)
FY 1994 close to ($5 million)
FY 1995 approximately ($5.6 million)

(Div. Ex. 192 at 89-94.) In FY 1993, FY 1994, and FY 1995, accumulated deficits in the enterprise funds totaled $47 million, approximately $62 million, and $67.5 million, respectively.[10] (Div. Ex. 16 at 48, Div. Ex. 18 at 47, Div. Ex. 192 at 101-02, 104.)

In FY 1994, the internal service funds experienced a deficit of $10 million. (Div. Ex. 18 at 47, Div. Ex. 192 at 102.) In FY 1995, the accumulated deficiency in internal service funds totaled $107.5 million (Div. Ex. 16 at 48, Div. Ex. 192 at 104.) The City's Financial Statements in FY 1993, FY 1994, and FY 1995 reported that most of its enterprise funds and internal service funds had accumulated deficiencies. (Div. Ex. 192 at 114-15, 144.) In FY 1995, the City borrowed $43.5 million from the funds it had set aside for capital improvements. (Div. Ex. 16 at 40, Div. Ex. 92 at 114.)

The City put all its cash in one "pooled" account. The alleged documentation that identified amounts belonging to the general fund, to the individual enterprise funds, and to the internal service funds did not exist. (Tr. 393-96, 596, 599-601, 662; Div. Ex. 181S.)

Florida law requires that the City's fiscal year begin on October 1 and end on September 30 of the following year. See Fla. Stat. Ann. § 166.241(2). The City's FY 1995 ran from October 1, 1994, through September 30, 1995. (Tr. 138.) On September 30, 1994, the Financial Advisor delivered a written statement of concerns, similar to what it had expressed on previous occasions, about the City's "deteriorating fiscal condition" to Mr. Garcia, Finance Director. The Financial Advisor referenced the following specifics:

The City's issuance of $18 million Special Non-Ad Valorem Revenue Bonds to finance a self-insurance claims reserve fund for the payment of liability settlements or judgments against the City for the next two (2) fiscal years, in conjunction with the City's Fiscal Year 1994/1995 Budget are particular sources of concern. Other continuing concerns include the low level of unreserved general fund balances; the City's reliance on non-recurring revenue initiatives; asset sales; basic infrastructure maintenance needs; as well as the City's overall revenue inflexibility.

(Div. Ex. 181I.)

In the same correspondence, the Financial Advisor warned that the major rating agencies would downgrade the City's general credit rating in the near future. (Div. Ex. 181I.) Mr. Garcia responded by chastising K. Parekh and informing him not to put anything of that nature in writing in the future.[11] (Tr. 376-78.) On October 17, 1994, S&P downgraded $36.1 million of the City's general obligation bonds from A+ to A noting that the:

[D]owngrade reflects continued fiscal stress arising primarily from revenue inflexibility, which has caused the city to utilize nonrecurring sources to support operations . . . . The unreserved general fund balance has remained at a minimum level of less than 2% of expenditures and transfers, with the liquid portion continuing to decrease.

(Tr. 367-68; Div. Ex. 181J.)

Deloitte & Touche, LLP, ("Deloitte") audited the City's financial statements from 1989 through 1995. (Div. Ex. 178 at 12.) The audits were of the City's financial statements for each fiscal year ending September 30; the audit work continued until the end of February of the following year, which was the date that appeared on the audit reports.[12] The audit had to consider events occurring between the end of the fiscal year audited and the audit date as part of its subsequent events work. (Tr. 808-09; Resp. Ex. 70 at 2.) Deloitte completed the audit fieldwork for the FY 1994 audit on February 28, 1995, and it signed the audit opinion on the City's 1994 Financial Statements on that date. (Div. Ex. 18 at 15, Div. Ex. 178 at 85.) The persuasive evidence is that the City received the audit of its 1994 Financial Statements in February or March 1995.[13] (Tr. 723, 794, 814, 830; Div. Ex. 18 at 5.)

During the FY 1994 audit, Deloitte became aware of a trend that showed a deterioration of the City's cash balances. (Div. Ex. 177 at 10-12, Div. Ex. 178 at 19-23, Div. Ex. 178B.) In December 1994 or early January 1995, Mr. Paredes informed Mr. Garcia and Mr. Odio that the City faced a potential shortfall of $35 to $40 million for FY 1995, and that the City could run out of cash to meet payroll as early as May 1995. (Tr. 158-61; Div. Ex. 177 at 56-57, Div. Ex. 178 at 12, 19-29, 33, 35-37.)

The City was aware that it had serious cash deficiency problems before Deloitte raised the issue. (Div. Ex. 177 at 56-57, Div. Ex. 178 at 26.) The City was the only source of financial information about its operations for Deloitte. The auditor's concern about the City's cash deficits was based on a cash flow study prepared by Mr. Garcia. (Div. Ex. 178 at 54-56.) Deloitte kept the City fully informed of its work on the audit, and only discussed the audit work with City officials and consultants. (Div. Ex. 177 at 126, 134-36, Div. Ex. 178 at 54-58, 201-02.) Deloitte continuously consulted with industry specialists on this engagement. (Div. Ex. 178 at 201-02.)

Mr. Odio convened a series of meetings with department heads, union representatives, a City Commissioner, and persons from Deloitte during the first quarter of calendar year 1995, to address the projected $35 million revenue shortfall that Mr. Padares had informed him about ("Orange Bowl meetings").[14] (Tr. 227-28, 247, 737.) The participants at these meetings knew the City Commission had a record of refusing to raise revenues by increasing taxes or service fees because of political considerations.[15] (Tr. 123-34, 300-02; Div. Ex. 192 at 130-33.) For example, the City refused to increase its annual solid waste fee of $160 per single-family residence even though the cost of rendering the service was over $380. (Tr. 127.) The City paid annual operating deficits of $12 to $15 million from the general fund because the City Commission refused to raise the solid waste fee. (Tr. 128.)

Without increased revenues, the City had to achieve cost savings in operations and it had few options. Close to eighty percent of the City's budget went to payroll costs that increased $7 million annually. (Tr. 228-29, 234.) As most City workers were union members, reductions in the work force could not be accomplished unilaterally.

(Tr. 737-39.) On February 28, 1995, Mr. Odio, Mr. Surana, and Mr. Garcia met with persons from Deloitte to discuss the City's plans to address the projected cash deficit. (Resp. Ex. 50 at Bates 2676.) The City projected that an early retirement program, "Operation Right Size," effective June 1, 1995, would reduce City expenditures by $15 million to $25 million annually by, among other things, reducing the number of City employees by 300 to 400 people, and introducing a two-tiered salary structure to replace long-time employees whose average salary was $50,000 with lower-cost employees.[16] (Tr. 228-29, 815; Div. Ex. 177 at 77; Resp. Ex. 50 at Bates 2676, Resp. Exs. 61, 62, 63, 64.)

Issuing debt was a viable revenue alternative because the legal limit was fifteen percent of assessed value and the City in late 1994 had a debt to assessed value ratio of 1.6 percent. (Div. Ex. 176K at 185-86.) S&P characterized the City's overall debt as moderately high. (Div. Ex. 181J.) Some municipal managers believed that it was highly inappropriate to issue debt to pay operating expenses such as pension expenses. (Tr. 610-11, 639-40, 679-80.) On the other hand, other municipalities had been issuing debt to fund their pension costs. (Div. Ex. 183 at 87.)

The City releases and broadly disseminates a CAFR annually. (Tr. 195, 378-79.) The document contains the independent auditor's report of the City's Financial Statements, and a transmittal letter to the Mayor and City Commissioners from the City Manager and Finance Director. (Div. Exs. 16, 17, 18.) Basically the CAFR is the City's Financial Statements, which rating agencies and investors require from a municipality that offers securities. (Tr. 535.) The City mailed the 1994 CAFR to persons in the financial community who were interested in information about the City's financial well-being. (Tr. 195-96, 378-79.)

By letter dated February 28, 1995, Mr. Odio and Mr. Garcia transmitted the City's 1994 CAFR to the Mayor and City Commissioners. The letter transmitting the 1994 CAFR noted that:

Responsibility for both the accuracy of the data, and the completeness and fairness of the presentation, including all disclosures, rests with the City of Miami. To the best of our knowledge and belief, the enclosed data is accurate in all material respects and is reported in a manner designed to present fairly the financial position and results of operations of the various funds and account groups of the City. All disclosures necessary to enable the reader to gain an understanding of the City's financial activities have been included.

. . . .

The City maintained its 1993 bond ratings of A by Moody's Investors Service and A plus by Standard & Poor's ("S&P"). Shortly after year end, S&P lowered its rating on the City's general obligation bonds to A.

(Div. Ex. 18 at 5, 8.)

The 1994 CAFR included Deloitte's independent auditor's report that the City's 1994 Financial Statements for the fiscal year ending September 30, 1994, presented "fairly, in all material respects, the financial position of the City . . . at September 30, 1994 and the results of its operations and the cash flows of its proprietary funds" in conformity with generally accepted accounting principles ("GAAP"). (Div. Ex. 18 at

15.) The only disclosures in the 1994 CAFR and the transmittal letter alluding to Deloitte's projection that the City would run out of cash by May 1995, appeared in Note 5 and Note 9 to the 1994 Financial Statements. (Div. Ex. 161 at 2-3.) Note 5 showed funds "Due From/To Other Funds." Almost $20 million of the $23.8 million "Due from Other Funds" came from five capital improvement funds. (Div. Ex. 18 at 39, Div. Ex. 189, Tab 8 at B-25.) Note 9 is considered below.

Generally, a management letter is sent to a client at the end of an audit engagement and typically addresses internal controls and operating efficiencies. The client usually responds in a written communication. (Div. Ex. 178 at 86-88.) Deloitte sent the City a management letter at the conclusion of each of its audits from 1989 through 1995. (Div. Ex. 178 at 90.) On February 28, 1995, Deloitte sent a management letter to the City in regard to its FY 1994 audit, stating that the "City's cash position needs improvement," and noting that in February 1995, the City implemented several programs to "right-size" its operations that were estimated to reduce the City's operating budget by approximately $30 million. (Tr. 246-47; Div. Ex. 6 at 2, Resp. Ex. 49 at 2.) Because of the City's deteriorating financial cash position, Deloitte warned the City to avoid two consecutive years of budget deficits, as defined by Section 218.503 of the Florida Statutes Annotated, that would trigger emergency financial provisions.[17] (Div. Ex. 6 at 2, Div. Ex. 178 at 94-96, Resp. Ex. 49 at 2.)

The City's cash deficiencies continued through the end of calendar year 1995. (Tr. 463-64, 482-83; Div. Ex. 182M.) In this same time period, the City used the proceeds of three bond issues that will be described later to create a positive impact on the balance in its general fund. (Tr. 198, 719-20; Div. Ex. 160 at 8, Div. Ex. 161 at 4, Div. Ex. 186B.) The City's Financial Statements for the fiscal year ended September 30, 1995, showed the general fund with a $26 million balance while a "statement of revenues, expenditures, and changes in fund balances" showed the general fund with a $33.8 million deficit. (Div. Ex. 16 at 20-21, 23.) The positive general fund balance came about because over $71 million was transferred into the general fund from "operating transfers," land sales, and bond proceeds. (Div. Ex. 16 at 23.)

Mr. Paredes believed the "City's finances at the end of [FY] 1995 were in a difficult situation." (Div. Ex. 178 at 84.) Deloitte's original draft of its management letter following the audit of the City's 1995 Financial Statements included the following paragraph:

As a result of the challenges, the City was temporarily not in compliance with Florida Statutes, Section 166.241(3), as a result of deficiencies of revenues and other sources of approximately $26 million under appropriations. The deficiency resulted from receiving approximately $12.5 million less in planned revenues and incurring unplanned expenditures for police and fire overtime, claim payments and other. The deficiency became apparent in February 1995 and the City immediately began the process of correcting the deficiency through several actions including workforce reductions, cost reductions and operating efficiencies. The benefits of these measures principally affected the 1996 Budget, whereby the City was able to reduce expenditures by $36 million. In addition, in July 1995, the City Commission approved a bond program to address the immediate cash flow requirements. On December 1, 1995, the City issued the first series of pension bonds in the amount of $62 million to cover current and future pension contributions.

(Div. Ex. 176AA.) Mr. Paredes eliminated this language from Deloitte's management letter after City officials objected to it and a technical person at Deloitte informed him that Florida law required the City to have balanced budgets not balanced results.[18] (Tr. 216-17; Div. Ex. 178 at 205-07.)

Deloitte issued "clean" or unqualified audit opinions to the City in 1994 and 1995. (Tr. 668-69; Div. Exs. 16, 18.) The clean audit opinions indicated, among other things, that the auditors believed that the City would be able to continue as a going concern and pay its bills for a year from the date of the Financial Statements.[19] (Tr. 663, 786-87; Div. Ex. 4, Resp. Ex. 70 at 2.) A Deloitte going concern work paper noted that FY 1995 presented a difficult cash flow situation, but that FY 1996 would be much stronger due to the cost savings program instituted. A best-case scenario for FY 1995 projected a cash balance of approximately $2.3 million and a worst-case scenario projected a cash deficiency of $18.2 million. (Div. Ex. 178 at 44-45, 50-51, 54, Resp. Ex. 50 at Bates 02676.) The work paper noted Mr. Odio's representation that the City would prepare another $20 million bond offering to fund self-insurance expenses "only if cash flow is necessitated." (Div. Ex. 178 at 52, Resp. Ex. 50 at Bates 02675.)

Deloitte decided to give a clean audit opinion for the 1994 Financial Statements:

Because the City had plans and was instituting processes . . . they were managing the process and that's what this analysis shows. They had the capacity to issue debt and sell assets which all generate resources to make their ends meet.

I think we need to understand that this analysis was done to see if there was a going-concern need in the opinion. We concluded clearly that there was no need for that.

We further concluded that, based now on the facts as we have determined, that it might be a good idea for them to put some disclosures on the financial statements showing that they are experiencing cash deficits that were being funded by other funds and that they probably needed to do some belt tightening.

(Div. Ex. 177 at 91-92.) As the result of consultations between Deloitte and the City, the City added Note 9 to its 1994 Financial Statements. (Div. Ex. 177 at 87, 89.)

On September 13, 1996, seventeen days before the end of FY 1996, Merrett R. Stierheim, a government professional, became interim City Manager.[20] (Tr. 591.) Mr. Stierheim quickly learned that the City was in "very serious financial difficulty," "the budget was a mess, the capital side was beyond description." (Tr. 596.) From 1989 through 1995, the City's general fund had consistently incurred deficiencies and operating losses.[21] (Div. Ex. 192 at 71.) Funds intended for capital expenditures had been "cannibalized" to meet operating expenses; the City had regularly used money from trust accounts to meet operating costs; responsible City personnel did not know what capital funds were available; the records needed to determine what funds should have been in the capital accounts did not exist; and the capital accounts held no reserves. (Tr. 599-600, 610.) For example, $8 million was taken from the storm water trust fund account and put in the general fund to contribute to the appearance of a positive balance on September 30, 1995, when the FY 1995 operating budget had a shortfall of about $45 million, and an audit revealed a $73 million shortfall in the self-insurance reserves. (Tr. 609-10.)

On September 26, 1996, after thirteen days as interim City Manager, Mr. Stierheim informed the Mayor and City Commissioners that the City would close out FY 1996 with a $19.4 million revenue shortfall, and that an incomplete analysis of the capital improvement budget showed serious problems. (Tr. 596; Div. Ex. 186A.) Mr. Stierheim's memorandum expressed frustration "as to how this situation could have progressed so far without disclosure," and he included the following conditions in a list of eighteen causes of the City's financial crisis:

Inadequate and insufficient financial reporting,
Inadequate and questionable auditing practices, both internal and external,
The manipulation and commingling of funds that should be segregated,
The depletion of necessary or required reserve accounts,
The issuance of bonds to meet operating requirements, and
The withholding of critical financial information that sheltered this crisis.

(Div. Ex. 186A.)

Dipak M. Parekh ("D. Parekh"), K. Parekh's brother, understood how the City financed its operations in 1994 and 1995. (Tr. 398-99.) D. Parekh worked in the City's Finance Department from 1984 through 1999. (Tr. 710.) From 1993 through 1995, D. Parekh was the City's Revenue Management Administrator, from 1995 through 1997 he was Deputy Director of the Finance Department, and from 1997 through 1999 he was Budget Director. [22] (Tr. 398-99, 710-11.) D. Parekh "walked [Mr. Stierheim] through" how the City disguised the projected $40.8 million deficit in its general fund balance at the end of FY 1995, by the following transfers into the general fund so that the fund showed a positive fiscal year-end balance of $26 million:[23] (Tr. 620-28, 679, 714-23; Div. Ex. 186B.)

<u>Amount Source</u>

$2.3 million a state grant
$8.8 million storm water capital reserve
$25.0 million pension bond proceeds
$9.7 million sale of City land
$21.0 million Florida Power & Light ("FP&L") bond proceeds

(Tr. 593-94, 624-28; Div. Ex. 178G at 2, Div. Ex. 186B.)

Mr. Stierheim organized thirteen task forces with executives from government and the private sector to analyze almost every facet of the City's government and to prepare a recovery plan for the City. (Tr. 598.) Mr. Stierheim found the performance of the City's internal auditor deficient so he accepted the auditor's resignation. (Tr. 602-03.) Mr. Stierheim recommended that the City fire Deloitte and sue the external auditor for damages. (Tr. 607, 678-79.) The City Commission voted to institute the lawsuit at an emergency meeting two days before a primary election. (Div. Ex. 192 at 153-155.) On November 4, 1997, the City initiated a civil action against Deloitte seeking over $86 million in damages alleging negligence, breach of contract, and breach of fiduciary duty in connection with audits of the City's Financial Statements for the fiscal years ended September 30, 1989, through September 30, 1995. <u>See City of Miami, Florida, vs. Deloitte & Touche, L.L.P., and Frank Paredes</u>, Case No. 97-25179-CA-10, Dade County Florida, 11th Judicial Circuit Court (Nov. 4, 1997). (Div. Exs. 10, 11.) As of June 2001, the civil suit was pending.

After two months of exhaustive efforts, Mr. Stierheim determined that the City's FY 1996 budget had a shortfall of $50 million in the general operating fund and a shortfall of $18 million in the capital budget. (Tr. 595-96.) In response to questions from the City's unions on the status of pension funds, Mr. Stierheim discovered that the City had only $2 or $3 million of the $72 million proceeds from the pension bond offering in December 1995, because it had: (1) used $25 million to fund the Gates Judgment in the City budget for FY 1995; (2) used $35 million to fund the Gates Judgment in the City budget for FY 1996; and (3) put $9.7 or $10 million into something else. (Tr. 593-94, 626; Div. Ex. 178 at 175.)

On December 3, 1996, the Governor of the State of Florida declared that the City was in a financial emergency. Eight days later he appointed a Financial Emergency Oversight Board ("Oversight Board") to oversee the City's finances. (Tr. 739-40; Div. Ex. 17 at 2.) The Oversight Board approved a five-year plan designed to achieve financial stability for the City by 2001. The Oversight Board has "continuous existence until three years after the City has produced two successive years of balanced operations and none of the statutory conditions for determining a local government financial emergency exist." (Div. Ex. 17 at 20.)

The City's Three Bond Offerings in Calendar Year 1995

The City made disclosure for each bond offering through an Official Statement that included:[24]

1. The City's 1994 Financial Statements.[25] (Tr. 379; Div. Ex. 189, Tab 8, Div. Ex. 190, Tab 10, Div. Ex. 191, Tab 29.)

2. A summary of the City's budget for FY 1995. (Div. Ex. 189, Tab 8 at 23, 25, Div. Ex. 190, Tab 10 at 16, 19, Div. Ex. 191, Tab 29 at 17, 20.)

3. A letter from Deloitte consenting to inclusion of the 1994 Financial Statements in the bond offering. On each occasion, the City entered an engagement letter and paid Deloitte a fee to use the City's 1994 Financial Statements in the Official Statement, and Deloitte prepared a consent letter that was required for the closing to occur.[26] (Tr. 665; Div. Ex. 66, Div. Ex. 177 at 108-12, 146.) The consent letter followed a "consent due diligence memorandum" that Deloitte prepared outlining actions it took to assure itself that no subsequent events occurred that had a material effect on the City's 1994 Financial Statements and therefore required no adjustment to the 1994 Financial Statements or disclosure in the Official Statements. (Div. Ex. 161 at 5-6, Div. Ex. 177 at 114-15.) As part of this process, Mr. Paredes inquired of City officials whether anything had changed that would have a bearing on the 1994 Financial Statements.[27] (Div. Ex. 177 at 117-18.)

The three bond issues were insured so that bondholders had an unconditional guaranty to full payment of principal and interest. (Div. Ex. 175 at 36.) The investors involved in the offerings had a high comfort level because the bonds were insured and assumed that the City's finances had received careful scrutiny. (Div. Ex. 183 at 81-83.) It appears that the City limited its disclosure for the same reasons.[28] (Tr. 244, 283-85.) According to Mr. Odio, [M]ost people don't read [the Official Statement], nobody reads this. They go by what the raters, that is Moody's, Standard & Poor's, saying that these bonds are safe to buy. By rating them AAA, they're a very good buy. Therefore, they wouldn't go reading this. Nobody does.

(Tr. 286.)

1. Sewer Bond Offering

On June 27, 1995, the City closed an offering in which it sold $22.5 million in general obligation, twenty-year bonds to finance sewer system improvements ("Sewer Bond Offering") pursuant to authorization passed on May 25, 1995.[29] (Tr. 460; Div. Ex. 189 at 1 and Tab 2.) The closing memorandum for the offering reported that the bonds were general obligations of the City payable from unlimited ad valorem taxes levied on all taxable property located in the City. The Sewer Bond Offering was a competitive or bid type offering and Merrill Lynch & Company, Inc. and Prudential Securities, Inc. were the underwriters.[30] (Tr. 655.) The City used many "highly paid" people to represent them. (Tr. 241-42.) A Miami law firm was bond counsel. The City attorney was shown as handling certain issues. Howard Gary and Raymond James participated as Financial Advisor to the City. (Div. Ex. 189, Tab 8.)

The City transferred $8.8 million or thirty-nine percent of the sewer bond proceeds into the general fund to address the revenue deficiency it faced in operating funds. (Tr. 719-20; Div. Ex. 186B.) The Official Statement for the Sewer Bond Offering did not state that the proceeds would be used for operating costs. According to the Official Statement, "The City Commission has approved the expenditure of funds for improvements and extensions to the sanitary sewer system of the City," and the total amount for the eleven sanitary sewer projects described was $22.5 million. (Div. Ex. 189, Tab 8 at 12.)

I conclude that a major purpose of the Sewer Bond Offering was to solve the deficits in the general fund. This is conformed by Mr. Paredes's remarks to Mr. Odio in June 1995, congratulating him on getting the City "off the hook," "turning the corner," and "saving the situation," in dealing with the City's cash crisis. (Tr. 226.) This conclusion is buttressed by the testimony of K. Parekh that Mr. Surana and other City officials appeared to calm down about the City's cash deficit crisis around May or June 1995, at about the time the City Commissioners approved the Sewer Bond Offering. (Tr. 459-62.)

2. Florida Power & Light Bond Offering

In August 1995, the City offered and sold $22 million in special obligation non-ad valorem revenue bonds in a negotiated offering pursuant to the July 13, 1995, authorization of the City Commission. (Tr. 655; Div. Ex. 190, Tab 2.) According to the Official Statement, the funds were to be used to purchase an FP&L property for $15.6 million; capital improvements at a specific site for $1 million; and acquisition of another FP&L building for $2 million. (Div. Ex. 190, Tab 10 at 3-4.) The City temporarily transferred $21 million of the bond proceeds into the general fund so that on September 30, 1995, the general fund had a $26 million balance.[31] (Tr. 198, 211-14, 627-28, 721-22; Div. 161 at 4, Div. Ex. 178 at 151-52, Div. Ex. 186B.)

William R. Hough & Co. and First Southwest Company were senior managing underwriters and WR Lazard, Laidlaw & Mead Inc. and Muriel Siebert & Co., Inc. were underwriters. A Miami law firm was bond counsel. The underwriters had two law firms located in Miami as co-counsel. The City attorney was shown as handling certain issues. Howard Gary and Raymond James participated as Financial Advisor to the City. (Div. Ex. 190, Tab 8.)

3. Pension Bond Offering/Gates Judgment

On July 13, 1995, the City adopted Resolution No. 95-564 that authorized the City Manager to issue bonds totaling $309 million.[32] (Tr. 499-503, 517.) The City's first offering pursuant to Resolution No. 95-564, was a negotiated offering of $72 million of revenue bonds: $62,135,000, taxable pension series 1995, and $9,865,000, taxable compensated absence series 1995. (Div. Ex. 191, Tab 14.) The Official Statement dated December 1, 1995, bears the designation $72 million Non-Ad Valorem Revenue Bonds and states that the purpose is to pay "all or part of the City's unfounded actuarial accrued and future liabilities to certain City pension plans and providing for the payment of all or part of the City's accumulated and future compensated absence liabilities, including reimbursing the City for payments made for Fiscal Year 1995." (Div. Ex. 178 at 68-70, Div. Ex. 191, Tab 29 at 2.) The offering closed on December 19, 1995. (Div. Ex. 191, Tab 8.)

Rauscher Pierce Refsnes, Inc. ("Rauscher") and Smith Barney Inc. were co-senior managing underwriters and three other firms were participating underwriters. (Div. Ex. 183 at 80, Div. Ex. 191, Tab 29.) A Miami law firm was bond counsel. Three firms were co-counsel to the underwriters.[33] The City attorney was shown as handling certain issues. Howard Gary and Raymond James participated as Financial Advisor to the City. (Div. Ex. 191, Tab 29.)

III. POSITIONS OF THE PARTIES

The Division

The Division alleges that the Official Statements for the three bond offerings and the City's 1994 CAFR made material misrepresentations as to why the City adopted "Operation Right Size," gave the false impression the City would finish FY 1995 in "better financial shape," and did not acknowledge that it was experiencing a severe cash flow crisis. (Div. Br. 41-42.)

The Division alleges that the City had a responsibility to disclose fully and accurately material changes to "Operation Right Size," which occurred after FY 1994 closed, because the City raised the subject in its 1994 CAFR. (Div. Br. at 1, n.1.)

The Division alleges that that the Official Statements materially misrepresented the City's 1995 budget. (Div. Br. 22, 42.) The Division also alleges antifraud violations in the bond offerings because the City falsely certified that its finances had not adversely changed and then used the 1994 Financial Statements in the bond offerings; and the City failed to disclose that the pension bond offering was a bailout of its cash flow crisis. (Div. Br. 20-22.)

The Division does not challenge the accuracy of the numeric figures in the City's 1994 Financial Statements and does not charge the City with misusing the bond proceeds.[34] (Tr. 185; Div. Br. at 7, n.11, Div. Reply 13.)

The City

The City argues that the Division has fixated improperly on its cash flow position during FY 1995 rather than its year-end results. It reasons that the gist of the Division's allegations is that the City did not disclose "adequately" its cash position during the fiscal year since the Division does not allege that the figures that the City presented in its 1994 Financial Statements were wrong. (Resp. Br. 2-3.)

The City contends that due to the constant flux between incoming revenue and outgoing expenses, the Division's focus on cash flows at any particular point in the fiscal year is inapposite. The City cites to three positive "going concern" inquiries that Deloitte made on September 21, 1994, March 13, 1995, and June 30, 1995, where it concluded that the City would continue as a going concern for the next fiscal year to support its position that it made adequate disclosure in the Official Statements. (Div. Ex. 4, Resp. Exs. 50, 69; Resp. Br. 2-3.) Furthermore, the City contends that it properly relied on its outside auditors, the underwriters, underwriters' counsel and bond counsel. (Resp. Br. 4.) Specifically, the City asserts that the underwriters were responsible for preparation of the Official Statements and due diligence of the City's 1994 Financial Statements. (Resp. Br. 4-5, 16-18.)

The City relies heavily on Deloitte's representations, expressed by Mr. Paredes, that the City made appropriate disclosure about its financial situation and "Operation Right Size" in its 1994 Financial Statements because City officials were making plans and instituting processes to remedy the financial crisis. There was no reason to state that the City was expected to be unable to meet its operating expenses because the City had the capacity to issue debt and sell assets to generate resources. (Resp. Br. 7-15.)

The City also denies that it failed to inform investors that pension bond proceeds would be used to pay a prior year's pension obligation and cites language on page one of the pension bond Official Statement that the purpose of the offering included "reimbursement to the City for payments made for fiscal year 1995." (Resp. Br. 15.)

IV. CONCLUSIONS OF LAW

Congress exempted offerings of municipal securities from the registration requirements and civil liability provisions of the Securities Act and the periodic reporting requirements of the Exchange Act. It did not, however, exempt municipal securities from Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act or Rule 10b-5, the antifraud provisions of those statutes. See Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, 56 SEC Docket 596, 597 (March 9, 1994). The antifraud provisions are used to determine whether in the offer or sale, or in connection with the purchase or sale, of municipal bonds, using the means of interstate commerce or the mail, a person employed any device, scheme or artifice to defraud, obtained money by means of an untrue statement or omission of a material fact needed to be stated so as not to mislead, or engaged in a transaction, practice, or course of business which operated or would operate as a fraud and deceit.

Considerable evidence in the record does not elucidate the issues. For example, Mr. Stierheim had a problem with the use of funds set aside as storm sewer reserves for operating expenses. (Tr. 626.) D. Parekh believed that money intended for capital sewer improvements should not be used to balance the operating budget. (Tr. 720.) Mr. Stierheim had a "serious problem" with the use of bond proceeds to pay pension costs because it created a continuing obligation to pay an annual operating obligation, and he found it "highly unusual" to put $25 million in an account after the books closed to show a positive closing balance. (Tr. 610-11.) Evidence about the responsibilities of accountants and auditors, and whether municipalities should pay operating expenses by issuing bonds and transferring funds from capital accounts do not address the single issue that is the basis for this proceeding.

Furthermore, the adequacy or inadequacy of Deloitte's audit of the City's 1994 Financial Statements is not the focus of this proceeding. In determining whether the City misled investors through the use of the CAFR and Official Statements, I need not and do not make any determination as to the adequacy of the 1994 Financial Statements in relation to GAAP or GAAS standards. The issue is not whether the material within the 1994 Financial Statements complies with these standards; the issue is whether the City made full and fair disclosure of material information through the 1994 CAFR and the three Official Statements to investors when it issued bonds. See SEC v. Caserta, 75 F.Supp.2d 79, 92 & n.2 (E.D.N.Y. 1999) (recognizing that an audit's compliance with GAAP and GAAS does not foreclose a finding that the same documents could be misleading to investors.)

The jurisdictional requirements for application of the antifraud provisions are present. The three bond offerings involved the offer and sale of securities. The City's 1994 CAFR was used in connection with the purchase or sale of securities as it was distributed to inform and influence the investing public. The City conducted both activities using the mails and instruments of interstate commerce. See SEC v. Softpoint, Inc., 958 F.Supp 846, 865 (S.D.N.Y. 1997), aff'd, 159 F.3d 1348 (2d Cir. 1998) (stating that these requirements "are broadly construed, so as to be satisfied by any activity connected with a national securities exchange, by intrastate telephone calls, and by even the most ancillary mailings"). Courts have also interpreted the phrase "in connection with," that appears in Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, broadly.[35] See Superintendent of Ins. of N.Y. v. Bankers Life and Cas. Co., 404 U.S. 6, 12 (1971); In re Ames Dep't Stores Inc. Stock Litig., 991 F.2d 953, 964-67 (2d Cir. 1993). In general, "fraud can be committed by any means of disseminating false information into the market on which a reasonable investor would rely." Ames Dep't Stores, 991 F.2d at 967; SEC v. Hasho, 784 F. Supp. 1059, 1106 (S.D.N.Y. 1992).

To violate Section 17(a)(1) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, the misrepresentation or omission must be material. The standard for materiality is whether or not there is a substantial likelihood that a reasonable investor or prospective investor would consider the information important in deciding whether or not to invest. See SEC v. Steadman, 967 F.2d 636, 643 (D.C. Cir. 1992); see also Basic, Inc. v. Levinson, 485 U.S. 224, 231-32, 240 (1988); TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). In determining whether an official statement released in connection with a bond issue was misleading, one court has articulated this standard as, "whether an investor who had been reasonably diligent in reviewing the Official Statement would have been misled." Durning v. First Boston Corp., 815 F.2d 1265, 1268 (9th Cir. 1987).

Also, a person must act with scienter. Scienter is defined as "a mental state embracing intent to deceive, manipulate, or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976). A showing of recklessness or actual knowledge can satisfy the scienter requirement.[36] See SEC v. Steadman, 967 F.2d at 641-42; David Disner, 52 S.E.C. 1217, 1222 & n.20 (1997). Recklessness is defined as "an extreme departure from the standards of ordinary care . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569-70 (9th Cir. 1990) (quoting Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977)); see also Meyer Blinder, 50 S.E.C. 1215, 1229-30 (1992).

The City is responsible for the acts of its City Manager and Finance Department officials, and the knowledge of these individuals is imputed to the City. See Will v. Mich. Dep't of State Police, 491 U.S. 58, 79 (1989) (Brennan, J., dissenting) (quoting Poindexter v Greenhow, 114 U.S. 270, 288 (1885)) ("The state is a political corporate body, can act only through agents, and can command only by laws."); Albiero v. City of Kankakee, 122 F.3d 417, 420 (7th Cir. 1977) ("A municipality acts only through agents.").

1. Did the City make material misrepresentations and omit material information in its 1994 CAFR and in three Official Statements?

Material change since 1994 Financial Statements closed

The latest financial information in the three offerings was the City's 1994 Financial Statements that showed a general fund balance of $3.167 million on September 30, 1994. (Div. Ex. 18 at 20-21, Div. Ex. 189, Tab 8 at C-5, Div. Ex. 190, Tab 10 at C-5, Div. Ex. 191, Tab 29 at C-5.) An integral part of each offering was a closing certification by the City Manager that "[s]ince September 30, 1994, no material adverse change has occurred in the financial position of the City," and that the information in the Official Statement is true and correct and does not as of the date the bonds issued-June 1995, August 1995, or December 1995-omit any material information. (Div. Ex. 189, Tab 5, Div. Ex. 190, Tab 4, Div. Ex. 191, Tab 8.)

As an issuer of securities the City was obliged to make full and fair disclosure of material information. See Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 378 F. Supp. 112, 122 (S.D.N.Y. 1974), aff'd in part, rev'd in part on other grounds, 540 F.2d 27 (2d Cir. 1976) ("Fair presentation is the touchstone for determining the adequacy of disclosure in financial statements. While adherence to [GAAP] is a tool to help achieve that end, it is not necessarily a guarantee of fairness.") Based on the facts in this record, the City Manager's certification that "[s]ince September 30, 1994, no material adverse change has occurred in the financial position of the City" was a blatant misrepresentation. (Div. Ex. 189, Tab 5, Div. Ex. 190, Tab 4, Div. Ex. 191, Tab 8.) The undisputed facts are that after September 30, 1994, City officials became aware that the City's finances were deteriorating significantly.

The City was in a crisis situation beginning in January 1995, when the City Manager, people in the Finance Department, the Financial Advisor, and Mr. Paredes at Deloitte concluded that the City could run out of cash and not meet payroll by May 1995. (Tr. 150, 161, 268.) This was the worst threat to City finances that Mr. Odio had faced in his fifteen years with the City, and from January 1995, his concern was "surviving through May" with the City under a "constant barrage" of financial problems. (Tr. 154, 242-43, 268-69.)

The City's position that it achieved a positive general fund balance in FY 1995 was true in the technical sense that it met payroll and paid its bills, but in reality, the general fund was in a deficit, in that, operating expenses were much greater than budgeted operating funds. (Resp. Br. 20 n.4.) D. Parekh knew in June 1995, that the City's general fund was not "on budget" and that it had a deficit of at least $12 million. (Tr. 760-64.) Mr. Paredes, who warned Mr. Odio in early 1995 that the City would run out of cash by May 1995, considered the City's finances to be in a difficult situation at the end of FY 1995. (Div. Ex. 178 at 84.) Mr. Stierheim concluded after careful analysis, that the City's financial situation in the summer of 1995:

had to be shaky, certainly because of the cannibalization, if you will, of storm water trust money, of unfunded liabilities, utilizing pension bond issue proceeds to meet annual budget requirements for the pension funds.

. . . .

So you've got clear indications of fiscal shortfalls and questionable accounting, official policy.

(Tr. 629.)

The expert opinions of Arthur R. Wyatt, CPA,[37] and Antonio L. Argiz, CPA,[38] are persuasive evidence that the City acted to mislead investors by withholding material information.[39] Mr. Wyatt opined that the City's representation that no material adverse changes had occurred subsequent to issuance of the 1994 Financial Statements was misleading if "events subsequent to September 30, 1994, led to any significant deterioration in the City's financial position or in its ability to balance its operating budget from its ongoing operating activities." (Div. Ex. 160 at 7-8.) As previously discussed, the evidence is that subsequent events did lead to significant deterioration. The City's cash flow situation worsened significantly after FY 1994 closed, and in FY 1995 the City had insufficient appropriated revenues in the general fund for operations. The City's general fund avoided a deficit at the end of FY 1995 only because it received $50 million in transfers from capital accounts and $21 million from bond proceeds. (Tr. 629, 719-21, 754-56; Div. Ex. 161 at 4, Div. Ex. 178G at 2, Div. Ex. 186B.) Mr. Argiz independently concluded that the Official Statements for the bond offerings did not represent the facts that existed when they were issued since the City knew at the time of the issues that it had severe cash flow problems that were not fully disclosed in the 1994 Financial Statements.[40] (Tr. 820-21, 837; Div. Ex. 161.)

I accept Mr. Wyatt's opinion rejecting the City's defense that Deloitte's clean audit opinion on its 1994 Financial Statements made disclosure of its cash flow crisis unnecessary. According to Mr. Wyatt, "[T]here can be a marked difference between having cash flow problems and having an ability to survive. Those two are not equal." (Tr. 864-870.) Mr. Argiz independently agreed that the fact that Deloitte issued a clean audit on the City's 1994 Financial Statements is not inconsistent with the allegations that the City acted illegally in the three bond offerings. (Tr. 849.)

The fact that the three Official Statements did not inform investors or potential investors of S&P's downgrade of the City's general obligation bonds on October 17, 1994, from A+ to A was a material omission. Mr. Odio and Mr. Surana recognized that this information was important because they included it in the letter to the Mayor and City Commissioners dated February 28, 1995, transmitting the City's 1994 Financial Statements. (Div. Ex. 18 at 8.) Inexplicably, the City did not make the same disclosure in the Official Statements for the bond offerings in June, August, and December 1995. The City should have given notice to investors and potential investors in its general obligation sewer bonds and non-ad valorem FP&L and pension bonds as there was a substantial likelihood that a person considering investing in these debt instruments would consider the information important in making an investment decision. Investors consider the evaluations that rating agencies give municipal securities important in making an investment decision. The fact that S&P downgraded the City's overall credit worthiness is significant to a reasonable investor considering any City debt offering. Mr. Wyatt's credentials justify significant reliance on his expert opinion that the City violated the accounting standard of full disclosure by failing to disclose that S&P lowered its general credit rating on October 17, 1994, after the close of the 1994 Financial Statements.[41] (Tr. 860-62; Div. Ex. 160 at 7.)

City's 1994 Financial Statements in the 1994 CAFR and the Official Statements

The Division alleges that the 1994 CAFR and the Official Statements for each of the offerings, which incorporated the City's 1994 Financial Statements, were materially misleading in that they: (1) misrepresented why "Operation Right Size" was initiated, (2) failed to disclose the City's cash flow crisis, and (3) gave the false impression that the City expected its financial condition to improve in FY 1995. (Div. Br. 6-9, 21, Div. Reply 3.) The Division alleges that the 1994 Financial Statements made the 1994 CAFR and the Official Statements materially misleading because Note 9:

failed to reveal that [Operation Right Size] was undertaken to address the City's grave cash crisis. Instead, it gave the misimpression that Operation Right Size was just an exercise in good government that would strengthen the City's financial position over and above FY 1994.

. . . .

The clear, but entirely erroneous, impression that Miami conveyed was that Operation Right Size would put the City in a stronger financial position than it was at the end of FY 1994. In truth, Miami knew that it would finish FY 1995 in far worse condition than the prior year. (Div. Br. at 6-7.)

Note 9 to the 1994 Financial Statements, titled Fund Equity, shows a substantial deficit of about $80 million in the City's enterprise funds and internal service funds. (Tr. 872; Div. Ex. 189, Tab 8 at B-33, Div. Ex. 190, Tab 10 at C-33, Div. Ex. 191, Tab 29 at C-33)

Note 9 states:

The following schedule lists fund deficits for Governmental and Trust and Agency type funds as of September 30, 1994 (in thousands):

Rescue Services Special Revenue ($285)
Self-Insurance Trust Fund ($6,472)
Pension Administration Trust Fund ($34)

In addition to the above fund deficits, the City also experienced cash deficits in several of its operating funds that were temporarily remedied by loans from other funds. See Note 5. It is management's intention to replenish these deficits and, accordingly, in February 1995, the City initiated a review process to "right size" its operations with the goal of reducing its fiscal year 95-96 budget by $30 million. As part of this initiative, significant concessions obtained from the sanitation union are expected to reduce the Solid Waste Department's fiscal year 95-96 budget by $10 million. In addition, several departments are being consolidated and certain operations not directly related to the City's basic services are expected to be discontinued by September 30, 1995. Early retirement plans have been agreed to in principle by the City's administration and union leadership with the purpose of reducing the City's work force by approximately 400 employees by September 30, 1995. The implementation of the proposals discussed above are expected to strengthen the City's financial condition.

(Div. Ex. 18 at 47, Div. Ex. 189, Tab 8 at B-33, Div. Ex. 190, Tab 10 at C-33, Div. Ex. 191, Tab 29 at C-33.)

The inclusion of Note 9 in the 1994 CAFR and the Offering Statements went beyond putting a favorable "spin" on unfavorable information. Note 9 is a misleading and fraudulent description of the condition of the City's "operating funds." A reasonable person reading Note 9 would conclude that cash deficits in the City's main operating fund were temporary and that "Operation Right Size" initiated in February 1995, would help "replenish these deficits," and "strengthen the City's financial condition." None of these statements were true. When the City released its 1994 Financial Statements in March 1995, it had suffered deficits in the general fund for several years and had been continually borrowing from other funds to cover those deficits. A Deloitte "going concern" work paper prepared on or before March 1995, reports the following:[42] (Div. Ex. 178 at 45.)

1. Because of significant decreases in available cash balances in its operating funds over the last several years, the City has "borrowed" money from capital project funds including unspent bond proceeds to finance operations during the last few months of each fiscal year. For the last 6 years, the City has issued Tax Anticipation Notes ("TAN") each October for the last six to finance operations until subsequent year tax revenues are collected in December. (Div. Ex. 178 at 41-42, Resp. Ex. 50 at Bates 02672.)

2. The City is $20 to $40 million behind in cash flow, and it appears that the City had overdrawn all its cash in November 1994, but Director of Finance said it received $11 million that was not reflected in the general ledger. Mr. Garcia indicated that cash had been as low as $8 million when monthly payroll cost was $6 million. (Div. Ex. 178 at 39-42, Resp. Ex. 50 at Bates 02673.)

3. The best-case scenario is that the City will have sufficient funds to get through September 1995. Worst-case scenario is that the City will have insufficient funds to operate and meet debt service expenditures for FY 1995. The City cannot issue a

TAN until October 1, 1995, so this would not be available. (Div. Ex. 178 at 45, Resp. Ex. 50 at Bates 02673-74.)

When the fieldwork for the 1994 audit closed, the City was searching for additional revenue sources to have enough cash to meet payroll in May 1995. "Operation Right Size" was just getting off the ground. There is nothing in this voluminous record that supports the representation in Note 9 that "Operation Right Size" would replenish the deficits in the operating funds and in other funds created by transfers to the general fund. In March 1995, Mr. Surana requested that the Financial Advisor devise a strategy for the City to raise funds quickly because the City expected to be unable to pay its employees "fairly soon." (Tr. 382-84; Div. Exs. 181O, 181P, 181Q.) On May 9, 1995, the Financial Advisor met with Mr. Surana and persons from the City's Finance Department including D. Parekh, Mr. Luney, and Mr. Chircut seeking remedies for the City's cash deficiencies.[43] (Tr. 387-88, 395-96, 399-401; Div. Ex. 181R, Div. Ex.181S.) Notes from the meeting show that "actual cash deficits have to be solved by mid-June." (Tr. 401; Div. Ex. 181R.) On June 9, 1995, City officials, met with union representatives, persons from Rauscher, an underwriter on the pension bond offering, and its Financial Advisor to deal with the City's well-known cash flow problem. (Tr. 406-09; Div. Ex. 181V.)

Note 9 in the 1994 CAFR and the Official Statements was also fraudulent in that it conveyed the impression that "Operation Right Size" was some new, extremely beneficial program. In fact, the City had implemented a similar early retirement program in 1993 that did not solve its financial problems. (Tr. 231, 736.) No one expected "Operation Right Size" to solve the anticipated deficit in FY 1995 of $35 to $40 million that Mr. Paredes warned Mr. Odio about in December 1994 or January 1995. The emergency meetings and union cooperation had positive results but savings in FY 1995 were expected to be only $5 million. Note 9 does not disclose that the City was expected to save $5 million from "Operation Right Size" in FY 1995. (Tr. 158-59, 737, 740-42, 753; Div. Ex. 1 ¶ 20, Resp. Ex. 50 at Bates 2675.) Inexplicably, Note 9 in the 1994 Financial Statements did not contain the sentence, "Management estimates that these programs will result in savings of approximately $5 million and $30 million in fiscal year's 1995 and 1996 respectively" that appeared in the City's February 28, 1995, letter to Deloitte. (Div. Ex. 1 ¶ 20.)

The expert opinions of Messrs. Argiz and Wyatt provide persuasive support that the City failed to disclose fully and fairly material information about "Operation Right Size" in the Official Statements of the three bond offerings. Mr. Argiz opined that the disclosure in each bond offering was inadequate because the Official Statements did not disclose the severity of the City's cash flow difficulties and the possible consequences. Mr. Argiz supports his conclusions with the following:

1. Use of the 1994 Financial Statements in the 1995 bond offerings provided insufficient information about the City's financial situation at the time of the offerings. (Div. Ex. 161 at 4.) The only disclosure of the City's cash deficits appeared in the transmittal letter to the 1994 CAFR and in Notes 5 and 9 to the City's 1994 Financial Statements. (Tr. 799.) The City made inadequate disclosure because it did not indicate "the severity of the City's cash flow difficulties." (Div. Ex. 161 at 3.) Investors and possible investors were "not informed of the pertinent conditions and events giving rise to the cash flow difficulties, the possible effects of those conditions and management's evaluation of those conditions." (Tr. 820-22; Div. Ex. 161 at 4.)

2. The City's disclosure did not reveal how the City would deal with its cash flow deficiencies as of September 30, 1995, inasmuch as the benefits of "Operation Right Size" occurred in FY 1996. (Tr. 821-22, 826-27; Div. Ex. 161 at 4.)

Mr. Wyatt considered it misleading for the City not to disclose that curing a cash deficiency was a major motivation for "Operation Right Size." (Tr. 861, 863.) He faulted the City for presenting "Operation Right Size" as a program to improve operating efficiencies and cash flow without any mention of the fact that one of the program's objectives was to achieve a balanced operating budget. (Div. Ex. 160 at 6-7.) Investors consider it important that an issuer of municipal securities have adequate fund balances in its general operating fund. (Div. Ex. 175 at 20-21.)

It is telling that after the City made the three bond offerings, it disclosed that it initiated "Operation Right Size" because it faced a budget deficiency of $26 million. (Div. Ex. 16 at 33; Div. Br. 7-8.) The Notes to the City's 1995 Financial Statements report that:

In fiscal 1995, the City had a net deficiency of revenues and other sources of approximately $26 million under appropriations. The deficiency resulted from receiving approximately $12.5 million less in planned revenues and incurring unplanned expenditures for police and fire overtime, claim payments, and other. The deficiency became apparent in February 1995 and the City immediately began the process of correcting the deficiency through several actions including workforce reductions, cost reductions[,] and operating efficiencies. The benefits of these measures are expected to reduce operating costs of the City by more than $36 million in 1996. In addition, the City Commission approved a bond program in July 1995 to finance the City's current and future pension contribution. On December 1, 1995[,] the City issued $62 million of Pension Bonds to fund approximately $25 million of fiscal 1995 pension contributions and approximately $37 million for future contributions.

(Div. Ex. 16 at 33.) The City acknowledges that the information was material by including it in its 1995 Financial Statements made public in March 1996. It should have disclosed the true reason it initiated "Operation Right Size" to investors and potential investors in the calendar year 1995 bond offerings.

Conclusion

For all the reasons stated, the City violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, in three bond offerings in calendar 1995. City officials knowingly and with the intention to mislead, manipulate, or defraud, falsely represented that no material changes had occurred in the financial condition of the City since issuance of the City's 1994 Financial Statements, which were the most recent financial information provided in the offering, and it provided false and misleading material information in the 1994 CAFR and Official Statements and omitted material information that should have been conveyed.[44] These misrepresentations were material because there is a substantial likelihood that a reasonable investor would consider the changes that occurred in the City's financial status important in making an investment decision and disclosure of accurate information would have significantly altered the total mix of available information. Basic, Inc., 485 U.S. at 231-32, 240; TSC Indus., Inc., 426 U.S. at 449.

2. Did the City falsely represent that it had a balanced budget for FY 1995 in the Official Statements? Did the City make sufficient disclosure in the Official Statement for the pension bonds that the pension bond proceeds would be transferred to the prior fiscal year?

Balanced budget representation

Florida law requires that the City have a balanced budget. (Tr. 146, 160, 192; Fla. Stat. Ann. § 166.241.) The City adopted an annual budget before the start of each fiscal year in a process that involved a submission to the City Commission by the Finance Department, public hearings, and subsequent monitoring. (Div. Ex. 18 at 32.) On September 8, 1994, when the City adopted the FY 1995 budget that was ostensibly balanced, Mr. Odio, Mr. Surana, and others in the Finance Department, knew it had a $12 million revenue deficit because it included $9 million in revenue from a federal crime bill grant that the City would not receive. (Tr. 148-49, 154-56, 270-71, 274, 725-32, 735, 749-50, 768; Div. Exs. 21, 176G, 176I, 176J.) The $9 million in revenue was necessary to achieve a balanced budget. (Div. Ex. 176K at 186-87.) The same reasoning caused the City to include $3 million in revenue from the sale of fine sand or fill. (Tr. 736-37.) In FY 1995, the City received $132,152 of the anticipated $9 million from the crime bill grant and no revenue from the anticipated $3 million from the sale of fill. (Div. Ex. 176M.)

Each of the Official Statements contained a summary of the City's 1995 budget. Each summary showed the general fund with balanced revenues and expenditures. (Div. Ex. 189, Tab 8 at 22-24, Div. Ex. 190, Tab 10 at 16-19, Div. Ex. 191, Tab 29 at 17-20.) The City did not disclose during the three bond offerings that it was not "on budget" or that revenues were inflated by $9 million it was not going to receive from a crime bill grant and $3 million it would not recover from the projected sale of fill. (Tr. 760-61.)

I find that the City, acting knowingly and with the intention to mislead, manipulate, or defraud, violated the antifraud provisions by representing in the Official Statements that it was operating under a balanced budget for FY 1995 when it knew the $222 million in projected general fund revenues was deficient by at least $12 million. The omitted information was material because reasonable investors consider it significant that a municipality issuing securities has a balanced budget. (Tr. 146, 723.) The blatantly false revenue projection contained in the City's 1995 budget was, by itself, material to investors, and its significance was increased by the City's long-standing inability to finance operations from general fund revenues. This conclusion is supported by the expert opinion of Mr. Wyatt that the financial information included with the bond offering circular was incomplete because the City failed to disclose that it would not receive $12 million it needed to balance its FY 1995 budget. (Div. Ex. 160 at 8.)

Use of pension bond proceeds

In FY 1995, the City experienced an appropriated revenue deficiency of approximately $26 million. (Resp. Ex. 60 at 2.) Pension expenses are operating costs payable from the City's general fund. (Tr. 573, 610-11.) Because it lacked funds to pay its FY 1995 pension cost, the City transferred $25 million, or 34.7 percent, of the $72 million proceeds from the pension bond offering in December 1995, to the general fund for the pension obligation due in FY 1995. The FY 1995 general fund balance would have been negative without the use of $25 million from the pension bond proceeds. (Tr. 204-05, 755-56; Div. Ex. 161 at 4, Div. Ex. 178 at 119, Div. Ex. 178G at 2, Div. Ex. 183 at 90-91.)

The Division alleges the Official Statement in the pension bond offering provided only "cryptic" information and charges that the City violated the antifraud provisions by not disclosing "the extent of the bailout, thereby hiding the magnitude of its continuing cash flow crisis." (Div. Br. 22, Div. Reply 5 n.4, 11 n.8.)

The pension bond Official Statement stated in the Introduction that the bonds were being issued for the purposes of:

providing for the payment of all or part of the City's unfunded actuarial accrued and future liabilities to certain City pension plans and providing for the payment of all or part of the City's accumulated and future compensated absence liabilities, including reimbursing the City for payments made in Fiscal Year 1995.

(Div. Ex. 191, Tab 29 at 2.) In the purpose section of the Official Statement, the City notes that:

Since 1985 the City has made its contributions to the Pension Plans, pursuant to litigation settlements with various unions, from funds derived from operating millage which has imposed and continues to impose an increasing strain on the City's operating budget. . . .

Accordingly, the City has determined to issue the 1995 Bonds and to apply a portion of the proceeds thereof to the discharge of all or part of the Unfunded Actuarial Accrued Liabilities and the future liabilities of the City to the Pension Plan with respect to the fiscal years ending September 1995 through 2008.

(Div. Ex. 191, Tab 29 at 5.)

In my judgment, the Division's position would impose too stringent a standard on an issuer. I find that the City did not violate the antifraud provisions because a reasonable investor would know from the City's disclosure in the pension bond Official Statement that a portion of the proceeds would be used to pay a pension liability for the fiscal year ended September 30, 1995.

3. City's Defenses

I find the City's position that the Division's "snapshot" methodology caused it to focus inappropriately on the City's financial status at a single point in the year rather than at year-end results off-base because the issue here is whether the City committed fraud in failing to disclose material information about its financial status when it offered and sold bonds in June 1995, in August 1995, and in December 1995. (Resp. Br. 2, 13, 20, 22, 34.)

I reject the City's argument that it is not liable because it acted in good faith and followed the advice of many well-respected and well-paid firms in accomplishing each of the bond offerings and in incorporating the 1994 Financial Statements into the Official Statements. (Tr. 244; Div. Ex. 183 at 73, Div. Ex. 192 at 34; Resp. Br. 20, 32-33.) As a matter of law, the City as the issuer, not the auditors, had ultimate responsibility for making full and fair disclosure of material matters in the three Official Statements and its 1994 Financial Statements. (Tr. 581; 840-41, 875; Div. Ex. 160 at 4-5, Div. Ex. 161 at 4-5.) The City was responsible for the contents of notes to its 1994 Financial Statements and it made no difference who drafted the language. (Tr. 875.) The expert testimony is that with respect to auditors, "For at least forty years (and undoubtedly longer) the authoritative auditing literature has clearly specified that the primary responsibility for the fairness of presentation of financial statements and the related financial information lies with the management of the reporting entity." (Div. Ex. 160 at 4.) The rationale for this black letter rule is that the reporting entity has the best information. (Div. Ex. 160 at 4.) The City acknowledged that it carried this responsibility on three separate occasions in connection with the FY 1994 audit: (1) in the letter from Deloitte that Mr. Odio signed on November 22, 1994, (2) in the representation letter the City sent to the auditors dated February 28, 1995, and (3) in the letter from Mr. Odio and Mr. Surana transmitting the 1994 CAFR to the Mayor and City Commissioners dated February 28, 1995. (Div. Exs. 1, 18, 42.)

I reject the City's claim that it cannot be found to have acted with scienter because the federal courts have recognized good faith reliance on the advice of an accountant as a defense to scienter in a securities fraud action, and it followed Deloitte's advice.[45] See Caserta, 75 F. Supp. 2d at 94; SEC v. Goldfield Deep Mines Co., 758 F.2d 459, 467 (9th Cir. 1985).

To establish a good faith reliance defense based on the advice of an accountant or an attorney, one must show that she (1) made complete disclosure, (2) sought the advice as to the appropriateness of the challenged conduct, (3) received advice that the conduct was appropriate, and (4) relied on the advice in good faith. See Caserta, 75 F. Supp. 2d at 94; John Thomas Gabriel, 51 S.E.C. 1285, 1292 (1994), aff'd, 60 F.3d 812 (2d Cir. 1995) (Table). The City has not satisfied those elements. First, when it made the three bond offerings and when it distributed its 1994 CAFR, the City did not ask for, receive, or rely on advice from Deloitte as to whether its financial status had changed materially from what was shown in its 1994 Financial Statements dated February 28, 1995. To the contrary, Deloitte asked for, received, and relied on information from the City in preparing its consent letter for the three offerings. Mr. Paredes called the Finance Department and in response to his inquiry was told that nothing had happened that would have a material bearing on the City's 1994 Financial Statements. (Div. Ex. 177 at 117-18.)

Most important, when it took these actions in late March, June, August, and December 1995, the City knew that the information it was providing investors and potential investors did not fully and accurately describe its financial situation at those particular times. It is well-settled case law that a person cannot claim reliance on another when the person knowingly makes fraudulent statements and intentionally omits information about material subjects. The holding of the 7th Circuit sitting en banc in United States v. Erickson, 601 F.2d 296, 305 (7th Cir. 1979) (citations omitted) is applicable to these facts:

Although certified by accountants as prepared in accordance with [GAAP], the financial statements are nevertheless the representations of management. If a company officer knows that the financial statements are false or misleading and yet proceeds to file them, the willingness of an accountant to give an unqualified opinion with respect to them does not negative the existence of the requisite intent or establish good faith reliance.

See also Goldfield Deep Mines Co., 758 F.2d at 467; United States v. Colasurdo, 453 F.2d 585, 594 (2d Cir. 1971).

IV. CEASE AND DESIST

The Division urges the imposition of a cease and desist order inasmuch as the City's actions were deliberate, egregious, premeditated, and recurrent. It argues that a cease and desist order is needed because the Oversight Board will cease to oversee the City's finances in another year, and that the City has not recognized its wrongful actions or given any assurances against future violations. The Division concludes that the evidence satisfies the "reasonable likelihood" of future violations standard. (Div. Reply 23-25.)

The City maintains that a cease and desist order is inappropriate because: (1) it did not commit the alleged violations since it followed Deloitte's advice, and (2) the Division failed to make the required showing that it will likely violate the securities laws in the future. (Resp. Br. 30-36.)

Section 8A of the Securities Act and Section 21C of the Exchange Act authorize the Commission to order a person to cease and desist from committing any present or future violations where the Commission, after notice and hearing, finds that a violation of the statutes occurred.[46] The Commission's latest guidance on when such an order is appropriate is found in KPMG Peat Marwick LLP, 74 S.E.C. Docket 384, 436 (Jan. 19, 2001), appeal filed, D.C. Cir., No. 01-1131 (footnote omitted).

Along with the risk of future violations, we will continue to consider our traditional factors in determining whether a cease-and-desist order is an appropriate sanction based on the entire record. Many of these factors are akin to those used by courts in determining whether injunctions are appropriate, including the seriousness of the violation, the isolated or recurrent nature of the violation, the respondent's state of mind, the sincerity of the respondent's assurances against future violations, the respondent's recognition of the wrongful nature of his or her conduct, and the respondent's opportunity to commit future violations. In addition, we consider whether the violation is recent, the degree of harm to investors or the marketplace resulting from the violation, and the remedial function to be served by the cease-and-desist order in the context of any other sanctions being sought in the same proceedings. This inquiry is a flexible one and no one factor is dispositive. This inquiry is undertaken not to determine whether there is a "reasonable likelihood" of future violations but to guide our discretion.

See also Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979), aff,d on other grounds, 450 U.S. 91 (1981).

An objective consideration of the evidence indicates that a cease and desist order is necessary to protect investors. The violations involved conduct by top City officials intended to mislead the public about material information concerning the status of the City's finances in the offer and sale of bonds totaling approximately $116.5 million. The illegal actions were repeated on three occasions over a six-month period. The City's attitude that disclosure was not important because no one reads the Official Statement when the bonds are insured, and that regardless of what the 1994 Financial Statements showed, "people in the business" understood what was going on does not engender confidence in the City's future conduct. (Tr. 202, 243.) Even though the key people involved in these events are no longer with the City, the problems appear to be systemic since there is no evidence that the City is willing to acknowledge, or is even willing to consider, that that the City broke the law. Unfortunately, this evidentiary record does not support Mr. Stierheim's belief that the City is "on the road to recovery." (Tr. 661.)

V. RECORD CERTIFICATION

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), I certify that the record includes the items described in the record index issued by the Secretary of the Commission on April 5, 2001.

VI. ORDER

Based on the findings and conclusions set forth above:

I ORDER, pursuant to Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934, that the City of Miami, Florida shall cease and desist from committing any violations or any future violations of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder.

This order shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that rule, a petition for review of this initial decision may be filed within twenty-one days after service of the decision. It shall become the final decision of the Commission as to each party who has not filed a petition for review pursuant to Rule 360(d)(1) within twenty-one days after service of the initial decision upon such party, unless the Commission, pursuant to Rule 360(b)(1), determines on its own initiative to review this initial decision as to any party. If a party timely files a petition for review, or the Commission acts to review as to a party, the initial decision shall not become final as to that party.

By the Commission
Brenda P. Murray
Chief Administrative Law Judge

Footnotes

[1] I accepted the unopposed amendment at the prehearing conference on November 1, 1999, pursuant to Rule 200(d)(2) of the Commission's Rules of Practice, 17 C.F.R. § 201.200(d)(2). (Prehearing Transcript 15-16.)

[2] "(Tr. __.)" refers to the transcript of the hearing. I will refer to Division and Respondent exhibits as "(Div. Ex. __.)," and "(Resp. Ex. __.)," respectively. "(Ans. at ¶__.)" refers to Respondent City of Miami's Answer, Defenses and Affirmative Defenses.

[3] I will refer to the Division's initial posthearing filing as "(Div. Br.__.)"; the Respondent's initial posthearing filing as "(Resp. Br.__.)"; and the Division's second posthearing filing as "(Div. Reply __.)."

[4] An official statement is the "financial disclosure by a state or local government planning a municipal securities offering that states the purpose for the issue and how investors will be repaid. The official statement also discloses pertinent information on the issuer's financial condition." Barron's Dictionary of Banking Terms, 325 (3rd ed. 1997). It is also described as "the municipal equivalent of a [corporate] prospectus" which is a "formal written offer to sell securities that sets forth . . . the facts concerning an existing [business enterprise] that an investor needs to make an informed decision." Barron's Dictionary of Finance and Investment Terms, 294, 382, 445 (4th ed. 1995).

[5] In September 1994, Stephen P. Clark was Mayor, Miller J. Dawkins was Vice-Mayor and Wifredo Gort, Victor De Yurre, and J.L. Plummer, Jr., were City Commissioners. (Div. Ex. 176K at 172.)

[6] Mr. Surana was not an accountant. (Tr. 252.) In 1997, the consolidation was reversed. (Tr. 712.)

[7] The duties included reviewing and evaluating the City's financial condition, policies and plans; developing a financial plan; dealing with rating agencies; and preparing for bond sales. (Div. Ex. 181E.)

[8] In 1998, K. Parekh paid a sanction of $2,500 and agreed not to associate with any National Association of Securities Dealers ("NASD") member firm for ninety days to settle an NASD complaint. (Tr. 290-91.)

[9] The 1994 CAFR shows a $27,490 contribution to pension funds. (Div. Ex. 18 at 23.)

[10] The record does not explain why the sum of the accumulated deficit in FY 1993 and the deficit for FY 1994 and FY 1995 does not equal the accumulated deficits in FY 1994 and FY 1995 as shown in the Financial Statements for those years. (Div. Ex. 16 at 48, Div. Ex. 18 at 47.)

[11] However, the Financial Advisor raised "continuing concerns" in letters to Mr. Surana in November 1995, and January 1996. (Div. Exs. 182M, 182T.)

[12] I accept the representation by the Division's expert witness that the Statements on Auditing Standards set the date of the last day of fieldwork as the date of the audit report. (Tr. 807-08.) See Statements on Auditing Standards, No.1, § 530.

[13] The record does not explain the discrepancy between the considerable persuasive evidence that the City received the audit results in March 1995, and the belief of Francisco J. Paredes, the Deloitte partner who supervised the City's audits for several

years, that the audit report was issued to the City in late May 1995. (Div. Ex. 178 at 85-86.)

[14] Only City Commissioner Gort was present because the "Sunshine" law would have applied if more than one City Commissioner attended the meeting. (Tr. 162.) Despite attending the meetings, City Commissioner Gort testified he did not know that the City's effort to cut $30 million in costs was because Deloitte had warned of imminent cash shortages. (Div. Ex. 192 at 121-22, 127-29.)

[15] The Florida Constitution permitted the City to levy ad valorem taxes up to $10 per one thousand dollars of assessed valuation for general governmental services. For the fiscal year ending September 30, 1995, the rate was $9.5995 per one thousand dollars. (Div. Ex. 190, Tab 10 at 14.) The City had a tax rate at this level since 1988. (Div. Ex. 181J.)

[16] The City had implemented a similar retirement program in 1993 that did not solve its financial problems. (Tr. 231, 736.)

[17] Section 218.503 of the Florida Statutes Annotated, titled "Determination of financial emergency," describes a number of conditions that indicate a local government entity is in a state of financial emergency. These include when it fails to pay employees for one pay period due to lack of funds, and when it has a total fund balance deficit for which it does not have sufficient resources for two consecutive years. (Div. Ex. 178 at 110-12.)

[18] The governing body of each municipality "shall make appropriations for each fiscal year which, in any one year, shall not exceed the amount to be received from taxation or other revenue sources." Fla. Stat. Ann. § 166.241(3) (as written prior to 1996 amendment).

[19] According to City's expert, Paul Munter, Accounting Department Chairman and KPMG Professor of Accounting, School of Business Administration, University of Miami:

[P]reparation of financial statements in accordance with generally accepted accounting principles (GAAP) is based on the assumption of continued existence. Because the going concern concept is fundamental to financial reporting in accordance with GAAP, the auditor has a responsibility to evaluate the appropriateness of that assumption when conducting the audit engagement in accordance with generally accepted auditing standards (GAAS).

. . . .

Because going concern is embedded in the financial reporting process, the auditor has a responsibility, in accordance with [Statement on Auditing Standards] SAS No. 59, to make an evaluation of the entity's ability to continue as a going concern. . . . SAS No. 59 requires that the auditor evaluate the entity's ability to continue for a reasonable time - which is not to exceed one year from the financial statement date. However, the auditor has a responsibility to consider all matters which are presented up to the conclusion of the audit field work.

(Resp. Ex. 70 at 2.)

[20] Mr. Stierheim earned an undergraduate degree in commerce and finance and a master in government administration from the Wharton School of the University of Pennsylvania. Mr. Steirheim worked for the City early in his career. He was the City Manager of Clearwater, Florida, from 1967 to 1973, Administrator of Pinellas County from 1973 to 1976 and Manager of Miami-Dade County from 1976 to 1986. From 1986 to 1990, he headed Women's Professional Tennis Worldwide, and from 1990 to 1998 he was Director of the Greater Miami Convention and Visitors Bureau. When he testified in March 2000, Mr. Stierheim had been Manager of Miami-Dade County since 1998. (Tr. 588-91, 594.)

[21] City Commissioner Gort could not recall, or was unaware of, these deficiencies when they occurred in 1993 and 1994. (Div. Ex. 192 at 71-72, 80-96.) Mr. Gort's lack of knowledge is difficult to reconcile with his professional accomplishments, and the fact that he was the City Commissioner who was interested in finance. (Tr. 162.) In 1994, Mr. Gort was a majority owner and principal of AIBC Investment Services, a registered broker-dealer that dealt in municipal bonds. (Div. Ex. 192 at 6-9.) Mr. Gort earned several securities licenses, including municipal securities principal. (Div. Ex. 192 at 10-11, 20.) Prior to his election as a City Commissioner, Mr. Gort's firm participated as an underwriter in two or three security offerings by the City. (Div. Ex. 192 at 20.)

[22] D. Parekh has two bachelor's degrees from Middlesex University in London, and a master of science degree from the London School of Economics. (Tr. 710.)

[23] D. Parekh had worked closely with Mr. Surana, but Mr. Stierheim concluded that D. Parekh recognized the change in leadership and found D. Parekh honest and knowledgeable. (Tr. 624.) In his final report to the Mayor and City Commissioners, Mr. Stierheim extended appreciation to D. Parekh, Phil Luney, and Pete Chircut of the City's Finance Department "who consistently went above and beyond to research and assist in documenting what went wrong and helping me determine how we might proceed." (Div. Ex. 107 at 23.) Mr. Stierheim's notes written in 1996 indicate, "This is how the City Auditor told Surana and Dipak to close out the 1994/95 books so as to have a positive fund balance." (Tr. 609; Div. Ex. 186B.) However, D. Parekh denied meeting with the auditors in order to close out the City's year-end figures for FY 1995. (Tr. 715, 767-68.) D. Parekh was a credible witness. There is no explanation for the discrepancy in the evidence.

[24] The closing documentation also included a statement by the City that it had no knowledge that the Official Statement was incomplete or omitted any material facts. (Div. Ex. 189, Tab 18, Div. Ex. 190, Tab 24, Div. Ex. 191, Tab 29 at 41.)

[25] Since all municipalities end their fiscal year on September 30, it was not unusual for the offerings to use audited financial statements for a period that ended up to fourteen months before. (Div. Ex. 183 at 84.) The City did not issue interim financial statements. (Tr. 274, 276, 379.)

[26] The three Official Statements contain wording very similar to the following:

We agree to the inclusion in the Official Statement for the City of Miami, Florida . . . of our report dated February 28, 1995, appearing in [the] Appendix of such Official

Statement. We also agree to the reference to us under the heading "Financial Statements" in such Official Statement.

(Div. Ex. 189, Tab 25, Div. Ex. 190, Tab 40, Div. Ex. 191, Tab 23.)

[27] Mr. Paredes spoke with Mr. Surana, Mr. Chircut, or Mr. Luney. (Div. Ex. 177 at 117.)

[28] Mr. Odio stated, "I had no idea you have to disclose everything." (Tr. 244.)

[29] A general obligation bond is supported by the general full faith and credit of the issuer, while a non-ad valorem bond is supported by a specified revenue stream. (Div. Ex. 175 at 14, 40, Div. Ex. 178 at 64-65.) For example, the legally available non-ad valorem revenues for the FP&L bond offering were from the General Fund, Public Service Taxes, Orange Bowl Stadium, Convention Center and Exhibition Center, Marinas, Golf Courses, Parking Garage, Building & Zoning, and Solid Waste. (Div. Ex. 190, Tab 40.) The courts can compel the issuer of general obligation bonds to raise taxes to pay debt service on the bonds. (Div. Ex. 175 at 14.)

[30] Under a bid process, the winning bid becomes the purchaser and underwriter for the bonds. (Tr. 654-55.)

[31] Mr. Odio admitted that the $26 million general fund entry could mislead someone who was not familiar with the Financial Statements, but he insisted that anyone in the business would know the source of the $21 million transfer. For example, Moody's knew that the money originated from the proceeds of the FP&L bonds. (Tr. 201-02.)

[32] Resolution No. 95-564 specified that every year for a period of fifteen years, the City Manager could issue $15 million and $7 million, respectively, in revenue bonds to pay certain pension obligations and compensated absence (sick leave) costs. However, the annual amounts could be increased by the authorized amount times the number of years remaining. It was unusual for elected officials to delegate this significant responsibility to staff and to capitalize pension and sick leave costs. (Tr. 505.) Both of these expenses had been paid from the City's general fund. (Tr. 505-06.)

[33] According to one bond counsel involved in the pension bond offering, only one bond counsel and one underwriter's counsel were needed. When there is more than one, the reason is usually political. (Div. Ex. 183 at 72.) One explanation for three underwriters counsel is that "like everything else in South Florida, they were spreading the work around for political reasons." (Div. Ex. 183 at 71-72.)

[34] KPMG, LLP, the auditors who replaced Deloitte, did not have the City restate its prior- year Financial Statements, and issued an unqualified report of the City's 1996 Financial Statements. (Div. Ex. 160 at 6.) Based on these facts, the Division's expert, Arthur Wyatt, opined that "it is fair to conclude that the 1995 and 1994 (as well as prior years in question) Financial Statements as reported on by Deloitte had, in fact, contained accurate dollar amounts, used an appropriate reporting format and were not, as alleged by City of Miami management, misleading." (Div. Ex. 160 at 6.)

[35] The City does not dispute the applicability of these statutory provisions to these facts.

[36] Scienter is not required to establish a violation of Section 17(a)(2) or (3); a finding of negligence is adequate. See Jay Houston Meadows, 52 S.E.C. 778, 785 n.16 (1996); see also Steadman, 967 F.2d at 643 n.5 (citing Aaron v. SEC, 446 U.S. 680, 701-02 (1980)); Newcome v. Esrey, 862 F.2d 1099, 1102 n.7 (4th Cir. 1988).

[37] Mr. Wyatt earned a bachelor's degree, a master of science, and a doctorate in accountancy from the University of Illinois where he taught from 1949 to 1966, the year he joined Arthur Andersen & Co. ("Andersen"). In the course of his career with Andersen, Mr. Wyatt became a partner and chaired the accounting principles group. From 1975 to 1979, Mr. Wyatt was a member of the executive committee of the American Institute of Certified Public Accountants ("AICPA"), and he chaired the AICPA's executive committee in 1977 through 1979. Mr. Wyatt left Andersen to become a member of the Financial Accounting Standards Board from January 1, 1984, until October 31, 1987. From 1988 until 1992, Mr. Wyatt was the AICPA representative on the International Accounting Standards Committee in London. Following his retirement from Andersen in 1992, Mr. Wyatt became an adjunct professor at the University of Illinois. Mr. Wyatt has authored, co-authored, and edited five books and some fifty-seven articles on accounting. (Div. Ex. 160.)

[38] Mr. Argiz, a graduate of Florida International University, is a managing shareholder at Morrison, Brown, Argiz & Co., CPA, a public accounting firm and a member of the AICPA. Mr. Argiz, an audit and litigation support partner, heads the firm's dealership division. (Div. Ex. 161 at 1, 7.) Mr. Argiz has served on the governing body of the AICPA and has chaired the Florida Board of Accountancy and its Probable Cause Panel. Mr. Argiz has also served on the Board of Governors and as chairman of the Audit and Legislative Committee for the Florida Institute of Certified Public Accountants. (Div. Ex. 161 at 1, 7.) Mr. Argiz has conducted seminars and lectures and has published articles on accounting, auditing, and fraud prevention, and has testified as an expert in over thirty cases. (Div. Ex. 161.)

[39] I reject the City's dismissal of the experts' opinions. The City contends that both experts have not done municipal accounting, have not participated in a municipal offering, and are not current in the continuing education requirements needed to audit a municipality. (Tr. 771-73, 852-53; Resp. Br. 27-28.) The experts demonstrated familiarity with Government Accounting Standards Board ("GASB"). I accept Mr. Wyatt's position that GASB could not require less than GAAS and GAAP. (Tr. 855.) I accept Mr. Argiz's position that he has reviewed the accounting literature and nothing in GASB would change his position. (Tr. 775-77.)

[40] Mr. Argiz's opinion is based on the following assumptions which the evidence shows to be true: (1) after December 1994, the City was experiencing cash flow deficiencies and it expected these deficiencies to last through FY 1995 unless it reduced expenditures significantly or increased revenues; (2) when the City released its 1994 CAFR, the City had no assurance that the actions it planned would cure its cash flow deficiencies; and (3) if the City continued on course, it may have been in a position where it would not have sufficient funds to pay its obligations. (Tr. 819-22; Div. Ex. 161 at 2.)

[41] K. Parekh, a non-expert, believed that disclosure, if required, would only be for the general obligation bonds (sewer bonds). (Tr. 373-75.)

[42] An auditor must make a "going concern" determination in every audit. (Tr. 784.) See Statements on Auditing Standards, No. 59.

[43] The idea for the pension bond issue arose at this meeting. (Tr. 405.)

[44] Mr. Odio did not read what he signed, but there is nothing that indicates he did not realize the significance of the documentation and the importance of his actions as City Manager in issuing the bonds. (Tr. 168, 189-90.)

[45] The City is wrong that it should prevail because the Division did not produce evidence to refute the City's defense. The Division's witnesses addressed this issue.

[46] Under Section 2(a)(2) of the Securities Act, a "person" is defined to include a "government or political subdivision thereof," and under Section 3(a)(9) of the Exchange Act, a "person" is defined to include a "government, or political subdivision, agency, or instrumentality of a government."

In the Matter of the City of Miami, Florida, Securities Act Release No. 8213, Exchange Act Release No. 47552, A.P. File No. 3-10022 (March 21, 2003).

APPEARANCES:	Thomas Tew, and Daniel S. Newman of Tew Cardenas Rebak Kellogg Lehman DeMaria Tague Raymond & Levine, LLP, for the City of Miami, Florida.
	Teresa J. Verges, for the Division of Enforcement.
Appeal filed:	October 16, 2001
Last brief received:	December 10, 2001

I.

The City of Miami, Florida ("City"or "Miami") appeals from the decision of an administrative law judge. The law judge found that the City willfully violated Section 17(a) of the Securities Act of 1933,[1] Section 10(b) of the Securities Exchange Act of 1934,[2] and Exchange Act Rule 10b-5[3] with respect to its offer and sale of three municipal bond issues. The law judge ordered the City to cease and desist from committing or causing any violation or any future violation of the antifraud provisions. We base our findings on an independent review of the record, except with respect to those findings that are not challenged on appeal.[4]

II.

A. The City

During the period under review, the City had an annual budget of approximately $250 million and about 3,300 employees. The City had an elected City Commission form of government, consisting of the Mayor, Vice Mayor, and three Commissioners. The City Commission delegated the responsibility for the day-to-day management of the City's affairs to a City Manager, appointed by the Mayor. The City Manager had responsibility for all City departments and supervision of all City employees.

Cesar Odio was the City Manager from 1985 until his resignation in September 1996. At the time, Manohar Surana was the City's Director of Management and Budget.[5] In February1995, when Carlos E. Garcia retired as the City's Director of Finance, Odio consolidated the Departments of Finance and of Management and Budget and named Surana Director. Although not an accountant, Surana was directly responsible for preparation of the City's fiscal year ("FY") 1995 financial statements and the FY 1995 budget.

B. Miami's Financial Reporting

Miami's fiscal year began on October 1 and ended on September 30 the following year (e.g., the City's FY 1995 began on October 1, 1994 and ended on September 30, 1995). The largest component of the City's operating budget was the General Fund. The General Fund accounted for most of the City's core activities, such as the fire and police departments. Miami also maintained a series of separate funds. The Enterprise Funds recorded the operations that were supposed to be financed through the collection of user fees. The Internal Service Funds accounted for goods or services provided by one department or agency to another. The Capital Projects Funds accounted for the acquisition and construction of major capital facilities. During the period under review, Miami used "pooled accounting," that is, the City deposited cash for all funds in one account. No records were maintained to identify the amount of cash belonging to each fund.

C. The Gates Judgment

Further complicating the City's finances was a 1985 consent decree, the so-called "Gates Judgment," requiring Miami to repay money transferred from City pension funds. The City's obligation under the Gates Judgment was projected to total $473 million through 2012. Payments under the Gates Judgment and other annual pension payments totaled approximately $32 million per year. The City made these payments from the General Fund. Odio testified that in 1985, his first year as City Manager, he calculated that, unless the Gates Judgment was refinanced, by the mid-1990s Miami would face a fiscal crisis and experience a $66.5 million deficit.

D. Miami's FY 1994 - 1995 Financial Condition

1. The FY 1995 Budget

Under Florida law, Miami's annual budget was required to be balanced.[6] The City had sustained deficits in the General Fund for several years and had borrowed from other funds to satisfy operating expenses. The record demonstrates that, by the end of FY 1994, Miami's ongoing financial problems were well known to City officials.

On September 22, 1994, Miami's City Commission approved a $222 million budget for FY 1995.[7] This budget included $9 million dollars that were to come from the federal government in the form of a Crime Bill grant and $3 million in revenue to be generated from the sale of land fill. Earlier that month, City officials and City Commissioners had been informed that Miami should expect to receive the Crime Bill funds "starting in FY 1996." On September 21, 1994, the day before the budget was approved, Surana sent a memo to the City's Police Chief, with a copy to Odio, stating that program authorization for the Crime Bill would not begin until 1996.[8] Dipak Parekh ("D. Parekh"), the City's then Revenue Management Administrator who drafted the memo, testified that he gave this information to Odio. D. Parekh further testified that prior to the first bond offering, there was "no basis to believe that the City would ever get that $9 million."[9]

2. <u>Financial Advisers Warn Miami Of A Deficit</u>

Miami retained two financial advisers: Howard Gary & Company ("HG & Co.") and Raymond James & Associates, Inc., ("Raymond James"). Kishor Parekh ("K. Parekh"), a partner of HG & Co. and D. Parekh's brother, was the HG & Co. primary contact with Miami.[10] By letter dated September 30, 1994, addressed to Garcia, then Director of Finance, the financial advisers warned Miami that "the City's general credit rating will experience a downgrade in the near future." The letter highlighted Miami's "low level of unreserved General Fund balances, the City's reliance on non-recurring revenue initiatives, asset sales, basic infrastructure maintenance needs, as well as the City's overall revenue inflexibility." The financial advisers believed that Miami's fiscal health was approaching a "precarious situation."[11]

According to K. Parekh, Garcia chastised him for sending the letter and instructed that in the future any similar concerns should be raised only orally. Less than three weeks following the financial advisers' warning, Standard & Poor's ("S & P") downgraded Miami's outstanding general obligation bonds from A+ to A. S & P cited "continuing fiscal stress arising primarily from revenue inflexibility, which has caused the City to utilize nonrecurring sources to support operations."[12]

3. <u>Auditor Tells Miami That It Will Run Out Of Cash</u>

Deloitte & Touche, LLP ("Deloitte") was Miami's outside auditor from 1989 through 1995. Francisco Paredes was the partner who supervised the City's account for FY 1994 and FY 1995. During the FY 1994 audit, Deloitte determined that Miami faced a potential shortfall of $35 - $40 million for FY 1995, and that the City could run out of cash by May 1995. During a meeting in December 1994 or early January 1995, Paredes informed Garcia and Odio of Miami's cash flow problems. This conversation alerted Odio to the increased seriousness of the City's cash flow deficiency because it was the first time that Paredes had ever discussed Miami's finances directly with him.

4. <u>Operation Right Size</u>

Shortly after being confronted with Deloitte's warnings, Odio, Surana, Paredes, one of the City's Commissioners, and representatives of "all the City staff" met at the Orange Bowl to discuss the $35-$40 million deficit projected by Deloitte. Odio testified that those in attendance did not consider increasing taxes or service fees to raise needed revenue because they knew that the City Commission had rejected this option in the past for "political reasons."[13] Following the Orange Bowl meeting, Miami initiated a program called Operation Right Size, which required every city department to review its budget for possible savings, according to Odio to "salvage the situation." Operation Right Size, starting June 1, 1995, was expected to reduce City expenditures by $15 million to $25 million in succeeding years by, among other things, reducing the number of City employees and introducing a two-tiered salary structure that would replace long-time workers with lower-cost employees. However, in February 1995, Odio informed Paredes that, despite the City's best efforts to reduce expenditures through Operation Right Size, Miami would be expected to save only $5 million from the program in FY 1995. Odio testified that Miami's cash flow problems for FY 1995 could not be solved solely by implementing Operation Right Size. He added that making up a $35 million deficit in a $222 million budget would have been "kind of a miracle."

Deloitte debated whether it had to qualify its opinion on Miami's FY 1994 financial statements with respect to whether Miami would remain a going concern.[14] A Deloitte work paper, dated March 1995, stated that "it appears the City is approximately $20 to $40 million behind in cash flows," and projected that "the City will definitely have a deficit cash flow deficit in the General Fund at September 30, 1995." The work paper also included best-case and worst-case analyses of Miami's finances for FY 1995, based on projections prepared by Garcia using actual revenues through November 1994.[15] Both analyses assumed that Miami would sell bonds.

Paredes testified that Miami's leadership was "well aware" of Deloitte's prognosis for the City's finances, and that the City officials planned to issue $20 million in Self Insurance Bonds "if cash flow [] necessitated."[16] Odio admitted that Miami had to sell bonds to survive FY 1995 stating, "[T]hat's the only choice we had, to borrow money."

Deloitte did not qualify its opinion on Miami's financial statements.[17] According to Paredes, Miami avoided issuance of a going concern qualification on its FY 1994 financial statements because the City intended to sell bonds. Paredes testified that he also based his decision on his view that the City was "progressing as planned," many City employees hadagreed to take early retirement, and there had been discussions about the sewer and pension bonds.[18]

5. <u>1994 CAFR</u>

During the period under review, the City prepared and disseminated a yearly Comprehensive Annual Financial Report ("CAFR") containing the City's yearly audited General Purpose Financial Statements and a transmittal letter from the City Manager and other city officials to the Mayor and the City Commission. Miami sent its CAFR biannually to credit rating agencies, and widely disseminated the CAFR to bond insurers, and investors.

The 1994 CAFR included the independent auditor's report on the City's financial statements, and a transmittal letter to the Mayor and City Commissioners from the City Manager and Finance Director. The transmittal letter stated that:

To the best of our knowledge and belief, the enclosed data is accurate in all material respects and is reported in a manner designed to present fairly the financial position and results of operations of the various funds and account groups of the City. All disclosures necessary to enable the reader to gain an understanding of the City's financial activities have been included.

Note 9 to the financial statements discussed a deficit of about $80 million in the City's Enterprise and Internal Service Funds. Note 9, titled "Fund Equity," stated that:

The following schedule lists fund deficits for Governmental and Trust and Agency type funds as of September 30, 1994 (in thousands):

Rescue Services Special Revenue ($285)

Self Insurance Trust Fund ($6,472)

Pension Administration Trust Fund ($34)

In addition to the above fund deficits, the City also experienced cash deficits in several of its operating funds which were temporarily remedied by loans from other funds. See Note 5.[19] It is management's intention to replenish these deficits and, accordingly, in February 1995, the City initiated a review process to "right-size" its operations with the goal of reducing its FY 95-96 budget by $30 million. As part of this initiative, significant concessions obtained from the sanitation union are expected to reduce the Solid Waste Department's FY 95-96 budget by $10 million. In addition, several departments are being consolidated and certain operations not directly related to the City's basic services are expected to be discontinued by September 30, 1995. Early retirement plans have been agreed to in principle by the City's administration and union's leadership with the purpose of reducing the City's workforce by approximately 400 employees by September 30, 1995. The implementation of the proposals discussed above are expected to strengthen the City's financial condition.

6. Miami's Financial Condition Continues to Deteriorate

In March 1995, Surana directed Miami's financial advisers to explore various financing alternatives that would raise cash immediately. Ultimately, K. Parekh informed Surana that none of the proposed options was feasible. On May 9, 1995, K. Parekh was summoned to a meeting with Surana, Odio, other City officials, and representatives of the financial advisers. K. Parekh testified that the participants discussed "the City's inability to meet its obligations. They were running out of money." According to K. Parekh's contemporaneous handwritten notes, Surana stressed that, it was imperative that the City's "[a]ctual cash deficit must be solved by Mid-June [1995]" and that "[a]ll GF/Budget must be solved by [September 1995]" (emphasis in original). Surana warned that, if the cash crunch was not resolved prior to this date, City employees' paychecks would bounce.

In advance of the May 9 meeting, K. Parekh and Miami's Debt Service Coordinator prepared an analysis demonstrating that, although Miami's financial statements showed a positive $3.167 million General Fund balance as of September 30, 1994, in reality, the account had a $3.156 million deficit.

7. <u>The Bond Issues</u>

a) Sewer Bonds

On May 25, 1995 the City Commission authorized the sale of the $22.5 million general obligation Sewer Bonds for improvements to the City's sewer system and to pay pensionliabilities for the fiscal year ending September 30, 1995. The Official Statement[20] for the Sewer Bonds included the City's FY 1994 audited financial statements, including Note 9, and incorporated a certificate executed by Miami's City Manager stating that the Official Statement was free of misstatements and omissions of material facts, and that there had been no material adverse change in Miami's financial condition since September 30, 1994, the close of the prior fiscal year.[21] The Official Statement also contained a summary of Miami's $222 million FY 1995 budget, claiming that the City anticipated receiving $9 million in Crime Bill monies and the $3 million proceeds from the sale of land fill, and represented that the City's "Revenues and Other Financing Sources" equaled "Expenditures and Other Uses" (the "balanced budget summary").

The Sewer Bonds were sold on June 27, 1995. Following the bond sale, Miami transferred $8.8 million, or 39 percent, of the bond proceeds into the General Fund in order to address the impending operating fund deficiency. The Sewer Bonds were insured by Financial Guaranty Insurance Company ("FGIC").

On June 9, 1995, Surana, Odio, K. Parekh, representatives of the City's employees, and representatives of Rauscher Pierce Refsnes, Inc. ("Rauscher Pierce"), an underwriter, met to discuss the City's cash flow problems. K. Parekh testified that, although the attendees expressed concern that Miami "was running out of money," it was "obvious" that the City had found a solution to its cash flow crunch because, in contrast to the prior month's meeting, "people weren't running around as crazy as they used to before" and no one talked about the City running out of cash by mid-June.

b) <u>FP & L Bonds</u>

On August 24, 1995, the City sold the $22 million Special Obligation Non-Ad Valorem Revenue Bonds ("FP & L Bonds"). According to the Official Statement, proceeds from the bond sale were to be used to purchase property, to make capital improvements, and to acquire an administration building. Financial disclosures in the Official Statement for the FP & L Bonds were the same as those for the Sewer Bonds. The FP & L Bonds were also insured by FGIC. The City transferred $21 million of the bond proceeds to the General Fund for an ending balance of $26 million on September 30, 1995.

c) <u>Pension Bonds</u>

Miami asked Rauscher Pierce to examine refinancing strategies that would provide immediate cash flow. In a letter to Deloitte dated June 14, 1995, Rauscher Pierce made clear that Miami was looking for a "big bang" to solve the City's fiscal problems. On the same day, Rauscher Pierce's Sarasota, Florida office faxed a document to its Miami office concerning a proposed issuance of Pension Bonds. The Sarasota office concluded that, if the bond proceeds were used directly for operating expenses, the City's liability would in essence be doubled, and the financing would be "pure deficit financing," which was prohibited by Florida law. The document also noted that "[t]his instrument is a deferral of the budget problem from one year to the next. So in essence, it buys one year's time."[22]

On July 13, 1995, the City Commission adopted a resolution that gave the City Manager authority to issue bonds totaling $309 million between 1995 and 2008 (the "pension bonds resolution"). Pursuant to this resolution, the City Manager had sole authority to issue bonds up to $22 million annually in order to make payments under the Gates Judgement and for other pension costs.[23]

On October 19, 1995, K. Parekh again met with Surana and others to discuss the City's cash flow needs.[24] In a follow-up letter dated November 7, 1995, K. Parekh reminded Suranathat one aim of the July 1995 pension bonds resolution was to "reduce (to the maximum possible extent) the amount of 'fiscal stress' upon the City." K. Parekh testified that later in November Surana telephoned him at home and reported that Miami was "out of money."

On December 12, 1995 the City's sold its first offering pursuant to the July 13, 1995 pension bonds resolution, a negotiated offering of $72 million Non-Ad Valorem Revenue Bonds (the "Pension Bonds"). The Official Statement declared the bond proceeds would be used to pay accrued and future liabilities to City pension plans and to reimburse the City for payments made in FY 1995. Financial disclosures in the Official Statement for the Pension Bonds were the same as those for the Sewer Bonds and the FP & L Bonds. The Pension Bonds were insured by AMBAC Insurance.

8. <u>Appointment of the Oversight Board</u>

On September 13, 1996, following the resignations of Odio and Surana, the City appointed an Interim City Manager. In December 1996, the Mayor and City Commissioners declared a fiscal emergency, causing Florida's Governor to put the City under the aegis of a Financial Emergency Oversight Board ("Oversight Board"). The Oversight Board was to have "continuous existence until three years after the City has produced two successive years of balanced operations and none of the statutory conditions for determining a local government financial emergency exists."

III.

Antifraud Violations

The antifraud provisions of the securities laws prohibit fraudulent and deceptive acts and practices in connection with the offer, purchase, or sale of a security.[25] In 1989, when the Commission adopted Exchange Act Rule 15c2-12, "Municipal Securities Disclosure," the Commission noted that municipal "issuers are primarily responsible for the content of their disclosure documents and may be held liable under the federal securities laws for misleading disclosure."[26] We have long emphasized the need for adequate disclosure in the sale of municipal securities.[27]

Early in FY 1995, Miami learned that it was facing an unprecedented cash flow shortage and would not be able to meet its obligations by May 1995, unless it took drastic steps both to generate cash flow and reduce expenses. To survive the year, Miami had to sell bonds and use the proceeds to meet its operational expenses. Miami officials knew that Operation Right Size would not turn around the City's financial crisis in FY 1995. Contrary to the "balanced budget" summary included in the Official Statements, before the first of the three bond issues was sold the City knew that it faced at least a $12 million deficit because it would not receive either the land fill or Crime Bill monies, and that the City would experience a deficit in FY 1995.

Note 9 to Miami's financial statements, included in the 1994 CAFR and Official

Statements, failed to reveal Miami's cash flow problem and, instead, gave the misleadingimpression that the City was taking steps that would allow it to finish FY 1995 in a stronger financial position than in FY 1994. Miami did not disclose that the City was facing such severe cash flow challenges that, absent borrowing funds, it might be unable to pay municipal workers in FY 1995. Nor did it disclose that Deloitte had informed Miami of a projected $35 - $40 million deficit for FY 1995.

Miami claims that "Note 9 made it absolutely clear that the majority of the savings from the right-sizing efforts were not anticipated to be realized until FY 1996, and this fact was obvious to any reader, as were the consequences of the right-sizing efforts not being successful." The disclosures regarding Operation Right Size were anything but "obvious." Note 9 did not disclose that Operation Right Size would generate only $5 million in savings in FY 1995. It also did not state that Miami would have to sell bonds to stay afloat in FY 1995. Paredes admitted that Note 9 only "implied" that Miami would incur cash deficits in FY 1995.[28]

The certificate stating that there was no material change in Miami's financial condition included in the Official Statements for the bond offerings was false because it did not represent the financial facts that existed at the time of the bond sales. Soon after September 30, 1994, City officials became aware that the City's finances were deteriorating significantly. Odio testified that FY 1995 was the worst threat to City finances he had confronted in his fifteen years with the City. Although it appeared that the City had met payroll and paid other ongoing expenses, and had achieved a positive General Fund balance in FY 1995, in reality, the ever-growing budget deficit was masked by transfers from other funds and the use of bond proceeds. The Interim City Manager concluded that in the summer of 1995 the City's financial situation:

had to be shaky, certainly because of the cannibalization, if you will, of storm water trust money, of unfunded liabilities, utilizing pension bond issue proceeds to meet annual budget requirements for the pension funds. So you've got clear indications of fiscal shortfalls and questionable accounting, official policy.

In light of the City's critical cash flow shortfall, the certification was a material misrepresentation. The balanced budget summary[29] was misleading because, throughout FY 1995, Miami's operating expenses exceeded budgeted operating revenues by millions of dollars and Miami knew that it would not receive some of the projected revenues.

Miami's cash flow crisis and the consequent possibility that it would not meet its operating expenses would be viewed by a reasonable investor as a material factor in deciding whether to purchase Miami's debt.[30] A reasonable investor would have considered it important to know that Miami could not generate sufficient revenues to pay its bills or its employees. The fact that Miami needed to use bond proceeds to satisfy operational expenses demonstrated the gravity of its cash flow deficit, and, thus, the City's need to disclose this fact to public investors and the marketplace. Miami's financial disclosures would be no less important to investors, who held previously issued City bonds, and were entitled not to be mislead about Miami's current financial condition in deciding whether to hold or sell their bonds. "Information about the issuer and other obligated persons is as critical to the secondary market . . . as it is in primary offerings."[31]

Miami argues that it was excused from disclosing that the City was experiencing cash flow stress and would be unable to meet its obligations because Deloitte did not issue a "going concern" qualification.[32] Miami erroneously equates the absence of a going concern qualification with the absence of adverse financial conditions that should have been disclosed. A going concern qualification discloses that the client will not meet its obligation in the coming twelve months. Paredes testified that, although Miami's cash position was "very tight," the City avoided a "going concern" qualification only because City officials represented that bonds would be issued to address any cash needs - - the very bonds at issue here. Although Miami's plan to survive the fiscal year by selling bonds may have removed the need for a going concern qualification, it did not relieve Miami of its obligation to disclose adequately the City's cash crisis or the role of those bonds in remedying the crisis. We have previously found antifraud violations where a municipal issuer failed to disclose that its cash flow position had materially declined (since the close of the prior fiscal year's financial statements included with its Official Statements) and misrepresented that there had been no material change in its financial condition.[33]

Miami asserts that the law judge erred in concluding that the balanced budget summary, included in the Official Statements, was a material misrepresentation because the summary "reflected historical information." Although the City Commission's approval of the FY 1995 budget was "historical," publication of the budget summary in the Official Statement was misleading. Before the first offering, City officials knew that Miami's FY 1995 budget was not balanced and that the City would not receive the Crime Bill Funds or much, if any, revenue from the sale of landfill. We conclude that the misrepresentations, false statements and omissions made by Miami in the Official Statements and 1994 CAFR were material.[34]

Scienter is a necessary element of a violation of Section 17(a) (1) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder.[35] Proof of scienter need not be direct, but may be "a matter of inference from circumstantial evidence."[36] Scienter has been defined by the Supreme Court as "a mental state embracing intent to deceive, manipulate, or defraud."[37] A showing of recklessness or actual knowledge can satisfy the scienter requirement.[38]

Miami argues that the Division failed to meet its burden of proving scienter because the Division failed to establish that Miami "did not act in good faith." As made clear above, in the face of obvious indicators to the contrary, Miami was at least reckless in misstating that its FY 1995 budget was balanced, downplaying its cash flow crisis, failing to disclose that Miami needed to issue debt to resolve its crisis, and misrepresenting that there were no material changesin its financial condition. Miami's officials ignored the City's disclosure responsibilities. Odio admitted that he was not familiar with Miami's disclosure requirements and dismissed the importance of the bond offering documents.

Let me ask you this, does anybody read this [Official Statement]? I mean, only experts read this . . . . [M]ost people don't read this, nobody reads this. They go by what the raters, that is Moody's, Standard & Poor's, saying that these bonds are safe to buy. By rating them AAA, they're a very good buy. Therefore, they wouldn't go reading through this. Nobody does.

Bond insurance did not give Miami license to misrepresent its financial condition or withhold material information from the marketplace.[39]

Miami further asserts that the City relied on Deloitte, and other professionals who participated in the bond offerings, to advise the City on its disclosure in the Official Statements.[40] Primary responsibility for the accuracy of information filed with the Commission and disseminated among investors rests upon the municipality.[41] A city does not discharge this obligation by the employment of independent public accountants or other professionals.[42] As we have repeatedly emphasized, issuers of municipal securities "are primarily responsible for the content of their disclosure documents and may be held liable under the federal securities laws for misleading disclosure."[43] Municipal issuers have an affirmativeobligation to know the contents of their securities disclosure documents, including their financial statements.[44]

Moreover, the record is unclear as to whether and to what extent Miami consulted with or relied on professionals.[45] Miami does not point to any professional advice that it received with respect to its certificate of no material change or its budget summary. Miami claims that Deloitte drafted Note 9 to its 1994 financial statements. However, Paredes testified that he recommended that Miami disclose the "cash deficits that were being funded by other funds," and that as the result of a "consultative type process" Miami decided to add Note 9. Paredes further testified that he could not "specifically recall exactly who wrote the first draft of Note 9."

Even if Paredes drafted Note 9, however, Miami knew that Note 9 did not disclose the scope of its cash flow predicament or the necessity to issue debt to remedy that problem. If a company officer knows that "financial statements are false or misleading and yet proceeds to file them, the willingness of an accountant to give an unqualified opinion with respect to them does not negative the existence of the requisite intent or establish good faith reliance."[46]

Accordingly, we find that Miami willfully violated Sections 17(a)(1)-(3) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder in connection with the offer and sale of the three bond issues. We further find that Miami willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder in connection with its outstanding bonds by makingmaterially false and misleading statements and omitting material information in its 1994 CAFR.[47]

IV.

Sanctions

In assessing whether a cease-and-desist order is an appropriate sanction, we focus on the risk of future violations.[48] "This inquiry is a flexible one and no one factor is dispositive. This inquiry is undertaken not to determine whether there is a 'reasonable likelihood' of future violations but to guide our discretion."[49] In the ordinary case, and absent evidence to the contrary, a finding of past violation raises a risk of future violation sufficient to support our ordering a respondent to cease and desist. "To put it another way, evidence showing that a respondent violated the law once probably also shows a risk of repetition that merits our ordering to cease and desist."[50] We also consider:

the seriousness of the violation, the isolated or recurrent nature of the violation, the respondent's state of mind, the sincerity of the respondent's assurances against future violations, the respondent's recognition of the wrongful nature of his or her conduct, and the respondent's opportunity to commit future violations. In addition, we consider whether the violation is recent, the degree of harm to investors or the marketplace resulting from the violation, and the remedial function to be served by the cease-and-desist order in the context of any other sanctions being sought in the same proceeding.[51]

We further may consider the function a cease-and-desist order will serve in alerting the public that a respondent has violated the securities laws.[52]

Miami argues that the cease-and-desist order is inappropriate because the violative conduct giving rise to the sanction occurred approximately seven years ago, and the officials involved with that conduct are no longer with the City. The Division emphasizes that the mere passage of years alone cannot determine whether Miami will commit violations in the future, and that the departure from City government of officials responsible for Miami's financial misrepresentations and omissions is not determinative of the appropriateness of a cease-and-desist order. We agree with the Division. The departures of Odio and Surana from City government provide no assurance that Miami will not commit similar violations in the future.

Miami's actions were not the result of an isolated incident but were recurrent and stretched from one fiscal year and into the next. In the three bond issues, the City used financial statements that failed to warn investors about its ongoing financial stress; falsely certified that there had been "no material adverse change" in its financial condition since FY 1994, even though Miami faced a cash shortfall of over $30 million; and depicted a balanced budget, knowing that $12 million in revenue would not be forthcoming. These violations were committed with at least recklessness.

Miami argues that its conduct did not result in harm to either public investors or the market place. This is not true. Because Miami failed to make full and accurate disclosures about its financial condition, investors purchased the City's debt without full information.

Miami also asserts that appointment of the Oversight Board negates the need for a cease-and-desist order. The Oversight Board was not a permanent watchdog over

Miami's finances. Miami has not adduced evidence of what changes in policy and financial controls have been introduced to eliminate the "possible risk" of future violation. We disagree with Miami's contention that a cease-and-desist order will serve no remedial purpose. We believe that the order will help prevent future violations.

Miami still maintains that it did nothing wrong. The fact that Miami has pointed its finger at Deloitte, and other bond professionals, without taking any responsibility for its own conduct, suggests that Miami has not accepted fully its responsibility for the City's financial disclosures. It is likely that Miami will sell bonds in the future. The City must be given the clear message that Miami is responsible for the adequacy of its financial disclosures when seeking money from the investing public. Accordingly, we will order Miami to cease-and-desist from committing or causing any violations or future violations of the antifraud provisions of the securities laws.

An appropriate order will issue.[53]

By the Commission (Chairman DONALDSON and Commissioners GLASSMAN, GOLDSCHMID and ATKINS); Commissioner CAMPOS not participating.

Jonathan G. Katz
Secretary

Footnotes

1 15 U.S.C. § 77q.

2 15 U.S.C. § 78j.

3 17 C.F.R. § 240.10b-5.

4 Miami requests that we conduct a de novo review of the record and "reject" the law judge's decision. Rule of Practice 410 requires the petitioner to "set forth the specific findings and conclusions of the initial decision as to which exception is taken." In our discretion, we may deem that the petitioner waived any exception not stated in the petition for review.

Under Rule of Practice 411, we "make any findings or conclusions that in [our] judgment are proper and on the basis of the record." We give "considerable weight and deference" to the trier of fact's credibility determinations and reject them only where there is substantial evidence for doing so. Jay Houston Meadows, 52 S.E.C. 778, 784 (1996), aff'd, 119 F. 3d 1219 (5th Cir. 1997).

5 Odio and Surana, who were respondents in this proceeding, resigned their positions as theresult of a joint state/federal investigation of corruption in Miami's municipal government, known as Operation Green Palm. The Commission subsequently accepted Odio's and Surana's Offers of Settlement. Without admitting or denying liability, Odio and Surana agreed to cease and desist from committing or causing any violations or future violations of Sections 17(a)(1), 17(a)(2), and 17(a)(3) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Our findings here with respect to Odio and Surana are solely for the purpose of this opinion. Manohar Surana, Securities Act Rel. No.

1110 (Sept. 22, 2000) 73 SEC Docket 869; Cesar Odio, Securities Act Rel. No. 7851 (Apr. 14, 2000) 72 SEC Docket 614.

6 The governing body of each municipality "shall make appropriations for each fiscal year which, in any one year, shall not exceed the amount to be received from taxation or other revenue sources." Fla. Stat. Ann. § 166.241(3).

7 According to minutes of the Commission meeting at which the budget was approved, the Vice-Mayor observed: "This is the same method of budget balancing we do each year. OK? Now, you see it; now, you don't. OK? That nine million dollars will never show up anyplace but on paper, and it will be shifted around from place to place []. You will never see nine million dollars." Another Commissioner responded: "Tell my colleague it goes back to his old saying of 'voodoo economics.'"

8 During his testimony at the hearing, Odio could not recall receiving the document.

9 Miami asserts that D. Parekh's statement about when Miami found out that the Crime Bill had changed from a block grant to a discretionary program was impeached by his prior investigative testimony. D. Parekh initially testified that in January or February 1995, after the FY 1995 budget had been approved, the City learned that the nature of the program had changed. Miami concludes that this is also when the City came to know the timing of its receipt of funds under the Crime Bill. We find no connection between the two events. D. Parekh testified that, before the FY 1995 budget had been approved, City officials learned that the Crime Bill monies would not be received until FY 1996. The law judge found D. Parekh to be a credible witness; D. Parekh's hearing testimony is consistent with substantial documentary evidence in the record including the Suranamemo and the discussion at the City Commission meeting. See nn.4, 7 supra.

10 Howard Gary, the president, CEO, and principal of HG & Co., was Miami's City Manager prior to Odio. Miami terminated its contract with HG & Co. in late 1996.

11 K. Parekh testified that the financial advisers put their concerns in writing to ensure that Miami understood that the City's "deteriorating fiscal condition" would continue to decline, and was "extremely important" to address. K. Parekh further testified that in deviation from their usual practice, the financial advisers captioned the letter to Miami, "PRIVILEGED AND CONFIDENTIAL," in order to stress the sensitivity of the issues raised.

12 For example, in September 1994, the City issued $18 million Pension Bonds to finance payments under the Gates Judgement. The financial advisers had informed Miami that they opposed issuing these bonds because they felt it was inappropriate to fund an operating expense (like a legal settlement) with municipal securities having a 20-year maturity.

13 For example, from 1990 through 1995 Miami charged each citizen $160 annually for garbage fees when the service actually cost over $380 per year. This shortfall, which cost Miami between $12 million and $15 million per year, was paid from the General Fund.

The Florida Constitution permitted the City to levy ad valorem taxes up to $10 per thousand dollars of assessed valuation for general governmental services. For the FY ending September 30, 1995, the rate was $9.5995 per thousand dollars; the same level since 1988. Witnesses testified that raising the rate would not have been sufficient to close the deficit.

For the six years prior to the period under review, Miami issued Tax Anticipation Notes ("TAN") in October to finance operations until the subsequent year's tax revenues were collected in December. Miami could not issue additional TANs until October 1, 1995.

[14] Pursuant to Statement of Auditing Standards No.59, an auditor must conduct a "going concern" review to determine a client's ability to meet its operating expenses and debt service for the twelve months following the date of the audited financial statements. Where there is doubt about the client's ability to do so, the auditor must evaluate management's plans to mitigate those concerns, and determine whether to issue a "going concern" qualification on the audit report.

[15] Deloitte's work papers noted that Miami's projected FY 1995 budget "included the Federal Crime Bill, land sales and others, whose realizeability was not assured." Miami knew that it would not realize the $3 million from the sale of land fill included in its budget for FY 1995. In his "Best Case" projection, Paredes assumed that Miami would receive only $500,000 from the sale of land fill. Ultimately, no revenue was realized from the sale of land fill in FY 1995.

[16] Miami did not issue the Self Insurance Bonds but sold the three bonds at issue here.

[17] Paredes testified that: "Because the City had plans and was instituting processes . . . . They had the capacity to issue debt and sell assets which all generate resources to make their ends meet. I think we need to understand that this analysis was done to see if there was a going-concern need in the opinion. We concluded clearly that there was no need for that."

[18] Deloitte completed its fieldwork for the FY 1994 audit on February 28, 1995, the date appearing on the signed audit opinion. However, the record is unclear as to when the City received the FY 1994 audit. Miami asserts that the law judge improperly concluded that the City received the FY 1994 audit in February or March 1995.

Odio testified that he received Deloitte's Management Letter on February 28. However, Paredes testified, based Deloitte's Record of Report Issuance, that the audited financial statements were delivered to the City on May 31, 1995. Notwithstanding the dispute about the date of Miami's receipt of the audit opinion, the record is clear that the City was aware of its serious cash flow problems by February 1995.

[19] Note 5 to the financial statements showed that almost $20 million of the $23.8 million "Due from Other Funds" came from five Capital Improvement Funds.

[20] An Official Statement is the "municipal equivalent of a corporate prospectus." It constitutes "financial disclosure by a state or local government planning a municipal securities offering that states the purpose for the issue and . . . discloses pertinent information on the issuer's financial condition." Barron's Dictionary of Finance and Investment Terms, 318, 408, 475 (4th ed. 1995).

[21] The certificate was required for the Official Statement for each of the three bond issues, as well as for the bond purchase agreements for the FP & L and Pension Bonds. K. Parekh testified that none of the bond transactions could have closed without the representations in the certificate.

[22] On September 27, 2001, pursuant to Rauscher Pierce's Offer of Settlement, the Commission issued an Order Instituting Proceedings and Cease-and-Desist Proceedings, Making Findings and Imposing Remedial Sanctions ("Order") against Rauscher Pierce in connection with its role as underwriter of Miami's Pension Bonds in December 1995. The Order required Rauscher Pierce to cease-and-desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act, Section 15B(c)(1) of the Exchange Act, and MSRB Rule G-17, and ordered Rauscher Pierce to pay a civil penalty in the amount of $200,000. See Rauscher Pierce Refsnes, Inc., Exchange Act Rel. No. 44864 (Sept. 27, 2001), 75 SEC Docket 2510, 2516.

[23] Griffith Pitcher, Miami's bond counsel on the Pension Bonds, testified that it would be "very unusual" for any City Commission to delegate to the City Manager discretion as to the timing and amount of debt to issue.

[24] K. Parekh testified that Surana had suggested a number of novel transactions, including "Yankee bonds, issuing Yen-denominated securities, to securities issued in Austrian shillings, to currency swaps to interest rate swaps, and lots of innovative and interestingstructures." According to K. Parekh, during the October 19 meeting, he advised Surana that some of those financing scenarios were "illegal" or "extremely improper." K. Parekh further testified that in response Surana berated him for two hours and told him that he was "incompetent."

In an attempt to discredit K. Parekh's testimony about Miami's ongoing cash deficiency, the City asserts that K. Parekh fabricated the October 19 dispute between Surana and himself because he had an "ax to grind" with Surana. Miami claims that Griffith Pritcher, bond counsel, contradicted K. Parekh's testimony that Surana berated Parekh by testifying that he had no recollection of the incident. Regardless of what occurred at this meeting, K. Parekh's overall testimony regarding Miami's financial condition is corroborated independently by other testimony and substantial record evidence. See e.g., pp. 5-6 supra and 10-11 supra.

[25] See U.S. v. Naftalin, 441 U.S. 768 (1979).

[26] 17 C.F.R. § 240.15c2-12. See Release Adopting Exchange Act Rule 15c2-12, 54 FR 28799, 28811 n.84 (July 10, 1989). See also County of Nevada, Securities Act Rel. No. 7535 (May 5, 1998), 67 SEC Docket 256 (settlement to cease-and-desist order finding violations of Sections 17(a)(2) and (a)(3) in sale of municipal bonds); Maricopa County, Securities Act Rel. No. 7354 (Oct. 3, 1996), 62 SEC Docket 2834 (settlement to cease-and-desist order finding violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule l0b-5 thereunder); County of Orange, California, Exchange Act Rel. No. 36761 (Jan. 24, 1996), 61 SEC Docket 487 (public issuers are primarily liable for the content of their disclosure documents and are subject to proscriptions under the antifraud provisions); and County of Nevada, Initial Decision Rel. No. 153 (Oct. 29, 1999), 70 SEC Docket 3303 (municipal bonds subject to Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule l0b-5 thereunder).

[27] See Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, Securities Act Rel. No. 7049, 59 FR 12748 (March 17, 1994) (municipal issuer that releases information that is reasonably expected to reach investors and the trading markets is subject to the antifraud provisions).

[28] In contrast, in its 1995 CAFR (issued after the sale of the subject three bond issues), Miami admitted that it had initiated Operation Right Size because a net deficiency of $26 million "became apparent in February 1995 and the City immediately began the process of correcting the deficiency through several actions including workforce reductions, cost reductions and operating efficiencies."

[29] See pp.11-12 supra.

[30] See, e.g., Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988) (in order to be material, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available") (quoting TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)).

[31] "Municipal Securities Disclosure," Exchange Act Rel. No. 34961 (Nov. 10, 1994), 57 SEC Docket 2993, 2993-94.

[32] Miami's argument would not be a defense to the City's affirmatively misrepresenting in the three bond sales that there had been no material adverse change in Miami's financial condition since the prior fiscal year, and that its budget was balanced.

[33] See Maricopa County, 62 SEC Docket at 2836.

[34] The law judge found that Miami's failure to disclose in the Official Statements that S & P had downgraded the City's general obligation bonds from A+ to A was a material omission. Miami argues that the Order Instituting Proceedings did not allege this violation. We do not reach the question of whether Miami's failure to disclose the downgrade constituted a material omission.

[35] See Aaron v. S.E.C., 446 U.S. 680, 695 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976); Steadman v. S.E.C., 603 F.2d 1126, 1132 (5th Cir. 1979), aff'd, 450 U.S. 91 (1981). Scienter need not be found to establish a violation of Section 17(a)(2) or (3) of the Securities Act. Aaron v. SEC, 446 U.S. at 697; SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 193 (1963); Steadman, 603 F.2d at 1134.

[36] Herman & MacLean v. Huddleston, 459 U.S. 375, 390 n.30 (1983); Pagel, Inc. v. SEC, 803 F.2d 942, 946 (8th Cir. 1986); In re Meyer Blinder, 50 S.E.C. 1215, 1230 (1992).

[37] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976).

[38] See Howard v. Everex Systems, Inc., 228 F. 3d 1057, 1063 (9th Cir 2000). The Ninth Circuit defined recklessness as: "an extreme departure from the standards of ordinary care [] which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." Id.

[39] See Release Adopting Exchange Act Rule 15c2-12, 54 FR at 28812 and n.89 ("The presence of credit enhancements generally would not be a substitute for material disclosure concerning the primary obligor on municipal bonds.").

[40] Courts have held that, in order to successfully assert a reliance-on-professionals defense, an issuer must demonstrate that it: (1) made complete disclosure to its counsel or accountant; (2) requested the professional's advice as to the legality of the contemplated action; (3) received advice that the conduct was legal; and (4) relied in good faith on that advice. See SEC v. Goldfield Deep Mines, 758 F.2d 459, 467 (9th Cir. 1985) (accountant and counsel). See also, SEC v. Caserta, 75 F. Supp.2d 79, 95 (E.D.N.Y. 1999) (accountants).

[41] See nn.26 and 27 supra.

[42] See Kahler Corp., 55 SEC Docket 24, 36 n.8 (Sept. 17, 1993) (settlement) (Unqualified opinion from independent auditors did not relieve issuer liability because "financial statements are management's responsibility.").

[43] In re Citisource, Inc. Sec. Lit., 694 F. Supp. 1069, 1072-75 (S.D.N.Y. 1988) (municipality can be held liable under Section 10(b) of the Exchange Act); In reWashington Public Power Supply Syst. Sec. Lit., 673 F. Supp. 411 (W.D. Wash. 1987), aff'd, 823 F.2d 1349 (9th Cir. 1987) (issuers of municipal securities can be held liable under Section 10(b) of the Exchange Act and Rule l0b-5 thereunder); In re Washington Public Power Supply System Sec. Lit, 650 F. Supp. 1346 (W.D. Wash. 1986); New York City Municipal Sec., 507 F. Supp. 169, 184-85 (S.D.N.Y. 1980) (issuers of municipal securities must comply with antifraud provisions of the federal securities laws).

[44] County of Orange, California, 61 SEC Docket at 501. See also County of Nevada, 67 SEC Docket at 259.

[45] Miami's financial advisers expressly disavowed responsibility for any of the financial information contained in the Official Statements. A disclaimer in the Official Statements stated that:

The Financial Advisors are not obligated to undertake, and have not undertaken to make, an independent verification or to assume responsibility for the accuracy, completeness, or fairness of the information contained in this Official Statement or any exhibits, schedules, or appendices hereto.

K. Parekh testified that, although it was "unusual" to include such a disclaimer, he did so because he "did not have any comfort as to the accuracy of any of the information that I was receiving from the City."

In his investigative testimony, Griffith Pritcher, bond counsel, denied any role in Miami's financial disclosures. Pritcher testified that: "[my legal] opinion doesn't go to the financial aspect of it [the Official Statement] . . . ." The audit opinion letter declared that "no opinion is expressed as to . . . any financial, demographic, or statistical data set forth therein." Robert Moore, the analyst at AMBAC Insurance, noted during his investigative testimony that AMBAC relied on financial information provided by Miami in performing its credit analysis for the Pension Bonds. Moore further testified that he did not speak with anyone in connection with performing the credit analysis and relied solely on the Official

Statements and the FY 1994 financial statements.

Paredes admits that he carried out certain "due diligence procedures" for Miami prior to each bond offering. However, Paredes testified that this "subsequent events analysis" was not extensive and consisted of obtaining assurances from Miami officials that there had been no changes that impacted City's FY1994 financials. Paredes noted that Miami provided Deloitte a letter confirming that "[n]o events have occurred subsequent to September 30, 1994 that have a material effect on the financial statements that should be disclosed." Paredes testified that he had no interaction with the City's financial advisers, underwriters, or bond counsel. Paredes further testified that Deloitte did not look at any interim financial information and did not make any inquiries regarding Miami's cash flow. The City sued Deloitte claiming that each and every financial statement from 1989 through 1995, including the financial statement used to sell the three bond issues in 1995, was false and misleading.

We do not reach the issue of whether these bond professionals fulfilled their responsibilities with respect to these offerings.

[46] See U.S. v. Erickson, 601 F.2d 296, 305 (7th Cir. 1979) (criminal case); See U.S. v. Colasurdo, 453 F.2d 585, 594 (2nd Cir. 1971). See also Mishkin v. Peat, Marwick, Mitchell & Co., 744 F. Supp. 531, 538 (S.D.N.Y. 1990) (management is responsible for entity's financial statements).

[47] The Order Instituting Proceedings charged only that the CAFR violated Exchange Act Section 10(b) and Rule 10b-5 thereunder.

[48] Exchange Act Section 21C(a) authorizes the Commission to order persons to cease and desist from committing securities laws violations or future securities law violations if it finds that "any person is violating, has violated, or is about to violate any provision" of the Exchange Act. 15 U.S.C. § 78u-3 (a).

[49] KPMG Peat Marwick LLP, Exchange Act Rel. No. 43862 (Jan. 19, 2001), 74 SEC Docket 384, 436, motion for reconsideration denied, Exchange Act Rel. No.44050 (Mar. 9, 2001), 74 SEC Docket 1351, petition denied, 289 F.3d 109 (D.C. Cir. 2002).

[50] 74 SEC Docket at 430.

[51] Id. at 436.

[52] Id. at n.148.

[53] We have considered all of the arguments and contentions made by the parties. We reject or accept these arguments and contentions to the extent that they are inconsistent or in accord with the views expressed in this opinion.

Commission Orders – Settled Administrative Proceedings

In the Matter of the Massachusetts Turnpike Authority and James J. Kerasiotes, Securities Act Release No. 8260, A.P. File No. 3-11198 (July 31, 2003).

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") against the Massachusetts Turnpike Authority ("Turnpike Authority") and James J. Kerasiotes ("Kerasiotes") (collectively "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the "Offers"), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, Respondents consent to the entry of this Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933 ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' respective Offers, the Commission finds that:

A. Summary

This matter involves misrepresentations resulting from the delay in disclosing cost increases at the Massachusetts Central Artery/Ted Williams Tunnel Project (the "Project"), popularly known as the "Big Dig," by the Turnpike Authority and Kerasiotes in connection with three municipal bond offerings during 1999. The offerings were by the Turnpike Authority in March 1999, the Commonwealth of Massachusetts ("Commonwealth") in September 1999, and the Massachusetts Bay Transportation Authority ("MBTA") in December 1999. At the time of each of these offerings, the Project staff had projected cost increases exceeding $1 billion, which should have been disclosed to the public, including potential bondholders, underwriters, and credit rating agencies in connection with the bond offerings. However, because the cost increases had not been fully quantified or confirmed, the Respondents deemed them to be speculative and did not disclose them. Instead, beginning in the spring of 1999, the Project staff embarked upon an effort to quantify and confirm the specific amount of any cost increases, including a "bottom-up" review of every Project contract. As a result, the offering materials accompanying each of the bond offerings indicated that the Project was on budget and that it would cost only $5.5 billion to complete. The cost increases were ultimately disclosed to the public in February 2000. Although Respondents' approach to dealing with projected cost increases was part of an effort to control Project costs, their failure to disclose such cost increases did not take into account their obligations under the federal securities laws. By their negligent conduct, the Turnpike Authority committed and Kerasiotes committed and caused violations of Sections 17(a)(2) and (3) of the Securities Act.

B. Respondents

1. The Turnpike Authority, at all times relevant to this matter, was an agency of the Commonwealth. From 1997 through the present, the Turnpike Authority was responsible for overseeing the Project, described more fully below. The Project was staffed by approximately 625 employees of a joint venture between two major international construction companies, Bechtel Corporation and Parsons Brinckerhoff Quade & Douglas ("Bechtel/Parsons"), approximately 125 employees of the Turnpike Authority, and legal counsel (collectively referred to herein as the "Project staff").

2. Kerasiotes, age 49, of Medfield, Massachusetts, was the chairman of the Turnpike Authority from 1996 through April 11, 2000. Kerasiotes oversaw the Project for a decade in various positions -- first as Massachusetts Transportation Secretary (from 1990 through 1992), then as Secretary of the Executive Office of Transportation and Construction (from 1992 through 1996), and finally as Chairman of the Turnpike Authority (from 1997 through April 11, 2000). Kerasiotes delegated day-to-day management duties to the Project director, who reported to him regularly.

C. Other Relevant Entities

1. The Executive Office for Administration and Finance ("Administration and Finance") is an agency of the Commonwealth responsible for, among other things, preparing municipal bond offering materials for the Commonwealth and certain of its agencies that describe the financial condition of the Commonwealth.

2. The MBTA is an agency of the Commonwealth that operates mass transit facilities in 78 cities and towns in greater Boston. At all times relevant to this matter, the MBTA was authorized to issue municipal bonds, and the Commonwealth was the guarantor of such bonds.

3. Bechtel/Parsons was hired as the Project's outside private contractor and management consultant. Hired for their expertise at financial oversight of multi-billion dollar construction projects, Bechtel/Parsons was contractually obligated to create, track, and estimate the Project's budget, which Bechtel/Parsons did at all times relevant hereto. Bechtel/Parsons' contract required it to prepare quarterly cash flow projections reflecting the financial status of the Project, which the Turnpike Authority reviewed and provided to Administration and Finance for inclusion in bond offering materials.

D. Facts

1. Background

The Project is a large, complex highway construction project that involves the depression under ground of a three-mile portion of Interstate 93 in downtown Boston (known as the Central Artery) and the construction of a new tunnel under Boston Harbor to link the Massachusetts Turnpike to Logan International Airport (the Ted Williams Tunnel) and two bridges over the Charles River. Construction of the Project began in 1991 and is currently expected to be completed in December 2004.

Historically, Project costs were borne by the Commonwealth, the Turnpike Authority, and the federal government. Through 1999, a majority of Project costs were borne by the federal government. However, as of March 1999, the federal contribution was reaching its limit, and by late 1999, it was apparent that the federal government would not provide additional funds for the Project. Accordingly, any Project cost increases were the responsibility of the Commonwealth and the Turnpike Authority.

Given the scope of the Project, costs were a concern from its inception. In an attempt to contain costs and achieve the Project's budget, the Project staff continually reviewed cost trends and pressures. Bechtel/Parsons regularly prepared cost estimates, which were reviewed and then used by the Turnpike Authority to manage the Project. Throughout this period, Kerasiotes told the Project staff that budget management was a "zero sum game," meaning that, for every cost increase, the Project staff must find a corresponding cost reduction or source of revenue. Kerasiotes was reluctant to approve increases in the Project budget estimates in part because hebelieved that public disclosure of an increase before it was absolutely certain that such an increase was unavoidable would make such an increase a self-fulfilling prophecy, thereby leading to Project cost increases that might otherwise have been prevented. Although this approach was an effort by Respondents to attempt to hold Project costs down, Respondents were negligent in failing to disclose cost increases in 1999, given how far the Project had progressed.

In 1997, Kerasiotes presided over a budget revision that established the total cost of the Project at $10.8 billion. From 1997 until February 2000, at Kerasiotes' direction, the Turnpike Authority, its employees, and Bechtel/Parsons consistently stated to the public that the Project cost would total $10.8 billion and that the Project was "on time and on budget." However, by March 1999, Respondents and the Project staff had become aware of significant projected cost increases that they negligently failed to disclose.

2. Project Costs Increased

The $10.8 billion budget was built on a number of budget assumptions adopted in connection with the Project staff's last detailed budget review in 1995. The budget assumptions, which were based in part upon experience through 1995 and then recently-implemented cost controls, included: (1) the Project would be able to award contracts for 13% less than the Project's market estimates (a "market discount"); (2) the cost of previously-awarded contracts would not increase (due to unexpected construction problems) by more than 10.7% overall and 7% going forward; and (3) the Project would terminate and stop paying Bechtel/Parsons as the Project's management consultant in 2002 -- two years before the Project's then-projected completion date -- after construction of the underground artery was scheduled to be completed and the less complicated demolition of the existing highway was scheduled to begin.

From April 1998 through December 1999, the Project staff regularly prepared internal projections of best and worst-case budget scenarios, known as "up-down" charts. By July 1998, these charts consistently showed projected cost increases in excess of $1 billion, most of which would be incurred in 2000 and 2001. Most of the cost increases were directly related to the failure of various assumptions underlying the $10.8 billion budget, both on a historical and going-forward basis. These charts also showed potential offsets consisting of sources of revenue and scope or cost reductions to pay for the cost increases, such that the charts reflected no net increase in the budget. However, by the summer of 1999, the Project had progressed to the point where meaningful scope or cost reductions were no longer feasible.

In February 1999, and on additional occasions thereafter, the Project staff reviewed the various assumptions underlying the $10.8 billion budget. Those reviews revealed significant cost increases arising from the failure of those assumptions. As of February 1999, contracts were being awarded for 6.5% less than the Project's market estimates (not 13%), the cost of previously-awarded contracts had increased by 11.6% (not 7%), and it had become apparent that the Turnpike Authority would not terminate Bechtel/Parsons as the Project's management consultant in 2002. As a result, by March 1999, Respondents should have recognized that significant projected cost increases would occur. Instead of disclosing this information, beginning in the spring of 1999, the Project staff embarked upon a process to quantify thespecific amount and timing of the cost increases. Between September and December 1999, the Project staff conducted a comprehensive bottom-up review of all Project contracts and costs. Kerasiotes believed that the Project staff could not determine the actual amount of a budget increase until it completed such a review and then submitted that review to an outside consultant for verification, a process that had been followed prior to the Project cost increases announced in 1995. Moreover, Kerasiotes did not want to disclose the problem until the Project staff determined its scope and came up with a solution. However, given Respondents' awareness of significant projected cost increases, Respondents acted negligently in failing to disclose such increases in the three bond offerings in 1999.

By mid-November 1999, the bottom-up review indicated that the Project's actual and projected costs were likely to exceed the Project's budget by approximately $1.4 billion and that additional funding would be needed beginning in 2001. After a series of meetings between the Turnpike Authority staff, Bechtel/Parsons, and legal counsel, the results of this review were presented to Kerasiotes on December 15, 1999.

3. The March 1999 Turnpike Authority Offering

On March 24, 1999, the Turnpike Authority sold approximately $809 million in 30-year revenue bonds that were insured by a AAA-rated insurance company. In its Official Statement accompanying the bond offering, which was signed by Kerasiotes, the Turnpike Authority stated that future Project costs would total approximately $5.5 billion. This amount was derived from a quarterly cash flow projection prepared by the Project staff (and reviewed by Turnpike Authority finance personnel) by subtracting the costs incurred to date on the Project from the $10.8 billion budget. The $5.5 billion figure did not include any cost increases.

4. The September 1999 Commonwealth Offering

On September 22, 1999, the Commonwealth sold $500 million in 20-year general obligation bonds using an Official Statement containing information concerning Project costs provided by the Turnpike Authority. The Official Statement accompanying the bond offering, prepared by Administration and Finance, contained the Project's cash flow information provided by the Turnpike Authority, which represented that the Project's cash needs and sources for each fiscal year from 1999 through completion of the Project would total $5.5 billion. This amount was derived from a quarterly cash flow projection prepared by the Project staff (and reviewed by Turnpike Authority finance personnel) by subtracting the costs incurred to date on the Project from the $10.8 billion budget amount. Pursuant to Kerasiotes' approach to addressing cost increases, the $5.5 billion figure did not include any cost increases.

5. The December 1999 MBTA Offering

On December 9, 1999, before the Project staff presented the results of its bottom-up review to Kerasiotes, the MBTA sold $200 million in 30-year general obligation bonds using an Information Statement containing information concerning Project costs provided by the Turnpike Authority. The bonds were general obligations of the MBTA payable from theMBTA's general revenue fund. However, if the MBTA was not able to pay the bonds, they would be paid by the Commonwealth and were secured by the Commonwealth's full faith and credit. Accordingly, the MBTA's Official Statement contained an Information Statement from the Commonwealth. Based upon information the Turnpike Authority provided to Administration and Finance, the Information Statement stated that it would cost $5.5 billion to complete the Project. This amount was derived from a quarterly cash flow projection prepared by the Project staff (and reviewed by Turnpike Authority finance personnel) by subtracting the costs incurred to date from the $10.8 billion budget amount. Pursuant to Kerasiotes' approach to addressing cost increases, the $5.5 billion figure did not include any cost increases.[1]

6. Disclosure of Cost Increases and Subsequent Events

On February 1, 2000, Kerasiotes and the Turnpike Authority disclosed to the media that the Project would cost approximately $1.4 billion more than the $10.8 billion budget. These cost increases equaled approximately 3% of the total revenues of the Commonwealth estimated for fiscal year 2000 and 2001 and 9% of the total Commonwealth debt load as of January 1, 1999. Moreover, these cost increases exceeded the amount of the Commonwealth's Stabilization (or "rainy day") Fund, which the Commonwealth had pledged to use to provide tax relief, save for future contingencies, and fund one-time expenditures.

Following the disclosure of the cost increases, the Turnpike Authority took several steps to improve its disclosure practices. These steps included, but are not limited to, generating a publicly-available monthly report that includes detailed information regarding the Project's cost projections, conducting an annual, detailed review similar to the reviews conducted in 1994 and 1999, utilizing estimates of an outside consultant to test budget assumptions and cost figures generated by Project staff, and retaining outside counsel to provide disclosure advice on an ongoing basis.

E. Violations

As a result of the negligent conduct described above, the Turnpike Authority committed and Kerasiotes committed and caused violations of Sections 17(a)(2) and (3) of the Securities Act.[2] In order to establish a cause of action under Sections 17(a)(2) and (3) of the Securities Act, it must be established that: (1) the misrepresentations were material; and (2) the misrepresentations were in the offer or sale of securities. Basic, Inc. v. Levinson, 485 U.S. 224, 231-32 (1988);

Superintendent of Ins. v. Bankers Life and Casualty Co., 404 U.S. 6 (1971); Aaron v. SEC, 446 U.S. 680, 686 n.5 (1980). A finding of scienter is not required to establish violations of Sections 17(a)(2) and (3) of the Securities Act; negligence is sufficient. Aaron, 446 U.S. at 696-97; SEC v. Hughes Capital Corp., 124 F.3d 449, 453-454 (3d Cir. 1997).

The cost increases identified by the Project staff were material to each of the three bond offerings in this matter. Information is material if there is a substantial likelihood that a reasonable investor would consider it important in making his or her investment decision. See Basic, 485 U.S. at 231-32, 240; TSC Industries v. Northway, Inc., 426 U.S. 438, 439 (1976); SEC v. Steadman, 967 F.2d 636, 643 (D.C. Dir. 1992); Selective Disclosure and Insider Trading, Rel. No. 33-7881 (Aug. 15, 2000), 2000 SEC LEXIS 1672 at *32 (adopting case law definition of materiality for purposes of Regulation FD). See also City of Miami, Initial Dec. Rel. No. 185 (June 22, 2001), 2001 SEC LEXIS 1250, *51 (whether official statement is misleading depends on "whether an investor who had been reasonably diligent in reviewing the Official Statement would have been misled") (citation omitted). This requirement is fulfilled if there is a substantial likelihood that the information would have been viewed by the reasonable investor as having significantly altered the total mix of information made available. Id. If the information relates to possible future events, materiality "will depend upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity." Basic, 485 U.S. at 238; SEC v. MacDonald, 699 F.2d 47, 50 (1st Cir. 1983) ("materiality of facts regarding a contingent future event is simply a function of the anticipated magnitude of the event if it occurs, discounted by the probability of its occurring"). See also Milton v. Van Dorn Co., 961 F.2d 965, 969-70 (1st Cir. 1992) (same).

Reasonable investors would have considered Project cost increases in excess of $1 billion to be an important factor in the investment decision-making process and would have viewed such information as significantly altering the total mix of information available. In addition to being a substantial amount in absolute terms, the cost increases equaled approximately 3% of the total revenues of the Commonwealth estimated for fiscal year 2000 and 2001 (when the majority of the cost increases would be incurred) and 9% of the total Commonwealth debt load as of January 1, 1999, and exceeded the amount of the Commonwealth's rainy day fund. Reasonable investors were entitled to know about cost increases of this magnitude that would have to be met by the Commonwealth and/or the Turnpike Authority so the investors themselves could evaluate the financial condition of the Turnpike Authority and/or Commonwealth and analyze fully the bond offerings. See Basic, 485 U.S. at 234 ("[d]isclosure, and not paternalistic withholding of accurate information, is the policy chosen and expressed by Congress"). See also Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, Exchange Act Release No. 34-33741 (March 9, 1994), 1994 SEC LEXIS 700, *16 (citing same standard for municipal security offerings).

Because the Project cost information provided by the Turnpike Authority was included in the materials accompanying each offering at issue here, the misrepresentations about such costs were made in the offer or sale of securities under Section 17(a) of the Securities Act. See Miami, 2001 SEC LEXIS 1250 at *50 (finding violations of Sections 17(a) where issuer's offering materials "distributed to inform and influence the investing public"). Section 17(a) is to be interpreted broadly, and an individual who provides false or misleading information included in offering materials may be liable under this section even if that individual does not have direct contact with investors or editorial control of offering materials. See SEC v. Holschuh, 694 F.2d 130, 142-45 (7th Cir. 1982). Here, the Turnpike Authority and Kerasiotes are liable because they negligently created, directly or indirectly, the particular misrepresentations at issue.

F. The Turnpike Authority's Remedial Efforts

In determining to accept the Respondents' Offers, the Commission considered the remedial acts promptly undertaken by the Turnpike Authority.

IV.

In view of the foregoing, the Commission deems it appropriate to issue the cease-and-desist order specified in Respondents' respective Offers.

ACCORDINGLY, IT IS HEREBY ORDERED:

Pursuant to Section 8A of the Securities Act, that Respondents Turnpike Authority and Kerasiotes cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and (3) of the Securities Act.

By the Commission.
Jonathan G. Katz
Secretary

Footnotes

[1] Kerasiotes was not unjustly enriched and did not profit financially by his conduct in connection with any of the bond offerings at issue in this matter, and no investor suffered a financial loss.

[2] The actions and state of mind of high-ranking Turnpike Authority and Project staff officials, can be imputed to the Turnpike Authority even though no member of the Turnpike Authority's current board knew of the information set forth above during 1999. See City of Miami, Initial Dec. Rel. No. 185 (June 22, 2001), 2001 SEC LEXIS 1250, *53 ("City is responsible for the acts of its City Manager and Finance Department officials, and the knowledge of these individuals is imputed to the City"), aff'd, Securities Act Rel. No. 8213 (March 21, 2003), 2003 SEC LEXIS 676; Erik W. Chan, Initial Dec. Rel. No. 172 (Sept. 14, 2000), 2000 SEC LEXIS 2274 at 28-29 (same) (citing cases). Good faith conduct may constitute a violation when negligent. See SEC v. Brincat, 2001 U.S. Dist. LEXIS 20213, *3 (N.D. Ill. Dec. 5, 2001) ("Even if [respondent] acted in good faith, he may still be liable ... if he acted ... negligently"). See also SEC v. Pros Int'l, Inc., 994 F.2d 767, 769 (10th Cir. 1993) ([respondent] acted negligently even though "there has been no showing that [he] intended to defraud investors").

PUBLIC OFFICIALS

Commission Orders – Settled Administrative Proceedings

In the Matter of the Massachusetts Turnpike Authority and James J. Kerasiotes, Securities Act Release No. 8260, A.P. File No. 3-11198 (July 31, 2003).
See "ISSUERS" section.

OBLIGATED PERSONS

Injunctive Proceedings

SEC v. David W. McConnell and Charles P. Morrison, Civ. Action No. 00-CV-2261 (E. D. Pa.), Litigation Release No. 16885 (January 31, 2001).

Charles P. Morrison, the former chief financial officer of the Delaware Valley region of Allegheny Health Education and Research Foundation ("AHERF") and an AHERF senior vice president, consented, without admitting or denying the allegations of the Commission's Complaint, to the entry of a Final Judgment and Order in the case. The Order permanently enjoins him from violating Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and requires him to pay a civil money penalty in the amount of $25,000. The Order was entered on January 31, 2001, by the Honorable Norma L. Shapiro.

Also on January 31, 2001, the Commission instituted and simultaneously settled a Rule 102(e) proceeding against Morrison. Based upon the District Court injunction, the Commission suspended Morrison from appearing or practicing before the Commission as an accountant with the right to apply for reinstatement in three years.

The Commission's Complaint in the District Court action alleged that Morrison violated the securities laws by, among other things, creating, reviewing and approving false financial statements of AHERF and a group of its subsidiaries collectively known as the Delaware Valley Obligated Group ("Delaware Valley"), thereby masking, from at least December 1996 through July 1998, AHERF's severely deteriorating financial condition. Specifically, the Commission's Complaint alleged that the financial statements overstated: (a) the 1996 income of Delaware Valley by, approximately, $40 million; (b) the 1997 income of AHERF by approximately $59.6 million; and (c) the 1997 income of Delaware Valley by approximately $59.6 million, in documents issued to the public in December 1996 and February 1998.

AHERF is a Pennsylvania nonprofit healthcare organization. On July 21, 1998, AHERF filed for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code on behalf of itself and four of its subsidiaries in the U.S. District Court for the Western District of Pennsylvania. By the time of its bankruptcy filing in 1998, groups of one or more of AHERF's subsidiaries ("obligated groups") were responsible for repaying at least thirteen bond issues issued by or for the benefit of these obligated groups, totaling more than $900 million (the "AHERF Bonds").

On behalf of the obligated groups, AHERF provided to nationally recognized municipal securities information repositories annual Secondary Market Disclosure Reports which contained a section explaining the financial health of the reporting entities, debt service coverage ratios, and which attached audited financial statements. The Disclosure Reports were made available to the public through these repositories and were the most easily accessible source of information for investors and potential investors in AHERF bonds.

According to the Complaint, between December 12, 1996 and January 7, 1997, AHERF sent Delaware Valley's 1996 Disclosure Report and audited financial statements to the repositories and numerous other third parties. The Complaint alleged that Delaware Valley's audited financial statements for the year ended June 30, 1996 were materially false and misleading, and failed to comply with Generally Accepted Accounting Principles ("GAAP"), because they materially overstated Delaware Valley's 1996 income by, approximately, $40 million and misrepresented the condition of Delaware Valley accounts receivable. The Complaint further alleged that Delaware Valley's 1996 Disclosure Report was materially false and misleading in that it mirrored the numerical misstatements in the 1996 financial statements and it materially misrepresented the condition of Delaware Valley accounts receivable.

The Complaint further alleged that, in February 1998, AHERF distributed its 1997 audited consolidated financial statements with consolidating schedules and consolidated Disclosure Report to the repositories and numerous other third parties. According to the Complaint, AHERF's audited consolidated financial statements with consolidating schedules for the year ended June 30, 1997, which purported to be prepared in accordance with GAAP, were materially false and misleading and failed to comply with GAAP in that they materially overstated AHERF's 1997 consolidated net income by, approximately, $59.6 million and they materially overstated the 1997 net income of Delaware Valley by, approximately, $59.6 million. AHERF's 1997 consolidated Disclosure Report allegedly was materially false and misleading in that it: (1) mirrored the numerical misstatements in the AHERF 1997 audited consolidated financial statements and consolidating schedules; (2) misrepresented the condition of Delaware Valley accounts receivable; and (3) misrepresented the financial condition of another AHERF obligated group, namely the Centennial obligated group.

See Litigation Release No. 16534, Accounting and Auditing Enforcement Release No. 1254 (May 2, 2000)

http://www.sec.gov/litigation/litreleases/lr16885.htm

SEC v. Manoucher Sarbaz, Pacific Golf Community Development LLC and Lee Andrew Hill, Civ. Action No. CV 03 1310 JSL (CTX) (C.D. Cal.), Litigation Release No. 18001 (February 26, 2003) (complaint).

The U.S. Securities and Exchange Commission yesterday sued a Los Angeles developer and an appraiser for fraud in the issuance of more than $83 million in municipal securities to support the Rancho Lucerne Master Planned Community, a planned real estate project in San Bernardino County, California. Named in the Commission's complaint, filed in the federal district court in Los Angeles, are Pacific

Golf Community Development, LLC, a real estate development company; Manoucher Sarbaz, age 51, of Los Angeles, California, and Pacific Golf's managing director; and Lee Andrew Hill, age 59, of Little Rock, Arkansas, a real estate appraiser.

According to the Commission's complaint, from August 1996 to December 2000, Pacific Golf Community Development, Sarbaz, and Hill intentionally or recklessly misrepresented or omitted to disclose material facts about the Rancho Lucerne project in nine municipal securities offerings. In particular, Pacific Golf and Sarbaz are alleged to have repeatedly misrepresented facts indicating that the project would be completed quickly, that anticipated revenue from the project would be sufficient to repay investors when the securities matured, that in-tract financing for the project existed, that valuable land had been pledged as security for the municipal securities sold to investors, and that the developer had obtained contracts to sell developed lots to home-builders. Sarbaz also is alleged to have failed to disclose lawsuits and liens filed against the development. Hill is alleged to have provided appraisal reports in support of the municipal securities offerings in which he intentionally or recklessly misrepresented the value of the Rancho Lucerne land pledged as a security for the benefit of the investors who purchased the Rancho Lucerne offerings. According to the Commission, Hill opined that the Rancho Lucerne land was worth $28,000 per acre, or more, when, in reality, the land was worth several times less than that amount.

The Commission alleges in its complaint that Sarbaz, Pacific Golf Community Development, and Hill violated Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder, and also alleges that Hill aided and abetted violations Section 10(b) of Exchange Act and Rule 10b-5. The complaint seeks disgorgement of ill-gotten gains, civil penalties and injunctive relief against all defendants.

Yesterday's action is the second lawsuit brought by the Commission concerning the Rancho Lucerne municipal securities. On December 27, 2000, the Commission sued now-defunct Pacific Genesis Group, Inc., the underwriter of these securities, and its chairman, David Fitzgerald, to stop the last Rancho Lucerne offering. Following a trial, the district court found that Pacific Genesis Group and Fitzgerald had fraudulently misled investors about the existence of the developer's contracts with merchant home-builders for Rancho Lucerne, and ordered the return of all funds raised in the ninth offering. (To review the District Court's findings of fact and conclusions of law, see http://www.cand.uscourts.gov/cand/tentrule.nsf /4f9d4c4a03b0cf70882567980073b2e4/57122c38b133d8dd88256a1f007e3e6f?OpenDocument.)

After the district court trial, the California Department of Corporations revoked Pacific Genesis' business license and, in June 2001, the firm shut down. On March 20, 2002, pursuant to a settlement, the district court entered a final judgment against Pacific Genesis and Fitzgerald, entered permanent injunctions against each of them that barred them from selling more bonds on Rancho Lucerne by means of fraud and misrepresentation, and required Fitzgerald to pay $300,000 in disgorgement and civil penalties. Fitzgerald also consented to the entry by the Commission of an administrative order barring him from the brokerage industry, with a right to apply for readmission to the industry, in 5 years. See SEC v. Pacific Genesis Group, Inc. and David Fitzgerald, No. C-00-4802 CRB (N.D. Cal.) [Release No. 17432] (dated March 22, 2002).

SEC v. Terry Richard Martin, Silver Legacy Corporation, Silver Sound LLC, Jonas David Smith, Michael W. McCall, Charles J. Tull, Ibis Securities LLC, Kenneth R. Martin, George Tamura, Goldman Sig, Inc., Edward L. Tezak, Signal Mortgage Inc., and John H. White, Civ. Action No. C 03-2646 C (W.D. Wash.), Litigation Release No. 18315 (August 28, 2003) (complaint).

The Securities and Exchange Commission today announced the filing of civil charges relating to the fraudulent sale of $20 million in municipal bonds for the Holmes Harbor Sewer District, a small sewer district located on Whidbey Island, approximately 60 miles north of Seattle, Washington. The bonds were intended to finance the building of certain public purpose portions of a private office-building complex. However, according to documents filed in court, the developer and others lied to investors about how bond proceeds would be used to acquire land for the project; falsely claimed that a prominent investment bank was involved in providing additional private financing for the project; falsely claimed that the project was already fully leased to a "Triple A" credit-rated company; and failed to disclose kickbacks to several of the offering participants.

Currently, the bonds are in default and no substantial work has taken place on the project. When the bonds were sold to investors in October 2000, approximately half of the proceeds were used to acquire land and for professional fees. The balance of the proceeds remains in escrow.

Named in the Commission's complaint were Terry Martin of Mukilteo, Washington, the controlling shareholder of the project's developer; J. David Smith of Edmonds, Washington, the developer's attorney; John H. White of Stanwood, Washington, and Edward L. Tezak of Sheridan, Montana, who were involved in arranging private financing for the project; Signal Mortgage, Inc., a Washington state mortgage broker of which John H. White was a vice president and part owner; Michael McCall of Elk Grove, California, and Charles Tull of Bellingham, Washington, attorneys who represented Holmes Harbor Sewer District in the bond sale; and Ibis Securities of Walnut Creek, California, the underwriter of the bonds; Ibis principals Kenneth Martin of Concord, California, and George Tamura of San Leandro, California.

According to the complaint, the bonds were sold to investors in October 2000 based on information contained in an Official Statement, a written offering document that explains key features and risks for a bond offering, that the developer, attorneys and underwriter each either drafted or reviewed. The Official Statement contained several material misrepresentations and omissions, including the following:

Use of Proceeds to Acquire Land: According to the Official Statement, $6.2 million in bond proceeds would be used to acquire 15 acres of land for certain public purpose portions of the project. This claim was false. In fact, the developer used $6.2 million in bond proceeds to acquire a total of 39.9 acres, which included land for both the public and private purpose portions of the project.

Involvement of Prominent Investment Bank: The Official Statement represented that an entity called Goldman/Sig LLC had agreed to be a participating mortgage lender for the project. According to the Official Statement, Goldman/Sig LLC was formed by Goldman Sachs, Private Client Services, along with Signal Mortgage. This claim was false. Goldman Sachs, Private Client Services had no involvement with the bonds or the project, and did not participate in the formation of Goldman/Sig LLC.

Existence of Construction Financing for Project: The Official Statement represented that the developer had entered into an agreement with Goldman/Sig to "fund infrastructure construction and office building construction through completion and provide long-term mortgage financing." This statement was false and misleading because Goldman/Sig had no ability to provide the nearly $65 million in financing required to complete the project.

Value of, and Existence of Lease Agreement for, the Project: According to an appraisal contained in the Official Statement, at the time the bonds were sold the developer had entered into a lease agreement covering the entire property with a single, unidentified tenant with a "Triple A (corporate) credit rating." Based on this information, the appraisal concluded that the project when built would have a value of $90 million. This claim was false and misleading. In fact, the developer had entered into an agreement with a small firm with a total of six employees and annual revenues of approximately $600,000, and no capacity to meet the projected monthly lease payments for the six buildings to be constructed in the project. Moreover, the Official Statement failed to disclose that the developer had entered into a side agreement that allowed the lessee to cancel the lease at any time.

Undisclosed Payments to Offering Participants: The Official Statement disclosed that bond proceeds would be used to pay $100,000 to attorney Tull's law firm and $140,000 to attorney McCall's law firm for their work in providing legal opinions on the bond offering. However, the Official Statement failed to disclose that on the day the bond offering closed, the developer used bond proceeds to make additional payments of $60,000 to Tull and $45,000 to McCall. The Official Statement also failed to disclose that shortly after closing the developer used bond proceeds to make a $200,000 payment to underwriter Ibis and a $50,000 payment to Tezak, who was purportedly involved in obtaining private financing for the project.

The Commission's complaint charges Terry Martin and two of his corporate entities (Silver Legacy Corporation and Silver Sound LLC), as well as Smith, McCall, Tull, Kenneth Martin and Tamura with fraud in the offer and sale of securities, in violation of Section 17(a) of the Securities Act of 1933 ("Securities Act") and Section 10(b) of the Securities Exchange Act of 1934 ("Exhange Act") and Rule 10b-5 thereunder.

In addition, the complaint charges that Tezak, White, Signal Mortgage and Goldman/Sig violated Section 17(a) of the Securities Act and violated or aided and abetted violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

Finally, the complaint charges that Ibis violated Section 17(a) of the Securities Act, and Municipal Securities Rulemaking Board Rule G-17, and Sections 10(b) and 15B(c)(1) of the Exchange Act and Rule 10b-5 thereunder. The Commission seeks permanent injunctions prohibiting future violations against each defendant, as well as the return of all monies received as a result of the fraud plus pre-judgment interest, and civil money penalties.

In a separate action, the Office of the U.S. Attorney for the Western District of Washington also announced the filing of criminal charges against Terry Martin, Smith, White and Tezak for their roles in the bond offering.

SEC Complaint in this matter

UNDERWRITERS

Injunctive Proceedings

SEC v. David Fitzgerald and Pacific Genesis Group, Inc., Civ. Action No. C-00-4802 (CRB) (N.D. Cal.), Litigation Release No. 16854 (January 4, 2001).

On December 27, 2000, the U.S. Securities and Exchange Commission filed an action in federal district court in San Francisco against Pacific Genesis Group, Inc., a municipal securities underwriting firm based in Alameda, California, and its Chairman and managing director, David Fitzgerald, for fraud in connection with a series of bond offerings to finance a residential development in southern California. As part of the action, U.S. District Court Judge Vaughn Walker issued an order against Pacific Genesis and Fitzgerald that requires them to put the proceeds of another planned offering for the project in escrow, pending a further hearing on the Commission's action.

In its court filings, the Commission alleged that Pacific Genesis and Fitzgerald have underwritten over $70 million in tax-exempt municipal bonds to finance the Rancho Lucerne Master Planned Community, about 50 miles northeast of the City of San Bernardino, California. However, according to the Commission's filings, four years after the first offering, not a single road has been paved, no homes have been built and not a single residential lot has been sold to a homebuilder. The Commission alleges that Pacific Genesis and Fitzgerald intentionally or recklessly misrepresented or omitted material facts in the offering documents concerning the value of the land used as security for the bonds, the status of the project and the likelihood that the bonds would be repaid from the revenues of the project. By this conduct, the Commission alleges, Pacific Genesis and Fitzgerald violated Section 17(a) and the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder. In addition, the Commission alleges that Pacific Genesis violated Section 15B(c)(1) of the Exchange Act and Municipal Securities Rulemaking Board Rule G-17.

In particular, the Commission alleges that Pacific Genesis and Fitzgerald knew or recklessly disregarded the fact that an appraisal they used as the basis for the financings was materially false and misleading. Beginning in the late 1980s, the developer of the project acquired land in the area for an average of $1,564 an acre, the Commission alleges. However, in financing the land, Pacific Genesis and Fitzgerald relied on a materially false appraisal that drastically over estimated the value of the land involved in the development. Based on this false appraisal, the Commission alleges, Pacific Genesis and Fitzgerald fraudulently misled investors about the value of the land that secures the bonds, using land that is worth less than $5 million to underwrite some $70 million in debt financing.

As part of the action, the Commission sought a temporary restraining order against Pacific Genesis and Fitzgerald in connection with a planned $13.5 million offering for the project that was scheduled to close before December 31, 2000. Judge Walker granted the order, directing that if Pacific Genesis proceeds with the offering, it must maintain all of the offering proceeds in an escrow account pending a hearing on the Commission's order for a preliminary injunction, scheduled for January 5, 2001.

http://www.sec.gov/litigation/litreleases/lr16854.htm

SEC v. David Fitzgerald and Pacific Genesis Group, Inc., Civ. Action No. C-00-4802 (CRB) (N.D. Cal.), Litigation Release No. 16907 (February 23, 2001).

The Securities and Exchange Commission announced that on February 16, 2001, the Honorable Charles R. Breyer, U.S. District Court Judge for the Northern District of California entered an order halting a $13.5 million offering of municipal bonds underwritten by Pacific Genesis Group, Inc. and its Chairman David E. Fitzgerald by requiring that all proceeds raised in the offering be immediately returned to investors. The order further prohibits these defendants from future conduct in violation of section 17(a) of the Securities Act of 1933 and requires that they submit written marketing materials to the Commission seven days prior to offering any other bonds secured by the same development project.

The order, which entered a permanent injunction, was based upon Judge Breyer's February 14, 2001 finding that the defendants violated sections 17(a)(2) and (3) of the Securities Act, section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 by making fraudulent and negligent misrepresentations in the Official Statement for the offering. The Court's ruling came after a seven-day trial on the defendants' role in underwriting the most recent in a series of nine municipal bond offerings for the proposed Rancho Lucerne Master Planned Community located in the desert region of San Bernardino County California. The order also holds that prior to selling or offering any additional or existing bonds pertaining to Rancho Lucerne the defendants are required to provide the Commission with all information to be used in connection with the sale or offer of such bonds. Litigation is still pending with respect to the Commission's claims for disgorgement and penalties for the ninth offering, as well as for all claims against the defendants for their role in underwriting the eight previous offerings for Rancho Lucerne.

On December 27, 2000, the Commission filed its complaint in federal district court in San Francisco alleging that the defendants violated the antifraud provisions of the federal securities laws in connection with all nine offerings for a total of over $70 million in tax-exempt municipal bonds to finance Rancho Lucerne. According to the Complaint, four years after the first offering, not a single road has been paved, no homes have been built and not a single residential lot has been sold to a homebuilder.

http://www.sec.gov/litigation/litreleases/lr16907.htm

<u>SEC v. David Fitzgerald and Pacific Genesis Group, Inc</u>., Litigation Release No. 17432 (March 22, 2002).

A federal district judge in San Francisco enjoined Pacific Genesis Group, Inc., a municipal securities underwriting firm based in Alameda, California, and its former lead underwriter, David E. Fitzgerald. On March 20, 2001, United States District Judge Charles R. Breyer entered judgments ordering the firm and Fitzgerald to refrain from future fraudulent conduct in violation of the federal securities laws. The judgments also require Fitzgerald to pay $300,000 in disgorgement, interest and penalties.

In December 2000, the Commission brought suit against Pacific Genesis and Fitzgerald in connection with a series of bond offerings to finance a residential development in southern California. The Commission alleged that Pacific Genesis and Fitzgerald had underwritten over $70 million in tax-exempt municipal bonds to finance the Rancho Lucerne Master Planned Community, about 50 miles northeast of the City of San Bernardino, California. However, according to the Commission's filings, not a single road had been paved, no homes had been built and not a single residential lot had been sold to a homebuilder. The Commission alleged that Pacific Genesis and Fitzgerald intentionally or recklessly misrepresented or omitted material facts in the offering documents concerning the value of the land used as security for the bonds, the status of the project and the likelihood that the bonds would be repaid from the revenues of the project.

A portion of the case was brought to trial in early 2001. On February 16, 2001, Judge Breyer ordered that all proceeds of the latest bond offering be returned to investors. The order also prohibited Pacific Genesis and Fitzgerald from selling more bonds on the Rancho Lucerne project by means of fraud and misrepresentation. As part of a settlement of the remaining issues in the case, Pacific Genesis and Fitzgerald consented to the judgments entered this week.

In its complaint, the Commission alleged violations of Section 17(a) and the Securities Act of 1933 and Sections 10(b) and 15B(c)(1) of the Securities Exchange Act of 1934 ("Exchange Act"), Rule 10b-5 and Municipal Securities Rulemaking Board Rule G-17.

http://www.sec.gov/litigation/litreleases/lr17432.htm

<u>SEC v. Terry Richard Martin, Silver Legacy Corporation, Silver Sound LLC, Jonas David Smith, Michael W. McCall, Charles J. Tull, Ibis Securities LLC, Kenneth R. Martin, George Tamura, Goldman Sig, Inc., Edward L. Tezak, Signal Mortgage Inc., and John H. White</u>, Civ. Action No. C 03-2646 C (W.D. Wash.), Litigation Release No. 18315 (August 28, 2003) (complaint).
See "OBLIGATED PERSONS" section.

Commission Orders – Settled Administrative Proceedings

<u>In the Matter of Legg Mason Wood Walker, Incorporated, Thomas M. Daly, Jr., and Joseph A. Sullivan</u>, Exchange Act Release No. 44407, A.P. File No. 3-10068 (June 11, 2001).

I.

In these proceedings instituted pursuant to Sections 15(b), 15B(c), 19(h) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Respondents Legg Mason Wood Walker, Incorporated ("Legg Mason"), Thomas M. Daly, Jr. ("Daly") and Joseph A. Sullivan ("Sullivan") (collectively, the "Respondents") have submitted Offers of Settlement (the "Offers") which the Securities and Exchange Commission ("Commission") has determined to accept. Solely for the purpose of these proceedings and any other proceeding brought by or on behalf of the Commission or in which the Commission is a party, and without admitting or denying the findings contained herein, except jurisdiction, which each Respondent admits, the Respondents, by their Offers, consent to the findings and the imposition of the sanctions and other relief contained in this Order Making Findings and Imposing Remedial Sanctions and Cease-and-Desist Order ("Order").

II.

On the basis of this Order and the Offers submitted by the Respondents, the Commission finds that:

A. Respondents

1. Legg Mason is a Maryland corporation registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Exchange Act.

2. Daly is a Legg Mason Senior Vice President. From, at least, June 30, 1994 to April 18, 1997, Daly managed Legg Mason's municipal securities sales and trading and public finance functions.

3. Sullivan is a Legg Mason Senior Vice President. Since April 18, 1997, Sullivan managed Legg Mason's Fixed Income Department, including its municipal securities sales and trading function.

B. Background

1. From June 30, 1994 through June 30, 1998, Legg Mason was the senior-managing or sole underwriter in numerous primary offerings of municipal securities, including advance refundings.

2. At various times during the relevant time period, Legg Mason, Daly and, to a lesser extent, Sullivan, were given notice of increased attention to Municipal Securities Rulemaking Board ("MSRB") rule compliance and deficiencies in its MSRB rule compliance by both the NASD and, from, at least, September 1, 1998, the Commission, yet they continuously failed to effect full compliance with those rules.

Moreover, during this time period, publications such as the Bond Buyer and the Wall Street Journal reported increased regulatory efforts in this regard.

3. MSRB Rule G-36(b)(i) requires, among other things, the managing underwriter in initial offerings of municipal securities subject to Exchange Act Rule 15c2-12 to send two copies of the official statement form ("Form OS") and the final official statement to the MSRB no later than ten business days after the final agreement to purchase. Rule G-36(b)(ii) further requires, among other things, the managing underwriter in advance refundings of outstanding issues of municipal securities to send two copies of the advance refunding documents form ("Form ARD") and the advance refunding documents to the MSRB within five business days of delivery of the securities by the issuer to the managing underwriter.

4. From, at least, June 30, 1994 to April 18, 1997, Daly supervised certain Legg Mason employees whose functions included sending prescribed forms and documents to the MSRB on behalf of Legg Mason to comply with MSRB Rule G-36.

5. From, at least, April 18, 1997 through February 1999, Sullivan supervised certain Legg Mason employees whose functions included sending prescribed forms and documents to the MSRB on behalf of Legg Mason to comply with MSRB Rule G-36.

6. MSRB Rule G-27 requires each broker, dealer and municipal securities dealer to supervise the conduct of its municipal securities business and the municipal securities activities of its associated persons, and to adopt, maintain and enforce written supervisory procedures reasonably designed to ensure compliance with the MSRB rules and the applicable provisions of the Exchange Act and rules thereunder (collectively, the "applicable rules").[1] More specifically, MSRB Rule G-27(a) requires each broker, dealer and municipal securities dealer to supervise the conduct of its municipal securities business and the municipal securities activities of its associated persons to ensure compliance with the applicable rules. Subpart (b) requires the designation of principals to be responsible for such supervision, and the maintenance and updating of a written record of such designation, including the designated principal's responsibilities under Rule G-27. Subpart (c) requires the adoption, maintenance and enforcement of written supervisory procedures reasonably designed to ensure compliance with the applicable rules. In particular, Rule G-27(c) provides that such procedures should codify the dealer's supervisory system for ensuring compliance and should, at minimum, "establish procedures (i) that state how a designated principal shall monitor for compliance .... with all applicable rules; ... (iv) for the periodic review by a designated principal of each office which engages in municipal securities activities; [and] (v) for the maintenance and preservation, by a designated principal, of the books and records required to be maintained and preserved by rules G-8 and G-9 of the Board." Finally, subpart (e) imposes on the dealer the duty to revise and update written procedures as necessary to respond to changes in MSRB or other rules and as other circumstances require, to review annually its supervisory system and written supervisory procedures to determine whether they are adequate and up-to-date, and to ensure that the dealer is in compliance with Rule G-27.[2]

C. The Violations

1. With respect to Legg Mason's participation in advance refundings and initial offerings of municipal securities from June 30, 1994 through June 30, 1998, Legg

Mason willfully[3] violated MSRB Rules G-36(b)(i) and (ii) in that it failed to file, or filed delinquently, documents required to be filed under those rules. Legg Mason failed to file the required Form ARD for almost one quarter of the advance refunding transactions in which it acted as the managing underwriter during this four-year period.

2. From, at least, June 30, 1994 through April 18, 1997, Daly was a cause of Legg Mason's violations of MSRB Rules G-36(b)(i) and (ii) in that he knew or should have known of Legg Mason's Rule G-36 violations yet he did not cure those violations or otherwise ensure that Legg Mason complied with Rule G-36.

3. From, at least, April 18, 1997 through February 1999, Sullivan was a cause of Legg Mason's violations of MSRB Rules G-36(b)(i) and (ii) in that he knew or should have known of Legg Mason's Rule G-36 violations yet he did not cure those violations or otherwise ensure that Legg Mason complied with Rule G-36.

4. With respect to Legg Mason's participation in advance refundings and initial offerings of municipal securities during the relevant period, Legg Mason, Daly and Sullivan willfully violated MSRB Rule G-27(a) in that they failed to supervise the conduct of Legg Mason's municipal securities business and the municipal securities activities of its associated persons to ensure compliance with MSRB Rules G-36(b)(i) and (ii).

5. With respect to Legg Mason's participation in all offerings and transactions of municipal securities during the relevant period, Legg Mason further willfully violated MSRB Rules G-27(b), (c)(i), (c)(iv), (c)(v) and (e) in that it failed to designate principals responsible for supervision of its municipal securities business and the municipal securities activities of its associated persons as required by Rule G-27; failed to keep a written record of that supervisory designation and of the designated principal's responsibilities under Rule G-27; failed to adopt, maintain and enforce written supervisory procedures that (i) state how a designated principal shall monitor for compliance by the dealer with the applicable rules, (ii) provide for the periodic review by a designated principal of each office which engages in municipal securities activities, or (iii) provide for the maintenance and preservation, by a designated principal, of the books and records required to be maintained and preserved by MSRB Rules G-8 and G-9; failed to revise and update its written supervisory procedures as necessary to respond to changes in MSRB or other rules and as other circumstances require, or to review annually its supervisory system and written supervisory procedures to determine whether they are adequate and up-to-date; and failed to ensure that Legg Mason was in compliance with Rule G-27.

III.

On the basis of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions and other relief specified in the Respondents' Offers of Settlement.

Accordingly, **IT IS HEREBY ORDERED** that:

A. Legg Mason, Daly and Sullivan be, and hereby are, censured;

B. Daly and Sullivan cease and desist from committing or causing any violations and any future violations of MSRB Rules G-36(b)(i) and (ii) and Rule G-27(a) as it relates to Rule G-36;

C. Legg Mason cease and desist from committing or causing any violations and any future violations of MSRB Rules G-27(b), (c)(i), (c)(iv), (c)(v), (e) and G-36(b)(i) and (ii), as well as of Rule G-27(a) as it relates to Rule G-36;

D. Legg Mason shall, within 30 days of the entry of this Order, pay a civil money penalty in the amount of $50,000 to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Comptroller, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under a cover letter which identifies Legg Mason as a Respondent in these proceedings and the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Ronald C. Long, District Administrator, Philadelphia District Office, Securities and Exchange Commission, The Curtis Center, Suite 1120E., 601 Walnut Street, Philadelphia, Pennsylvania 19106;

E. Daly shall, within 30 days of the entry of this Order, pay a civil money penalty in the amount of $10,000 to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Comptroller, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under a cover letter which identifies Daly as a Respondent in these proceedings and the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Ronald C. Long, District Administrator, Philadelphia District Office, Securities and Exchange Commission, The Curtis Center, Suite 1120E., 601 Walnut Street, Philadelphia, Pennsylvania 19106;

F. Sullivan shall, within 30 days of the entry of this Order, pay a civil money penalty in the amount of $10,000 to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Comptroller, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under a cover letter which identifies Sullivan as a Respondent in these proceedings and the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Ronald C. Long, District Administrator, Philadelphia District Office, Securities and Exchange Commission, The Curtis Center, Suite 1120E., 601 Walnut Street, Philadelphia, Pennsylvania 19106;

G. Legg Mason shall, within 1 year of the date of this Order, comply with its undertaking to retain, at Legg Mason's expense, an independent consultant, not unacceptable to the Commission's staff who shall, among other things, conduct a comprehensive review of Legg Mason's policies, procedures and practices relating to the prevention or detection of the improper conduct described in § II.C., above. Within 30 days of retention, the independent consultant shall review such policies, procedures and practices with respect to the improper conduct described in § II.C.

with a view to determining if all such policies, procedures and practices have been implemented or require supplementation. Legg Mason shall cooperate with the independent consultant's review of Legg Mason's policies, procedures and practices, and shall provide the independent consultant with any and all requested documents that the independent consultant reasonably requests (other than materials or information protected by a valid claim of attorney-client privilege or attorney work product).

1. The independent consultant shall prepare a written report of findings and recommendations within 60 days of retention. Legg Mason shall be provided a reasonable opportunity to comment on the independent consultant's report, not to exceed 30 days after receipt of the independent consultant's report. With respect to any recommendation or proposal with which Legg Mason and the independent consultant do not agree, Legg Mason and the independent consultant shall attempt in good faith to reach agreement.

2. If the independent consultant concludes that all of Legg Mason's policies, procedures and practices relating to the prevention or detection of the improper conduct described in § II.C., above, have been implemented, the independent consultant shall inform Legg Mason and the Philadelphia District Office, Division of Enforcement of this conclusion in writing, and his or her responsibilities with respect to Legg Mason shall conclude. If the independent consultant does not conclude that all of Legg Mason's policies, procedures and practices with respect to the improper conduct described in § II.C. have been implemented, and/or makes additional recommendations to supplement existing policies, procedures and practices, he or she shall notify Legg Mason and the Philadelphia District Office, Division of Enforcement in writing of the policies, procedures and practices that have not been implemented and/or describe the additional recommendations. Legg Mason shall implement such policies, procedures and practices in a timely manner, but in any event no later than 3 months from the date of receiving notification from the independent consultant. By the same date, Legg Mason shall submit to the Philadelphia District Office an Affidavit detailing its efforts to implement the procedures discussed in the independent consultant's report and stating whether it has achieved compliance.

3. For good cause shown, and upon receipt of a timely application from the independent consultant or Legg Mason, the Philadelphia District Office may extend any of the procedural dates set above. Moreover, if, after a good faith attempt to reach agreement with the independent consultant, Legg Mason believes that implementing the independent consultant's recommended policies, procedures and practices is unnecessary, impractical, unduly burdensome and/or unreasonable, it may petition the Commission, with notice to the independent consultant and the Philadelphia District Office, Division of Enforcement, for relief from implementing such policies, procedures and practices.

4. For the period of engagement and for a period of 1 year from the completion of the engagement, the independent consultant shall not, without prior written consent of the Philadelphia District Office, enter into any employment, consultant, attorney-client, auditing or other professional relationship with Legg Mason, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity. Any firm with which the independent consultant is affiliated or of which he/she is a member, and any person engaged to assist the independent consultant in

performance of his/her duties under this Order shall not, without prior written consent of the Philadelphia District Office, enter into any employment, consultant, attorney-client, auditing or other professional relationship with Legg Mason, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of 1 year after the engagement.

By the Commission,
Jonathan G. Katz
Secretary

Footnotes

[1] Rule D-11 defines the terms "broker," "dealer," and "municipal securities dealer," to include their respective associated persons, excluding clerical or ministerial staff.

[2] Since the date of the institution of proceedings in this matter, the MSRB has amended Rule G-27, changing the subsection that deals with revising, reviewing and updating supervisory procedures from (d) to (e). The Commission approved the amendment on March 16, 2000, and it became effective on September 19, 2000.

[3] In applying the term "willful" in Commission administrative proceedings instituted pursuant to Sections 15(b), 15B, 15C, 17A, and 19(h) of the Securities Exchange Act, the Commission evaluates on a case-by-case basis whether the respondent knew or reasonably should have known under the particular facts and circumstances that his conduct was improper. In this case, as in all Commission administrative proceedings charging a willful violation under these statutory provisions, the Commission applies this standard to persons-specifically industry professionals-who are directly subject to Commission jurisdiction and who have a responsibility to understand their duties to the investing public and to comply with the applicable rules and regulations which govern their behavior.

http://www.sec.gov/litigation/admin/34-44407.htm

In the Matter of Rauscher Pierce Refsnes, Inc., now known as Dain Rauscher Incorporated, Securities Act Release No. 8013, Exchange Act Release No. 44864, A.P. File No. 3-10592 (September 27, 2001).

I.

The Securities and Exchange Commission ("Commission") deems it appropriate, in the public interest, and for the protection of investors to institute public administrative and cease-and-desist proceedings against Rauscher Pierce Refsnes, Inc., now known as Dain Rauscher Incorporated ("Rauscher or Respondent"), pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Sections 15(b), 19(h) and 21C of the Securities Exchange Act of 1934 ("Exchange Act").

II.

In anticipation of the institution of these proceedings, Respondent Rauscher has submitted an Offer of Settlement ("Offer"), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceeding brought by or on behalf of the Commission, or in which the Commission is a party, and without admitting or denying the findings contained herein, except as to jurisdiction of the Commission over Respondent and over the subject matter of this proceeding and as to the finding contained in Section III paragraph 1. below, which are admitted, Respondent Rauscher by its Offer consents to the entry of findings and remedial sanctions set forth below.

Accordingly, **IT IS ORDERED** that public administrative and cease-and-desist proceedings pursuant to Section 8A of the Securities Act and Sections 15(b), 19(h) and 21C of the Exchange Act be, and, they hereby are, instituted.

III.

On the basis of this Order and the Offer submitted by Respondent Rauscher, the Commission finds that:[1]

Rauscher is registered with the Commission as a broker-dealer and, at all relevant times, was a Delaware corporation with its principal place of business in Dallas, Texas.[2]

Introduction

In December 1995, the City of Miami (the "City") offered and sold, on a negotiated basis, $72 million in non-ad valorem revenue bonds to pay for certain of its annual pension and employee compensated absences obligations (the "Pension Bond Offering" or "Pension Bonds").

The Official Statement for the Pension Bond Offering ("Official Statement") contained the City's audited general-purpose financial statements for the period October 1, 1993 through September 30, 1994 ("fiscal year 1994").

Rauscher underwrote the Pension Bond Offering and, through its investment bankers, participated along with other professionals, including underwriters' counsel, in the drafting of the Official Statement. The Official Statement was the document that should have provided investors with accurate and complete disclosure of material facts regarding the City's financial condition and the Pension Bonds on which they could rely to make an informed investment decision. The Rauscher investment bankers that participated in the Pension Bond Offering approved the offering on behalf of Rauscher and bound the firm.

The City of Miami's Deteriorating Financial Condition

The City's financial condition began to decline materially after the close of fiscal year 1994 and continued to worsen through December 1995. Specifically, the City's cash position had deteriorated to the point where the City faced the very credible prospect of being unable to meet its operating expenses for October 1, 1994 through September 30, 1995 ("fiscal year 1995"). The City's top financial officials were keenly aware of the City's dire economic situation.

Material Omissions in the Official Statement

The Official Statement failed to disclose the City's financial condition to investors at the time of the Pension Bond Offering. Specifically, the Official Statement omitted to state that the City's cash position had materially declined since the close of fiscal year 1994 and that serious consequences could result, including being unable to pay its operating expenses and debt service going forward, if its cash position did not significantly improve. The Official Statement disclosed the existence of operating deficits, declining fund balances and unfunded liabilities as of the close of fiscal year 1994. Further, the Official Statement stated that the pension obligation was putting an "increasing strain on the City's budget," that the City had limited ability to raise revenue from ad valorem taxes because of a constitutional cap, and that using tax receipts to pay the operating expense of regularly required pension payments "could force a curtailment of City services." The Official Statement disclosed that for this reason the City had determined to issue the Pension Bonds and that the City would use the bond proceeds to meet its pension obligations, including reimbursing itself for pension payments made for fiscal year 1995. Finally, the Official Statement disclosed that the City was authorized to issue up to $210 million in additional bonds to fund its future pension obligations.

While the Official Statement disclosed the existence of Operation Right-Size, a program designed to significantly reduce City expenditures, it failed to disclose that the program was insufficient to remedy the City's immediate economic problems. Specifically, a footnote to the financial statements in the Official Statement stated that as of September 30, 1994, the City "experienced cash deficits in several of its operating funds which were temporarily remedied by loans from other funds," and that the City intended to replenish these cash deficits through, among other things, anticipated savings generated by Operation Right Size. This footnote omitted to state, however, that: (a) the City's cash position had materially declined since the close of fiscal year 1994, (b) the City faced the prospect of being unable to meet its operating expenses going forward absent significant improvement in its cash position and (c) Operation Right Size - a direct result of the city's deteriorating finances - although necessary for subsequent years, was insufficient to remedy the City's immediate cash flow problems because the bulk of the savings from the program would not take effect until the following year.

In sum, the Official Statement did not reveal the City's true financial condition to investors at the time of the Pension Bond Offering. [3]

Rauscher's Knowledge and Insufficient Due Diligence

At the time of the Pension Bond Offering, Rauscher reasonably should have known certain material information regarding the City's deteriorating financial condition as a result of several meetings held with City officials in which the City's financial goals in undertaking a potential pension bond offering were discussed with Rauscher. In these meetings, the City and Rauscher's investment bankers discussed: (a) the City's goal of funding only two years worth of its annual pension plan obligations through a bond or note offering; and (b) the City's desire for cash up front equal to a minimum of $26 million through a pension bond offering that provided for either upfront debt service savings or reimbursement of previous City pension plan expenditures.

City officials requested from Rauscher's investment bankers information regarding various possible bond offerings that would provide the City with cash flow relief and debt service savings. When it became apparent to the City that the bond offerings being proposed by Rauscher were insufficient to achieve the City's required level of upfront debt service savings, the City began to explore, with the assistance of Rauscher's investment bankers, potential bond offerings that had cash flow relief as their primary purpose. The City ultimately selected the Pension Bond Offering which permitted the bond proceeds to be used for the purpose of cash flow relief and included a reimbursement provision that permitted the City to reimburse itself for its pension plan expenditures fiscal year 1995. This maximized the City's ability to use the bond proceeds for cash flow relief.

As a result of the discussions Rauscher's investment bankers had with City officials, Rauscher knew that the City was seeking financing alternatives which would generate immediate cash flow relief and that, based on this, the City might have some sort of cash flow problem. Despite this knowledge, Rauscher, through its investment bankers, failed to sufficiently inquire into the City's cash flow situation and the potential financial problems the City might experience without the proceeds from the Pension Bonds. The facts that the Pension Bonds were fully insured and triple A rated did not relieve Rauscher's bankers from the obligation to inquire further into the City's cash flow and financial problems.

Based on the above, Rauscher reasonably should have known that the Official Statement failed to disclose the City's true financial condition to investors at the time of the Pension Bond Offering. In particular, the Official Statement did not disclose that the City's cash position had materially declined since the close of fiscal year 1994 and the City's intention that the Pension Bonds be issued in order to address the City's immediate cash flow requirements. Without these disclosures, the Official Statement was inaccurate and lacked complete disclosure regarding the City's deteriorating financial condition which was material to investors in the Pension Bond Offering because it is the type of information an investor would consider important in making an informed investment decision.

Legal Discussion

Rauscher Violated Sections 17(a)(2) and (3) of the Securities Act in the Offer and Sale of the Pension Bonds

Sections 17(a)(2) and (3) of the Securities Act make it unlawful for any person, through the means or instruments of interstate commerce or the mails, in the offer or sale of any security: (a) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or (b) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Scienter is not required to prove violations of Sections 17(a)(2) or (3) of the Securities Act. Aaron v. SEC, 446 U.S. 680, 697 (1980). Violations of these sections may be established by showing negligence. SEC v. Hughes Capital Corp., 124 F.3d 449, 453-54 (3d Cir. 1997); SEC v. Steadman, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992). Accordingly, Rauscher, through negligent conduct, violated Sections 17(a)(2) and (3) of the Securities Act in the offer and sale of the Pension Bonds.

Information about the City's deteriorating financial condition and cash flow problems were material to investors in the Pension Bonds. Information is material if there is a substantial likelihood that a reasonable investor in making an investment decision would consider it as having significantly altered the total mix of information available. See Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988); TSC Indus. Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

Accurate and complete disclosure about the City's deteriorating financial condition and cash flow problems was material to investors because as part of the total mix of information, a reasonable investor would have considered it important to know that the City faced the very credible prospect that it would not meet its operating expenses, including its debt obligations, going forward. In addition, this information would have affected the general perception of the City's creditworthiness.

Rauscher, as senior underwriter of the Pension Bonds, had a duty to conduct a professional review of the Official Statement, including an assessment of the information in its possession or reasonably accessible to it, sufficient to form a reasonable basis for believing in the accuracy and completeness of the key representations in the Official Statement. Rauscher, through its investment bankers, participated in drafting, reviewing and approving the Official Statement. Therefore, Rauscher reasonably should have known that the Official Statement omitted to disclose material information that was in its possession or reasonably accessible to it about the City's cash flow situation and the potential financial problems the City would experience without the proceeds from the Pension Bonds.[4]

Rauscher Violated Section 15B(c)(1) of the Exchange Act and MSRB Rule G-17

Under Section 15B(c)(1) of the Exchange Act, a broker, dealer, or municipal securities dealer is prohibited from using the mails or any instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in violation of any rule of the Municipal Securities Rulemaking Board ("MSRB"). As a broker-dealer conducting a municipal securities business, Rauscher was subject to Section 15(B)(c)(1) of the Exchange Act and the MSRB rules.

19. MSRB Rule G-17 provides that: "In the conduct of its municipal securities business, each broker, dealer, and municipal securities dealer shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice." For the reasons discussed above, Rauscher violated Section 15B(c)(1) of the Exchange Act and MSRB Rule G-17.

Legal Findings

Based on the foregoing, the Commission finds that Rauscher willfully violated, and committed or caused violations of, Sections 17(a)(2) and 17(a)(3) of the Securities Act, in that, in the offer and sale of certain securities, namely the Pension Bonds, by the use of the means and instruments of transportation and communication in interstate commerce and by the use of the mails, Respondent Rauscher directly and indirectly, obtained money or property by means of untrue statements of material facts and omissions to state material facts necessary in order to make statements made, in light of the circumstances under which they were made, not misleading; and engaged in transactions, practices and a course of business which would and did operate as a fraud and deceit upon the purchasers and prospective purchasers of such securities.

Based on the foregoing, the Commission finds that Rauscher willfully violated, and committed or caused violations of, Rule G-17 of the Municipal Securities Rulemaking Board ("MSRB") by not dealing fairly with all persons and by engaging in deceptive, dishonest or unfair practices in the conduct of its municipal securities business.

Based on the foregoing, the Commission finds that Rauscher willfully violated, and committed or caused violations of, Section 15B(c)(1) of the Exchange Act by effecting transactions in, or inducing or attempting to induce the purchase or sale of, municipal securities in violation of a rule of the MSRB.

IV.

Prior to the date of this Order, Rauscher revised its policies and procedures relating to municipal securities underwriting.

V.

Respondent Rauscher has submitted an Offer of Settlement in which, without admitting or denying the findings herein, it consents to the Commission's entry of this Order, which: (a) makes findings, as set forth above; (b) orders Rauscher to cease and desist from committing or causing any violation and any future violation of Sections 17(a)(2) and (3) of the Securities Act, Section 15B(c)(1) of the Exchange Act, and MSRB Rule G-17; (c) orders Rauscher to pay a civil penalty in the amount of $200,000 and (d) undertakes to maintain the policies and procedures referred to in Section IV. above.

VI.

In view of the foregoing, the Commission deems it appropriate, in the public interest, and for the protection of investors to accept the Offer of Settlement submitted by Rauscher.

Accordingly, **IT IS ORDERED** that, pursuant to Section 8A of the Securities Act and Sections 15(b), 19(h) and 21C of the Exchange Act:

Respondent Rauscher shall cease and desist from committing or causing any violation and any future violation of Sections 17(a)(2) and (3) of the Securities Act, Section 15B(c)(1) of the Exchange Act, and MSRB Rule G-17.

Rauscher shall, within thirty (30) days of the date of this Order, pay a civil money penalty in the amount of $200,000 to the United States Treasury. Such payment shall be: (a) made by United States postal money order, wire transfer, certified check, bank cashier's check or bank money order; (b) made payable to the United States Securities and Exchange Commission; (c) hand-delivered or mailed to the Comptroller, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, Virginia 22312; and (d) submitted under cover letter that identifies Rauscher as a Respondent in these proceedings, and the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to John C. Mattimore, Assistant Regional Director, Southeast Regional Office, Securities and Exchange Commission, 1401 Brickell Avenue, Suite 200, Miami, Florida 33131.

Rauscher shall comply with the undertakings specified in its Offer as follows: Rauscher undertakes to maintain the policies and procedures referred to in Section IV. above; provided, however, that Rauscher may modify such policies and procedures with alternative policies and procedures designed to achieve the same purposes.

By the Commission.
Jonathan G. Katz
Secretary

Endnotes

[1] The findings herein are made pursuant to Respondent Rauscher's Offer and are not binding on any other person or entity in this or any other proceeding.

[2] Dain Rauscher Incorporated is the corporate successor to Rauscher Pierce Refsnes, Inc. On January 2, 1998, Rauscher Pierce Refsnes, Inc. and Dain Bosworth Inc. were merged to form Dain Rauscher Incorporated. Dain Rauscher Incorporated is a Minnesota corporation with its registered office in Minneapolis, Minnesota. Dain Rauscher Incorporated was acquired by the Royal Bank of Canada on January 10, 2001 and currently operates as its wholly-owned subsidiary.

[3] The City of Miami and two former City officials were charged with disclosure violations concerning this offering in a cease-and-desist proceeding instituted on September 22, 1999. See In the Matter of The City of Miami, Florida, Cesar Odio and Manohar Surana, Securities Act Release No. 33-7741 (Sept. 22, 1999). On April 14, 2000 and September 22, 2000, Cesar Odio and Manohar Surana, respectively, without admitting or denying, each consented to the entry of cease-and-desist orders. See In the Matter of Cesar Odio, Securities Act Release No. 33-7851 (April 14, 2000); In the Matter of Manohar Surana, Securities Act Release No. 33-7895 (September 22, 2000). On June 22, 2001, the Chief Administrative Law Judge issued an Initial Decision which found that the City committed fraud in violation of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5, promulgated thereunder, in connection with this offering and two other bond offerings. The Initial Decision ordered the City to cease and desist from committing any violations or any future violations of these provisions. See In the Matter of The City of Miami, Florida, Initial Decision Release No. 185 (June. 22, 2001). On July 12, 2001, the City filed a petition for review of the Chief Administrative Law Judge's decision.

4 For purposes of Rauscher's violations, the conduct of the Rauscher officials and employees may be imputed to the firm. See SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1089 n.3 (2d Cir. 1972).

http://www.sec.gov/litigation/admin/33-8013.htm

In the Matter of Pryor, McClendon, Counts & Co., Inc., n/k/a Pryor, Counts & Co., Inc., Raymond J. McClendon, Allen W. Counts, and Theresa A. Stanford, Securities Act Release No. 8062, Exchange Act Release No. 45402, A.P. File No. 3-9884 (February 6, 2002).

I.

On April 29, 1999, the Commission instituted public administrative proceedings against Pryor, McClendon, Counts & Co., Inc., now known as Pryor, Counts & Co., Inc. (PMC) pursuant to section 8A of the Securities Act of 1933 (Securities Act) and sections 15(b)(4) and 21C of the Securities Exchange Act of 1934 (Exchange Act).

II.

PMC has submitted an offer of settlement, which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission or to which the Commission is a party, and without admitting or denying the findings contained in this order (except that PMC admits that the Commission has jurisdiction over it and over the subject matter of these proceedings), PMC consents to the entry of the findings and the institution of the remedial sanctions and the cease-and-desist order set forth below.

III.

The Commission finds the following:[1]

A. FACTS

1. Respondent

PMC, a New York corporation headquartered in Philadelphia, Pennsylvania, is a broker-dealer registered with the Commission pursuant to section 15(b) of the Exchange Act.

2. Summary

This matter concerns a series of federal securities law violations by PMC and two of its principals, and others scheming with them. The first group of violations relates to PMC's handling of the city of Atlanta's portfolio of zero-coupon securities issued by the United States Treasury ("Separate Trading of Registered Interest and Principal Securities" or "STRIPS"). The second group of violations concerns a series of concealed payments and political contributions to public officials and candidates for public office in Atlanta and New York.

As to the violations in Atlanta: From at least March 1992 through April 1994, PMC and others participated in a scheme to defraud the city of Atlanta in connection with the city's purchase and sale of approximately $9.8 billion in STRIPS. Atlanta's investment officer secretly set aside for PMC virtually all of the city's STRIPS business, at a time when PMC was providing substantial, undisclosed monetary benefits to the investment officer and her husband. PMC and the investment officer also churned Atlanta's STRIPS portfolio, generating over $15.3 million in revenue for PMC. Separate from but during part of the same period as the STRIPS trading scheme, PMC also made secret payments totaling $135,000 to an official with the city of Atlanta. At the time of the payments, PMC was seeking and obtaining municipal securities business from the City of Atlanta. (There is no evidence, however, that the official actually influenced the city's selection of underwriters.) By engaging in these activities, PMC violated the antifraud and books and records provisions of the federal securities laws as well as the Municipal Securities Rulemaking Board (MSRB) rule requiring fair dealing (rule G-17).

As to the violations in New York: PMC funneled political contributions through conduits to the campaign organization of a New York City official in May 1994 and a candidate for New York City office in July 1997. After each of these contributions, PMC participated in New York City negotiated bond offerings in violation of the MSRB rules prohibiting pay-to-play (rule G-37) and requiring fair dealing (rule G-17). One month after the 1994 contribution, PMC also violated the antifraud provisions of the federal securities laws by falsely representing to New York City that PMC's employees had made no contributions that would trigger the two-year underwriting ban of rule G-37. Finally, PMC mischaracterized as consulting expenses in its books and records the 1994 and 1997 campaign contributions, as well as a campaign contribution in 1993 to a candidate for New York state office and a payment in 1992 to a New York state official.

3. STRIPS Trading with the City of Atlanta

a. Atlanta's STRIPS Business

From March 1992 to April 1994, the value of Atlanta's securities portfolio ranged from approximately $1 billion to $1.4 billion, with approximately 40 percent to 60 percent of the portfolio consisting of STRIPS. During this period, PMC engaged in approximately $9.8 billion in STRIPS purchases and sales with Atlanta. The city's STRIPS transactions with PMC accounted for approximately 92 percent of the dollar amount of all STRIPS purchased and sold by Atlanta. All or nearly all of Atlanta's STRIPS transactions with PMC were done at the firm's recommendation.

b. Atlanta's Investment Officer Directs the City's STRIPS Business to PMC

During the relevant period, Atlanta maintained a list of broker-dealers with whom it could engage in securities transactions. On a monthly basis, the city mailed to those broker-dealers a report known as a "swap report." The purpose of the swap report was to inform the broker-dealers of Atlanta's securities holdings so that they could propose securities transactions beneficial to the city. The city's investment officer was responsible for evaluating whether securities transactions proposed by a broker-dealer enhanced the city's portfolio, as well as for buying and selling securities for Atlanta's portfolio.

At some point prior to March 1992, at a time when PMC had sold a substantial amount of STRIPS to Atlanta, the investment officer instructed her assistant to delete from the swap report all references to STRIPS before mailing the swap report to broker-dealers each month. Thereafter, the city's STRIPS did not appear on the swap report mailed to broker-dealers; this virtually eliminated PMC's competition for Atlanta's STRIPS business. However, PMC regularly received an internal city report known as a "security recall report," which showed all of the securities in Atlanta's portfolio. No other broker-dealer received the security recall report. And, with the exception of broker-dealers affiliated with banks where the city safe-kept its securities, no other broker-dealer besides PMC knew of the city's substantial holdings of STRIPS.[2]

c. PMC Provides Undisclosed Benefits to Atlanta's Investment Officer and Her Husband

Beginning no later than March of 1992, PMC began to provide financial benefits to the city's investment officer and her husband. In March 1992, PMC funneled through a conduit $30,000 to the investment officer's husband. The investment officer's husband used some of that money to capitalize, and set up office space for, his newly-formed company. From May 1992 until April 1994, PMC subcontracted with the company owned by the investment officer's husband, and paid the company $286,560 for services, $31,044 for expenses, and another $7,642 not designated as one or the other. PMC's payments to the company accounted for nearly all of the company's revenue during that period. In addition to that revenue and the $30,000 payment, PMC gave the investment officer and her husband other gifts of value. Neither PMC nor the investment officer ever disclosed, and the city never learned of, the financial and other benefits that the investment officer and her husband received from PMC.

d. PMC Trading in the City's STRIPS

PMC with others compounded the benefits that the firm received from the STRIPS business set aside for it by engaging in a course of trading that was excessive, improper, and inconsistent with the city's investment objectives, but designed to generate compensation for PMC in the form of markups and markdowns.[3] The city's stated investment policy was to pursue "a prudent, yet aggressive investment policy of maximizing investment income while minimizing risk" and to "hold investments until maturity." Yet from March 1992 until February 1994, PMC together with the investment officer caused Atlanta to engage in transactions with PMC that, in the aggregate, neither enhanced the value of the portfolio nor achieved the city's objectives, but instead turned over the STRIPS portion of the city's portfolio 8.6 times (or annually 4.5 times).

PMC caused the city to effect frequent exchanges, or "swaps," of one STRIPS for another STRIPS with a longer or shorter maturity. Generally, these series of STRIPS-for-STRIPS exchanges merely increased, then decreased, back and forth, the maturities of the STRIPS within a narrow range of short-term maturities. That course of trading provided PMC with at least $15,301,017 in revenues from markups and markdowns charged on the STRIPS transactions. The trading, however, provided no benefit to Atlanta, but instead materially diminished the city's investment returns, essentially through unnecessary transaction costs in the form of markups and markdowns received by PMC.[4]

4. Concealed Payments and Contributions

a. PMC Uses the Conduit to Make Payments to an Official of the City of Atlanta

Separate from but during the same period as the STRIPS trading scheme, PMC made secret payments to an official of the city of Atlanta. From December 1992 to August 1993, PMC funneled $135,000 to the Atlanta official through a company owned by the same conduit PMC used to funnel money to the husband of Atlanta's investment officer. PMC made the payments in four installments, recorded as professional fees paid to the conduit's company. With each of the four installments, PMC made a payment to the conduit's company, which, in turn, made an identical or similar payment close in time to the official's firm. During the period of the payments, PMC pursued and obtained underwriting business from Atlanta. (There is no evidence, however, that the official actually influenced the selection of underwriters by the city.)

b. Concealed Political Contributions after Rule G-37 took Effect

In the early 1990's, New York City selected a slate of underwriters to underwrite all of its negotiated bond offerings during a two-year period. In May 1994, while PMC was a member of the existing slate but shortly before the selection of underwriters for the next two-year slate, PMC funneled, through the same conduit that PMC used in Atlanta, a $10,000 contribution to the campaign organization of an official of New York City. On May 20, 1994, a PMC principal drew a $10,000 "loan" from PMC and wrote a personal check to the conduit for $10,400. On or about that same date, the conduit deposited that check into his personal checking account, and wrote a $10,000 check to the official's campaign organization.

Approximately one month after making the $10,000 contribution, PMC submitted a proposal to serve as an underwriter for the city's negotiated underwritings for the next two years. The proposal, submitted with a cover letter signed by a PMC principal, addressed conflict-of-interest questions that New York City had posed in its request for proposals. Notwithstanding the $10,000 contribution, PMC's proposal stated that:

In light of the recent action of the MSRB and the SEC in promulgating MSRB Rule G-37 which is founded upon conflict of interest concepts, PMC wishes to advise you of certain facts regarding political contributions. Prior to adopting a voluntary ban on all political contributions in December 1993, PMC did contribute to the election campaigns of a number of state and local New York political figures. In December 1993, however, PMC adopted a voluntary ban prohibiting all firm employees from making political contributions at the state and local levels and from soliciting contributions from outside parties. This voluntary ban remains in effect.

Following the submission of PMC's proposal, New York City selected PMC to serve on the city's slate of underwriters for negotiated bond offerings for the next two years. Between July 1994 and March 1996, PMC served as a co-manager or co-senior manager on more than $8.3 billion in New York City negotiated underwritings.

Three years later, a PMC principal made $750 in contributions, before the primaries, to a candidate for New York City office by way of three money orders made to appear as if they were from persons other than the PMC principal. In early July 1997, the PMC principal gave his administrative assistant $750 in cash, told her to purchase three separate money orders, and told her to make them payable for $250 each to the candidate's campaign. The PMC principal instructed his assistant to make out one of the money orders as if it were from the assistant herself, and to make out the other two as if they were from the wife of a PMC employee and a friend of the PMC principal. The PMC principal then caused those money orders to be delivered to the candidate's campaign together with the PMC principal's own personal check for $250. Within a week, the campaign returned (undeposited) two of the money orders (the money orders in the assistant's name and in the PMC principal's friend's name). The PMC principal instructed his assistant to deposit the returned $500 into PMC's bank account, which she did. In the 21 months thereafter, PMC participated as a co-managing underwriter in more than $4 billion of New York City negotiated bond offerings.

In total, PMC received between approximately $270,000 to $300,000 in management and other fees for serving as co-senior manager and co-manager on New York City negotiated bond offerings during the two-year periods immediately following the 1994 and 1997 contributions.

c. PMC Makes Secret Payment to a New York State Official and Concealed Political Contribution to a Candidate for New York State Office

Finally, PMC failed to keep accurate books and records in connection with the 1994 and 1997 campaign contributions described above, as well as two other payments made through the conduit mentioned above. In September 1992, PMC wrote a $12,000 check to the conduit, which was mischaracterized on the firm's books and records as a "consulting expense." On the same day and from the same account in which the PMC check was deposited, the conduit wrote a $12,000 check to a New York state official.

The following year, in April 1993, PMC funneled a $2,000 contribution through the conduit to the campaign organization for a candidate for New York state office. The PMC principal wrote a PMC check for $2,000 to the conduit, dated April 29, 1993, with the misleading notation, "house repair." The following day, the conduit deposited the check into his personal bank account. By check dated April 29, 1993, the conduit's company made a $2,000 contribution to the candidate's campaign organization. Again, PMC mischaracterized the payment in its books and records as a "consulting expense."

B. LEGAL ANALYSIS

1. Violations Related to the City of Atlanta's STRIPS Transactions

Section 10(b) of the Exchange Act and rule 10b-5 thereunder prohibit the use of schemes, practices or courses of business that operate as frauds, or the making of material misrepresentations or omissions, with scienter, in connection with the purchase or sale of securities. Section 17(a) of the Securities Act prohibits similar conduct in the offer or sale of securities, but under certain circumstances does not require a showing of scienter. Both knowing and reckless conduct establishes scienter. Rolf v. Blyth Eastman Dillon & Co., 570 F.2d 38, 46 (2d Cir. 1978), cert. denied, 439 U.S. 1039 (1978).

PMC and others participated in a scheme to defraud the city of Atlanta in connection with the city's purchase and sale of securities.[5] Atlanta's investment officer set aside substantial securities business for PMC, and funneled virtually all of the city's STRIPS business to PMC, at a time when the firm was providing substantial monetary benefits to the investment officer and her husband. Both PMC and the investment officer concealed the elements of the scheme from Atlanta. As a result of the scheme, and through PMC's and the investment officer's joint control of Atlanta's portfolio, PMC was able to engage in excessive STRIPS trading in Atlanta's portfolio, harming the city and generating over $15.3 million in revenue for PMC. PMC therefore violated section 10(b) of the Exchange Act, rule 10b-5, and section 17(a) of the Securities Act.

a. PMC's Failure to Disclose Material Information to Atlanta

PMC violated its duty as a broker-dealer to deal fairly with its client, consistent with industry practice. The violation occurred when PMC failed to disclose the actual and potential conflicts of interest it created by its business and financial relationship with the investment officer and her husband.[6] The Commission has held that a broker-dealer has a duty to disclose to its customer information indicating that the customer's agent is engaged in fraud with respect to the customer's investments.[7] In failing to make that disclosure, the broker-dealer shares in the agent's liability to the customer with respect to any transactions involving the broker-dealer. Id. This duty is clearest when the broker-dealer's own relationship with the customer's agent is the cause of the agent's faithlessness.[8]

PMC was required to disclose to Atlanta all material facts concerning its business and financial relationship with the investment officer and her husband. These facts included that the firm had (1) an ongoing business and financial relationship with the investment officer's husband, (2) provided the investment officer's husband with $30,000 to start his business, and (3) provided the investment officer and her husband with valuable gifts.[9]

b. Churning of the Atlanta STRIPS Portfolio

Having obtained virtually all of Atlanta's STRIPS business during the period of the scheme, PMC with others then churned the STRIPS portion of Atlanta's portfolio. Churning refers to excessive turnover in a controlled securities account for the purpose of increasing the amount of compensation received by a broker-dealer. See, e.g., Armstrong v. McAlpin, 699 F.2d 79, 90 (2d Cir. 1983). Proof of churning requires a showing (1) that the churner had either explicit or de facto control over trading in the account, (2) that trading in the account was excessive in light of the investor's objectives, and (3) that the churner acted with scienter. See, e.g., Miley v. Oppenheimer & Co., 637 F.2d 318, 324 (5th Cir. 1981); In re Donald A. Roche, Exchange Act Rel. No. 38741 (June 16, 1997), 64 SEC Dkt. 2042, 2048.

First, PMC shared control of Atlanta's securities accounts by engaging in a scheme to defraud Atlanta with the city's investment officer-the city employee with authority to trade Atlanta's securities portfolio. That shared control rendered PMC liable for purposes of churning analysis. [10]

Second, PMC with others turned over the STRIPS portion of Atlanta's portfolio at an annual rate of approximately 4.5. Excessive trading under the securities laws is not measured against some "magical per annum percentage" that establishes per se excessiveness. In re Gerald E. Donnelly, Exchange Act Rel. No. 36690 (Jan. 5, 1996), 61 SEC Dkt. 47, 51. Instead, excessive trading is determined based on the investment objectives of the customer.[11] The turnover of Atlanta's STRIPS portfolio exceeded the city's investment objectives and was inconsistent with the city's stated policy of "maximizing investment income while minimizing risk" and holding "investments until maturity." PMC's frequent selling, then re-buying, of STRIPS back and forth within a narrow range of short-term maturities provided no benefit to Atlanta but instead diminished the city's investment returns. See In re Russell Irish, 42 S.E.C. 735, 736 (1965) (churning found in frequent switching back and forth between mutual funds or between different series in the same mutual fund). While harming the city, the trading enriched PMC, generating over $15.3 million in revenue for the firm.

Third, PMC knew or was reckless in not knowing that the turnover it, with others, caused of Atlanta's STRIPS was inconsistent with the city's investment objectives, provided no benefit to Atlanta, and generated revenue for the firm at Atlanta's expense by diminishing the city's investment returns.

2. Violations Concerning Concealed Payments and Contributions

By violating the MSRB rules discussed below, PMC violated section 15B(c)(1) of the Exchange Act.[12]

a. Concealed Payments to Atlanta City Official

PMC's undisclosed payments to the city of Atlanta official at a time when the firm was seeking and obtaining municipal underwriting business from Atlanta created an actual or potential conflict of interest for the firm.[13] PMC's failure to disclose to Atlanta the payments, and the actual or potential conflicts created thereby, violated MSRB rule G-17. Id.[14]

b. Concealed $10,000 Contribution to New York City Official

Likewise, PMC violated MSRB rule G-17 by funneling the $10,000 contribution through a conduit to the New York City official at a time when the firm was seeking and obtaining municipal underwriting business from the city. The firm also violated MSRB rule G-37 because of the amount of the contribution and concealed manner in which it was made.[15]

The $10,000 contribution triggered rule G-37(b)'s ban forbidding PMC from underwriting New York City negotiated bond issues for two years.[16] By underwriting New York City negotiated bond offerings during the two years after the contribution, PMC violated MSRB rule G-37(b). By using the conduit to make the contribution, PMC also violated MSRB rule G-37(d), which prohibits broker-dealers from violating rule

G-37(b) through other persons or entities.[17] Finally, PMC violated rule G-37(e) by failing to disclose the contribution in its quarterly report to the MSRB.

PMC also violated the antifraud provisions of the federal securities laws in connection with the $10,000 contribution. When addressing conflict-of-interest questions posed by New York City, PMC wrote that since December 1993 the firm and its employees had in effect a voluntary ban on employees' political contributions to state and local officials. In the context in which those statements were made, PMC's failure to disclose the $10,000 contribution was misleading. Under the circumstances, materiality lies in the fact that the contribution had the effect of statutorily barring PMC from underwriting the city's negotiated bond offerings for two years, something a reasonable issuer would have wanted to know when selecting underwriters. The misrepresentation sufficiently touched on the sale of New York City's securities to satisfy the "in connection with" requirement of section 10(b) of the Exchange Act and rule 10b-5, because the misrepresentation bore directly on the city's decision concerning to whom it would sell its securities.[18] Finally, PMC knew or was reckless in not knowing that the funneled payment and its failure to disclose it operated as a fraud or deceit on the city.

c. Concealed Contributions to Candidate for New York City Office

In July 1997, PMC again violated MSRB rules G-17 and G-37 by making secret contributions to the campaign of a candidate for New York City office by way of three money orders in other persons' names. As a resident of New York City, rule G-37 allowed the PMC principal to contribute $250 to the candidate's campaign in the primary and in the general election, for a total of $500 during the election cycle. However, rule G-37 limits contributions to $250 before the primary, with an additional $250 allowed after the primary for the general election. MSRB Interpretations, published in MSRB Manual (CCH) ¶ 3681, at 5455 (April 1997). The PMC principal exceeded the $250 limit for the primary by making a $250 contribution with a personal check and making $750 in contributions through money orders made to appear as if they were from other people.[19] This triggered the two-year ban of rule G-37. But again PMC participated in underwriting New York City negotiated bond offerings. As a result, PMC violated MSRB rule G-37(b). The ban was triggered, and the violations occurred, even though the candidate subsequently lost the election.[20]

When PMC delivered three money orders to the campaign along with the PMC principal's own check, PMC also violated MSRB rule G-37(c) by coordinating contributions during a period when PMC was engaged in municipal securities business with New York City.[21] Finally, PMC failed to disclose the $750 in contributions in its quarterly report to the MSRB, and thereby also violated MSRB rule G-37(e).[22]

d. Violations of Books and Records Provisions

PMC, as a registered broker-dealer, was required by section 17(a)(1) of the Exchange Act and the rules promulgated thereunder to create and maintain books and records that accurately reflect its operations and dealings. Pursuant to section 17(a) and rule 17a-3 promulgated thereunder, PMC was required, among other things, to maintain ledgers or other records accurately reflecting all expense accounts.[23] Deliberate falsification of such records violates the Exchange Act's recordkeeping provisions. In re James F. Novak, Exchange Act Rel. No. 19660 (Apr. 8, 1983), 27 SEC Dkt. 1078, 1083.

PMC was also subject to MSRB recordkeeping requirements. MSRB rule G-8 sets out books and records requirements that parallel the Commission's, requiring broker-dealers to maintain, "clearly and accurately," specified books and records concerning their municipal securities business. Moreover, PMC was required by MSRB rule G-8(a)(xvi)(F) to maintain records reflecting all direct or indirect contributions to any official of a municipal bond issuer made by the firm's municipal finance professionals or executive officers.

PMC created and maintained inaccurate books and records with respect to the payments funneled through the conduit to the Atlanta investment officer's husband, an official of the city of Atlanta, a New York state official, and a candidate for New York State office. With respect to each of those funneled payments, PMC's books and records failed to record the true nature of the payments and characterized them in a misleading manner in violation of Exchange Act section 17(a) and rule 17a-3(a)(2) thereunder, and MSRB rule G-8(a)(x). In addition, PMC failed to make accurate records of the contributions he made to an official of New York City and a candidate for New York City office, in violation of MSRB rule G-8(a)(xvi)(F).

IV.

Based on the foregoing, the Commission finds that:

PMC willfully violated section 17(a) of the Securities Act, sections 10(b), 15B(c)(1), and 17(a)(1) of the Exchange Act and rules 10b-5 and 17a-3 thereunder, and MSRB rules G-8, G-17, and G-37.

V.

In view of the foregoing, the Commission finds that it is appropriate and in the public interest to impose the relief agreed to in the offer of settlement of PMC.

Accordingly, pursuant to section 8A of the Securities Act and sections 15(b)(4), 21B, and 21C of the Exchange Act:

1. **IT IS ORDERED** that PMC be, and hereby is, censured.

2. IT IS FURTHER ORDERED that PMC cease and desist from committing or causing any violations, and any future violations, of section 17(a) of the Securities Act, sections 10(b), 15B(c)(1), and 17(a)(1) of the Exchange Act and rules 10b-5 and 17a-3 thereunder, and MSRB rules G-8, G-17, and G-37.

3. **IT IS FURTHER ORDERED** that PMC shall pay a civil penalty of $40,000 to be paid within thirty days of the entry of this order.[24] Payment shall be: (1) made by United States postal money order, certified check, bank cashier's check, or bank money order; (2) made payable to the Securities and Exchange Commission; (3) hand-delivered or mailed to the Comptroller, Securities and Exchange Commission,

Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (4) submitted with a cover letter that identifies PMC as a respondent in these proceedings, and the file number of these proceedings. Copies of each cover letter and money order or check shall be sent to Russell Ryan, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 450 5th Street N.W., Washington, D.C. 20549-0806.

By the Commission.
Jonathan G. Katz
Secretary

Footnotes

[1] The findings herein are made pursuant to the offer of settlement of PMC and are not binding on any other person or entity in these or any other proceedings.

[2] Despite the investment officer's concealment, broker-dealers other than PMC managed to do limited STRIPS business with the city because on occasion the investment officer either sold STRIPS through a dealer other than PMC or a dealer proposed swaps in which it sold STRIPS to the city. After doing one of the latter transactions, the dealer involved then knew that the city owned those particular STRIPS and could then propose subsequent swaps involving those STRIPS.

[3] When a broker-dealer acts as a principal rather than an agent in a securities transaction with a customer, instead of charging a commission, the broker-dealer receives compensation (1) by adding a markup to the prevailing wholesale market price of the security in a sale to the customer and (2) by subtracting a markdown from the prevailing wholesale market price in a purchase from the customer. In re Lehman Bros. Inc., Exchange Act Release No. 37673 (Sept. 12, 1996), 62 SEC Dkt. 2324, 2330.

[4] For example, on March 12, 1993, Atlanta's general pension fund held STRIPS that had a market value that day of $27,389,030 and matured in May 1994. Through a series of STRIPS-for-STRIPS exchanges, PMC caused the city to turn that investment over six times in 194 days, while adding $105 in new money to the investment. At the end of that period, on September 22, 1993, the city held STRIPS that matured in February 1995 and had a market value of $27,525,520. Atlanta received $136,385 in total return from these exchanges, which translates into an annual rate of return of less than 1 percent. However, to effect this series of swaps, Atlanta paid transaction costs to PMC (in the form of markups and markdowns) totaling $491,776-more than 3½ times the city's total return from those swaps.

[5] A corporation, such as PMC, is liable for the acts of its principals when the conduct is carried out on behalf of the company. See Kerbs v. Fall River Industries, Inc., 502 F.2d 731, 741 (10th Cir. 1974) (corporation liable for securities fraud committed by its president); see also In re Lazard Frères & Co. LLC, Exchange Act Rel. No. 39388 (Dec. 3, 1997), 65 SEC Dkt. 3004, 3012 & n.7 (scienter of firm's principals imputed to firm).

[6] See SEC v. Feminella, 947 F. Supp. 722, 732 (S.D.N.Y. 1996) (broker's failure to disclose to customer that portion of consideration paid by customer included money that broker intended to provide to customer's agent); cf. SEC v. Scott,

565 F. Supp. 1513, 1527 (S.D.N.Y. 1983) (investor would consider apparent kickback agreement between issuer and underwriter material because the agreement raises inherent conflicts of interest and undermines the independence of the underwriter's investment judgment).

[7] See In re Moore and Co., 32 S.E.C. 191, 196 (1951) (broker effecting transactions directed by customer's agent without disclosing to customer facts known to broker about agent's self-dealing "was guilty along with [agent] of violations of the antifraud provisions"); In re William I. Hay, 19 S.E.C. 397, 407 (1945) (broker effecting transactions directed by customer's agent without disclosing to customer facts known to broker about agent's self-dealing violated antifraud provisions; noting that customers were victimized by "two agents, one with discretionary power over their accounts acting faithlessly and the other, a broker, knowing of the faithlessness yet claiming to be free of any duties").

[8] See also In re Thomas D. Pixley, Exchange Act Rel. No. 27316 (Sept. 29, 1989), 44 SEC Dkt. 1462, 1463 (registered representative who schemed with another to influence directing of pension fund investment business to the registered representative violated section 10(b) of the Exchange Act and rule 10b-5); In re E.H. Rollins & Sons, Inc., 18 S.E.C. 347, 385-86 (1945) (broker that provided secret payments to fund fiduciary who provided fund investment business to the broker violated section 17(a) of the Securities Act).

[9] Georgia law also imposed on PMC a duty to disclose to Atlanta its dealings with the investment officer. See O.C.G.A. § 23-2-53 (1996) ("Suppression of a material fact which a party is under an obligation to communicate constitutes fraud. The obligation to communicate may arise from the confidential relations of the parties or from the particular circumstances of the case."); Thompson v. Smith Barney, Harris Upham & Co., 539 F. Supp. 859, 864 (N.D. Ga. 1982) (duty to disclose under Georgia law arises "even absent a fiduciary relationship, where there is active concealment" or where one "takes advantage of a party he knows to be laboring under a delusion") (citing Young v. Hirsch, 199 S.E. 179, 184 (1938)).

[10] See Smith v. Petrou, 705 F. Supp. 183, 187 (S.D.N.Y. 1989) (proof of scheme between broker-dealer and customer's investment advisor establishes requisite control of broker-dealer for churning liability, even if advisor "alone made the investment decisions."); see also Moore, 32 S.E.C. at 196; William Hay, 19 S.E.C. at 407.

[11] In other enforcement actions, the Commission has found excessive annual turnover rates of 4.5 and lower. See, e.g., In re Laurie Jones Canady, Exchange Act Rel. No. 41250 (April 5, 1999), 69 SEC Dkt. 1468, 1476 (annual turnover rates ranging from 3.83 to 7.28 held excessive); In re Donald A. Roche, 64 SEC Dkt. 2046-47 (annual turnover rates of 3.3, 4.6, and 7.2 held excessive); In re Gerald E. Donnelly, 61 SEC Dkt. 50-51 (annual turnover rates ranging from 3.1 to 3.8 held excessive).

[12] Section 15B(c)(1) states that: "No broker, dealer, or municipal securities dealer shall make use of the mails or any instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in contravention of any rule of the [MSRB]."

[13] See In re Stephens Inc., Exchange Act Rel. No. 40699 (Nov. 23, 1998), 68 SEC

Dkt. 1854, 1866 (municipal securities broker-dealer violated MSRB rule G-17 by failing to disclose financial and other relationships between itself and the fiduciaries of a municipal issuer, because such relationships created actual or potential conflicts of interest).

[14] Rule G-17 provides that: "In the conduct of its municipal securities business, each broker, dealer, and municipal securities dealer shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice."

[15] Rule G-37 represents an attempt "to insulate the municipal securities industry from the potentially corrupting influence of political contributions that are made in close proximity to the awarding of municipal securities business." In re Morgan Stanley & Co., Exchange Act Rel. No. 39459 (Dec. 17, 1997), 66 SEC Dkt. 351, 353. The core of the rule, which took effect on April 25, 1994, is that "a firm may not engage in municipal securities business with an issuer for a two-year period if an official of the firm has made a contribution covered by the rule." Id. The rule provides a strict, broad prophylactic, and does not require any evidence of a quid pro quo. See Blount v. SEC, 61 F.3d 938, 942 (D.C. Cir. 1995), cert. denied, 116 U.S. 1351 (1996).

[16] Rule G-37(b) provides in pertinent part that: "No broker, dealer, or municipal securities dealer shall engage in municipal securities business with an issuer within two years after any contribution to an official of such issuer made by: (i) the broker, dealer or municipal securities dealer; [or] (ii) any municipal finance professional associated with such broker, dealer or municipal securities dealer [except for contributions not exceeding $250 per election to a candidate for whom the contributor is entitled to vote].

[17] Rule G-37(d) provides that: "No broker, dealer or municipal securities dealer or any municipal finance professional shall, directly or indirectly, through or by any other person or means, do any act which would result in a violation of sections (b) or (c) of this rule."

[18] See Superintendent of Ins. v. Bakers Life & Cas., 404 U.S. 6, 12-13 (1971) (an omission was "in connection with" the sale of securities because it was a "deceptive practice[] touching on the sale of securities."); SEC v. Jakubowski, 150 F.3d 675, 679-680 (7th Cir. 1998) (misrepresentation about buyer's eligibility to purchase securities from an issuer satisfied both "materiality" and "in connection with" requirements of section 10(b) of the Exchange Act and rule 10b-5).

[19] Even if all three-rather than just two-of the $250 money orders were returned, the two-year underwriting bar of rule G-37 still would have applied to PMC. The MSRB has stated that the bar applies after any contribution that does not meet the de minimis exception and that even if a refund of a contribution is obtained, dealers are still required to seek an exemption from the bar. MSRB Interpretations, published in MSRB Manual (CCH) ¶ 3681, at 5462-63 (April 1997).

20 Rule G-37(g)(vi) specifically includes "candidate" within the definition of persons to whom one cannot contribute without triggering the bar. The MSRB has stated that the rule renders the dealer "subject to the two-year ban on business with the issuer, regardless of whether the candidate wins or loses the election."

MSRB Interpretations, published in MSRB Manual (CCH) ¶ 3681, at 5469-70 (April 1997).

21 Rule G-37(c) provides that: "No broker, dealer, municipal securities dealer, or municipal finance professional may solicit or coordinate contributions to an official of an issuer with which the broker, dealer, or municipal securities dealer is engaging or is seeking to engage in municipal securities business."

22 Rule G-37(e) requires disclosure even of contributions that are returned to the contributor. MSRB Interpretations, published in MSRB Manual (CCH) ¶ 3681, at 5463 (April 1997).

23 As a municipal securities broker subject to the net capital requirements of Exchange Act rule 15c3-1, PMC was also required by MSRB rule G-8(a)(x) to maintain books and records specified in rule 17a-3 of the Exchange Act, including ledgers or other records reflecting all expense accounts.

24 In imposing this penalty, the Commission considered the Respondent's inability to pay such a penalty. See Exchange Act Section 21B(d).

http://www.sec.gov/litigation/admin/33-8062.htm

In the Matter of David E. Fitzgerald, Exchange Act Release No. 45599, A.P. File No. 3-10729 (March 20, 2002).

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest, and therefore institutes proceedings against David E. Fitzgerald ("Fitzgerald") pursuant to Sections 15(b) and 15B(c)(4) of the Securities Exchange Act of 1934 ("Exchange Act").

II.

In anticipation of the institution of these proceedings, Fitzgerald submitted an Offer of Settlement to the Commission that the Commission has determined to accept. Solely for the purposes of this proceeding and any other proceedings brought by or on behalf of the Commission or in which the Commission is a party, Fitzgerald admits the jurisdiction of the Commission over him, over the subject matter of this proceeding, and over the matters to be set forth in the Order and consents to the issuance of this Order.

Accordingly, **IT IS ORDERED** that a proceeding pursuant to Sections 15(b) and 15B(c)(4) of the Exchange Act be, and hereby is, instituted.

III.

FINDINGS AND CONCLUSIONS

The Commission finds that:

1. Fitzgerald, age 41, was a principal of and registered representative associated with Pacific Genesis Group, Inc., a broker-dealer and municipal securities dealer registered with the Commission from 1994 until June 2001. Fitzgerald is not currently associated with any registered entity.

2. On December 27, 2000, the Commission filed a complaint against Fitzgerald in an action entitled Securities and Exchange Commission v. David E. Fitzgerald and Pacific Genesis Group, Inc., No. 00-4802 CRB (N.D. Cal.). On February 14, 2001, the United States District Court found and concluded that Fitzgerald had violated Section 17(a) of the Securities Act of 1933, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder in connection with the sale of certain municipal securities. On February 16, 2001, the United States District Court entered a Permanent Injunction Against Defendants David E. Fitzgerald and Pacific Genesis Group, Inc., prohibiting future violations of Section 17(a) of the Securities Act in connection with the offer and sale of certain municipal securities and granting certain other injunctive relief.

IV.

Based on the foregoing, the Commission deems it appropriate and in the public interest to accept the Offer of Settlement of David E. Fitzgerald.

Accordingly, **IT IS ORDERED** that Fitzgerald is barred from association with any broker or dealer or municipal securities dealer, with the right to reapply for association after five years to the appropriate self-regulatory organization, or if there is none, to the Commission.

By the Commission.
Jonathan G. Katz
Secretary

http://www.sec.gov/litigation/admin/34-45599.htm

In the Matter of Fifth Third Securities, Inc., Exchange Act Release Nos. 46087, A.P. File No. 3-10804 (June 18, 2002).

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted against Fifth Third Securities, Inc. ("Fifth Third Securities" or "Respondent") pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") [15 U.S.C. §§ 78o(b) and 78u-3].

II.

In anticipation of the institution of these administrative proceedings, Respondent has submitted an Offer of Settlement ("Offer"), which the Commission has determined to accept. Solely for the purpose of these proceedings, and any other proceedings brought by or on behalf of the Commission or in which the Commission is a party, and prior to a hearing and without admitting or denying the Commission's findings contained herein, except that Respondent admits the jurisdiction of the Commission over it and over the subject matter of these proceedings, and admits the findings in paragraph III.B., Respondent consents to the entry of this Order Instituting Public Administrative Proceedings, Making Findings, Ordering Respondent to Cease and Desist, and Imposing Remedial Sanctions ("Order").

III.

On the basis of this Order and the Offer submitted by Fifth Third Securities, the Commission finds:

A. SUMMARY

This action involves violations of the law concerning political contributions and municipal securities business. Fifth Third Securities is a broker-dealer and municipal securities dealer affiliated with Fifth Third Bank. Between 1998 and 2000, officers of two affiliate banks of Fifth Third Bank engaged in solicitation activities that made the officers "municipal finance professionals" under Municipal Securities Rulemaking Board ("MSRB") Rule G-37.[1] The solicitation activities of the two Fifth Third Bank officers made them municipal finance professionals not just as to the issuers from which they solicited municipal securities business, but made them municipal finance professionals with respect to all issuers. Those officers also directed certain political contributions from Fifth Third Bank's political action committee and made direct political contributions to candidates for offices with influence over the awarding of municipal securities business by certain issuers. The issuers to whose officials the political contributions were made were different from the issuers from which the bank officers solicited municipal securities business. Within two years of these political contributions, Fifth Third Securities engaged in municipal securities business with the issuers associated with the candidates who received the political contributions. Fifth Third Securities' engagement in municipal securities business with these issuers violated Section 15B(c)(1) of the Exchange Act and MSRB Rule G-37.

B. RESPONDENT

Fifth Third Securities is an Ohio corporation with its principal place of business in Cincinnati, Ohio. At all times relevant to these proceedings, Fifth Third Securities was a broker-dealer registered with the Commission pursuant to Section 15(b) of the Exchange Act and with the MSRB as a municipal securities dealer as defined in Sections 3(a)(30) and 3(a)(31) of the Exchange Act. At all times relevant to these proceedings, Fifth Third Securities was a wholly-owned subsidiary of Fifth Third Bancorp and an affiliate of Fifth Third Bank, which is composed of affiliate banks located in Ohio, Kentucky, Indiana, Florida, Arizona, Michigan and Illinois.

C. FACTS

1. Background

Between 1998 and 2000, two senior Fifth Third Bank executives engaged in activities that constituted solicitation of municipal securities business from certain issuers on behalf of Fifth Third Securities. As a result, these two individuals (hereinafter "the two Fifth Third Bank executives") became municipal finance professionals associated with Fifth Third Securities under MSRB Rule G-37. In addition, the two Fifth Third Bank executives controlled Fifth Third Bank's political action committee (PAC) under certain circumstances. Specifically, between 1997 and 2000, the two Fifth Third Bank executives controlled certain political contributions made by the PAC using money contributed by employees of the two Fifth Third Bank executives' respective affiliate banks.

Between 1997 and 2001, the two Fifth Third Bank executives directed one contribution totaling $1,000 from the PAC and made thirteen direct contributions totaling $15,750 to candidates or incumbents for elective offices responsible for, or having the authority to appoint persons who were responsible for, the hiring of brokers, dealers, or municipal securities dealers for municipal securities business by certain units of state and local government in the State of Ohio (hereinafter "the Issuers"). Under Rule G-37, each of these contributions triggered a two-year ban on municipal securities business with the Issuers, starting with the dates of the contributions.[2]

2. Violative Conduct

Within two years of the above-mentioned political contributions, Fifth Third Securities sought, and was selected to participate in, twenty-four municipal securities transactions, which included negotiated underwritings of municipal securities offered by the Issuers. Fifth Third Securities engaged in these transactions despite the bans flowing from the above-mentioned political contributions.

In total, the twenty-four transactions represented sales to the public of approximately $2.3 billion. For its roles in the twenty-four transactions, Fifth Third Securities earned approximately $1 million in underwriting fees.

D. LEGAL ANALYSIS

1. MSRB Rule G-37

Rule G-37 was enacted for several reasons, among them to ensure that the high standards and integrity of the municipal securities industry are maintained and to remove any appearance that decisions by municipalities in awarding negotiated underwriting business might have been influenced by political contributions. Adherence to Rule G-37 ensures that all firms will compete, and be perceived as competing, for municipal finance business on the basis of merit rather than their association with campaign contributions.

Subsection (b) of Rule G-37 provides that no broker, dealer or municipal securities dealer shall engage in municipal securities business with an issuer within two years after any contribution to an official of such issuer made by (i) the broker, dealer or municipal securities dealer; (ii) any municipal finance professional associated with such broker, dealer or municipal securities dealer; or (iii) any PAC controlled by the broker, dealer or municipal securities dealer or by any municipal finance professional, unless the contribution is exempt.[3]

"Municipal finance professional" is defined in the Rule to include "any associated person who solicits municipal securities business." The two Fifth Third Bank executives were associated persons of Fifth Third Securities as defined in Exchange Act Section 3(a)(18) because the two executives were under common control with Fifth Third Securities, and they solicited municipal securities business on behalf of Fifth Third Securities. The solicitation activities of the two Fifth Third Bank executives made them municipal finance professionals not just as to the issuers from which they solicited municipal securities business, but made them municipal finance professionals with respect to all issuers.

Therefore, the political contributions to officials of the Issuers by the two Fifth Third Bank executives and by the PAC, in an instance when one of the two Fifth Third Bank executives controlled the PAC's contributions, triggered two-year prohibitions on Fifth Third Securities' engaging in municipal securities business with the Issuers, even though the solicitation activity of the two Fifth Third Bank executives did not involve the Issuers. Nevertheless, Fifth Third Securities engaged in municipal securities business with the Issuers during the two-year prohibitions, and therefore willfully violated MSRB Rule G-37(b).[4]

2. Exchange Act Section 15B(c)(1)

Fifth Third Securities willfully violated Section 15B(c)(1) of the Exchange Act in that, in contravention of MSRB Rule G-37, it made use of the mails or other means or instrumentalities of interstate commerce to effect transactions in, or to induce or attempt to induce the purchase or sale of, municipal securities.

IV.

Based on the foregoing, the Commission deems it appropriate and in the public interest to accept the Offer of Settlement and accordingly, pursuant to Sections 21B and 21C of the Exchange Act,

IT IS HEREBY ORDERED, effective immediately, that:

Fifth Third Securities cease and desist from committing or causing any present or future violation of Section 15B(c)(1) of the Exchange Act [15 U.S.C. § 78o-4(c)] and MSRB Rule G-37(b);

Fifth Third Securities pay a civil penalty of $1,000,000. Payment shall be made within ten days of entry of this Order by U.S. postal money order, certified check, bank cashier's check, or bank money order, made payable to the Securities and Exchange Commission, and shall be transmitted by certified mail to the Comptroller, U.S. Securities and Exchange Commission, Mail Stop 0-3, Operations Center, 6432 General Green Way, Alexandria, VA, 22312, under cover of a letter that identifies Fifth Third Securities, Inc. and the name and file number of these proceedings. A copy of the cover letter and of the form of payment shall be simultaneously transmitted to Lawrence A. West, Division of Enforcement, Securities and Exchange Commission, Washington, DC 20549-0807; and

Fifth Third Securities shall comply with its undertaking, as set forth in Section V. below.

V.

Fifth Third Securities undertakes:

To retain, within twenty days of the date of this Order, at Fifth Third Securities' expense, an Independent Consultant acceptable to the Commission's staff, to conduct a review of, and to report and make recommendations as to, Fifth Third Securities' supervisory and compliance policies and procedures related to the types of conduct which gave rise to these proceedings and which are described in this Order.

Fifth Third Securities shall cooperate fully with the Independent Consultant in this review, including making available such non-privileged information and documents as the Independent Consultant may reasonably request, and by permitting and requiring Fifth Third Securities' employees and agents to supply such non-privileged information and documents as the Independent Consultant may reasonably request. The Independent Consultant shall maintain the confidentiality of all materials provided by Fifth Third Securities and shall not provide the materials to any person, provided, however, that such materials may be provided to the Commission or its staff.

The Independent Consultant shall provide a written report to Fifth Third Securities and the staff of the Commission within three months of the date of this Order setting forth the Independent Consultant's recommendations. The Independent Consultant shall have the option to seek an extension of time by making a written request to the Commission staff.

Fifth Third Securities shall adopt all recommendations contained in the written report of the Independent Consultant; provided, however, that as to any recommendation that Fifth Third Securities believes is unduly burdensome or impractical, Fifth Third Securities may suggest an alternative policy or procedure designed to achieve the same objective, submitted in writing to the Independent Consultant and the Commission staff. Fifth Third Securities and the Independent Consultant shall then attempt in good faith to reach agreement as to any policy or procedure as to which there is any dispute, and the Independent Consultant shall reasonably evaluate any alternative policy or procedure proposed by Fifth Third Securities. Fifth Third Securities will abide by the Independent Consultant's determinations with regard thereto and adopt those recommendations deemed appropriate by the Independent Consultant.

Within thirty days of the receipt of the Independent Consultant's written report, Fifth Third Securities shall implement the recommendations of the Independent Consultant and shall submit an affidavit to the Commission staff stating that it has done so. Fifth Third Securities shall have the option to seek an extension of time by making a written request to the Commission staff.

To ensure the independence of the Independent Consultant, Fifth Third Securities (i) shall not have the authority to terminate the Independent Consultant without the prior written approval of the Commission staff; and (ii) shall compensate the Independent Consultant, and persons engaged to assist the Independent Consultant, for services rendered pursuant to this Order at their reasonable and customary rates.

For the period of the engagement and for a period of two years from the completion of the engagement, the Independent Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with Fifth Third Securities, directly or indirectly. Any firm with which the Independent Consultant is affiliated or of which he/she is a member, and any person engaged to assist the Independent Consultant in performance of his/her duties under this Order, shall not, without prior written consent of the Commission staff, enter into any employment, consultant, attorney-client, auditing or other professional relationship with Fifth Third Securities, directly or indirectly, for the period of the engagement and for a period of two years after the engagement.

By the Commission.
Jonathan G. Katz
Secretary

Footnotes

[1] Rule G-37(g)(iv)(B) provides that "the term `municipal finance professional' [includes] . . . any associated person [of a broker, dealer or municipal securities dealer] who solicits municipal securities business."

[2] The two Fifth Third Bank executives did not solicit the Issuers for municipal securities business.

[3] Rule G-37(b) exempts contributions by a municipal finance professional of up to $250 per candidate per election if the municipal finance professional is entitled to vote for that candidate.

[4] Rule G-37 is a broad prophylactic measure. Finding a violation of Rule G-37(b) does not require a showing of scienter or a quid pro quo. "Willfully" as used in this Order means intentionally committing the act which constitutes the violation. See Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000); Tager v. SEC, 344 F.2d 5, 8 (2d Cir. 1965). There is no requirement that the acting entity also be aware that it is violating any rule or statute.

http://www.sec.gov/litigation/admin/34-46087.htm

<u>In the Matter of Fifth Third Securities, Inc.,</u> Exchange Act Release No., 46088, A.P. File No. 3-10804 (June 18, 2002).

Fifth Third Securities, Inc. ("Fifth Third Securities" or "the firm") has submitted a letter, dated May 29, 2002, for an exemption pursuant to Section 15B(a)(4) of the Securities Exchange Act of 1934 (the "Exchange Act") from the prohibition on engaging in municipal securities business under Municipal Securities Rulemaking Board ("MSRB") Rule G-37(b). Fifth Third Securities' request for an exemption was made in conjunction with the firm's offer to settle administrative proceedings instituted by the Commission on June 18, 2002. That day, pursuant to the firm's offer of settlement, the Commission issued an order requiring the firm to cease and desist from committing or causing any violation or future violation of Exchange Act Section 15B(c)(1) and MSRB Rule G-37, pay a civil penalty of $1 million, and comply with its undertaking to retain an independent consultant to conduct a review of, and to report and make recommendations as to, the firm's supervisory and compliance policies and procedures related to the types of conduct that gave rise to the proceedings.

Fifth Third Securities has requested an exemption from any prohibition on engaging in municipal securities business that could result from five political contributions made by an executive of a bank affiliated with the firm, who had previously solicited municipal securities business on behalf of the firm. The five contributions were made to incumbents or candidates for elective offices responsible for, or having the authority to appoint persons who were responsible for, the hiring of brokers, dealers, or municipal securities dealers for municipal securities business by certain units of state and local government in the State of Ohio (hereinafter "the Issuers"). The contributions were made between December 2000 and October 2001 (the "five contributions"). The five contributions, which ranged between $500 and $2,500, totaled $6,000. The five contributions have since been returned to the bank executive by the recipients.

Section 15B(a)(4) of the Exchange Act provides that the Commission, by rule or order, upon its own motion or upon application, may conditionally or unconditionally exempt any broker, dealer, or municipal securities dealer from any provision of Section 15B or the rules or regulations thereunder, if it finds that such exemption is consistent with the public interest, the protection of investors and the purposes of Section 15B. MSRB Rule G-37 was adopted pursuant to Section 15B of the Exchange Act.

The firm has represented to the Commission that it discovered that the five contributions had been made by the executive, immediately reported them to the Commission staff, and promptly took remedial actions, which included improving compliance procedures and getting the contributions back from the issuer officials. It further represents that the contributor did not solicit and has never solicited municipal securities business from the recipients of the five contributions and, at the time of the five contributions, was not engaged in activities or holding a position that would trigger a "municipal finance professional" designation.

In light of the firm's above representations, the firm's offer of settlement in the related administrative proceedings, and the Commission's findings in those proceedings, the Commission has determined that it is consistent with the public interest, the protection of investors, and the purposes of Section 15B of the

Exchange Act to exempt Fifth Third Securities from MSRB Rule G-37(b)'s prohibition on municipal securities business resulting from the five contributions. The Commission's Order is conditioned upon the bank executive ceasing all activities that would trigger a "municipal finance professional" designation, and making no political contributions to officials of the Issuers until November 30, 2002, by which time the bank executive's status as a municipal finance professional will have expired under operation of Rule G-37.[1]

The Commission has considered Fifth Third Securities' exemption request solely in the context of the Commission's settlement of administrative proceedings against the firm. Unless made in connection with an offer to settle a Commission enforcement action, all requests for exemption from the prohibition on engaging in municipal securities business under MSRB Rule G-37 should continue to be directed to the registered securities association of which the broker, dealer or municipal securities dealer is a member, as set forth in MSRB Rule G-37(i).

Accordingly, **IT IS ORDERED**, pursuant to Section 15B(a)(4) of the Exchange Act that Fifth Third Securities shall be exempt from MSRB Rule G-37(b)'s prohibition on municipal securities business resulting from the five contributions, provided Fifth Third Securities complies with the above terms and conditions.

By the Commission.
Jonathan G. Katz
Secretary

Footnotes

[1] This exemption is based in part on our understanding of the material facts as the firm has represented them. If the facts are not as represented, if material facts have not been disclosed, or if new material information emerges, the Commission may vacate this order.

http://www.sec.gov/litigation/admin/34-46088.htm

In the Matter of RBC Dain Rauscher Incorporated, as successor to Rauscher Pierce Refsnes, Inc., Securities Act Release No. 8121, Exchange Act Release No. 46346, A.P. File No. 3-10863 (August 13, 2002).

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Rauscher Pierce Refsnes, Inc. ("Rauscher Pierce"), now known as RBC Dain Rauscher Incorporated ("Dain Rauscher" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of this proceeding and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, and the findings contained in Section III.B. below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions Pursuant to Section 8A of the Securities Act of 1933 and Sections 15(b) and 21C of the Securities Exchange Act of 1934, as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds[1] that:

A. <u>SUMMARY</u>

1. Rauscher Pierce was either the underwriter or the financial adviser to the issuer in twelve securities offerings that are the subject of this Order. The subject offerings were conducted in 1993 and 1994 by issuers located in Orange County, California ("Orange County" or the "County") and totaled over $680 million. The issuers were: the Cities of Anaheim and Irvine, the Irvine Unified School District ("Irvine USD"), the Newport-Mesa Unified School District ("Newport-Mesa USD"), the North Orange County Community College District ("NOCCCD"), and the Orange County Board of Education ("OC Board") (the latter four collectively, the "Four Districts").

2. The offerings were conducted to issue taxable notes. These notes were issued for the purpose of investing the proceeds in the Orange County Investment Pools ("Pools") and generating profits therefrom. The securities were sold to investors using Official Statements, which were the documents that should have provided investors with all material information upon which they could rely to make an informed investment decision. The Official Statements were materially misleading because they omitted to disclose that the offering proceeds would be invested in the Pools and the risks of that investment. In addition, the Official Statements for the six 1994 offerings omitted material information on the Pools' declining investment results.

3. Rauscher Pierce, through its investment bankers Kenneth Ough and Virginia Horler, participated in drafting these Official Statements and approved the final versions of these documents. At that time, Rauscher Pierce knew or should have known material information about the Pools. Rauscher Pierce should have known that, by omitting to disclose this material information, the Official Statements for all the transactions were misleading. As a result, Rauscher Pierce violated Sections 17(a)(2) and (3) of the Securities Act and Section 15B(c)(1) of the Exchange Act and Municipal Securities Rulemaking Board ("MSRB") Rule G-17.

B. RESPONDENT

4. **RBC Dain Rauscher Incorporated** is registered with the Commission as a broker-dealer (File No. 8-45411) and is based in Minneapolis, Minnesota. During the relevant time period, Rauscher Pierce Refsnes, Inc., was registered with the Commission as a broker-dealer (File No. 8-27271). Subsequently, Rauscher Pierce merged into Dain Rauscher Incorporated on January 3, 1998. Dain Rauscher Incorporated was then acquired by the Royal Bank of Canada on January 10, 2001, and currently operates as its wholly owned subsidiary, RBC Dain Rauscher Incorporated.

C. RELATED PARTIES

5. **Kenneth D. Ough ("Ough")** resides in Post Falls, Idaho, and, at the time of the offerings, was a Senior Vice President with Rauscher Pierce. Ough was the lead investment banker for nine of the taxable offerings and the financial adviser for one of the taxable offerings.

6. **Virginia L. Horler ("Horler")** is retired and resides in Moraga, California. Horler was a Senior Vice President and Co-Managing Director of Rauscher Pierce's San Francisco, California, public finance office. Horler was the lead investment banker for two of the taxable offerings.

D. FACTS

1. The Orange County Investment Pools

7. The Pools operated as an investment fund managed by the Orange County Treasurer-Tax Collector ("County Treasurer" or "Treasurer"), Robert Citron. As Orange County school districts, the Four Districts were mandatory Pool Participants because state law required them to deposit their funds with the County Treasurer; Anaheim and Irvine, cities within Orange County, were voluntary Pool Participants. As of December 6, 1994 (the date the County and the Pools filed bankruptcy petitions), the Pools held approximately $7.6 billion in Participant deposits, which the Treasurer had leveraged to an investment portfolio with a book value of over $20.6 billion.

8. The Commingled Pool was the principal investment pool and consisted of $6.126 billion in Participant deposits. The proceeds from eight of the offerings that are the subject of this Order were deposited into the Commingled Pool. The proceeds from the remaining four offerings were invested in Specific Investments.

a. The Pools' Investment Strategy

9.From at least April 1992 until December 1994, the Treasurer's investment strategy for the Pools involved: (1) using a high degree of leverage by obtaining funds through reverse repurchase agreements on a short-term basis (less than 180 days); and (2) investing the Participants' deposits and funds obtained through reverse repurchase agreements in debt securities (issued by the United States Treasury, United States government-sponsored enterprises, and highly-rated banks and corporations) with a maturity of two to five years, many of which were derivative securities.

10. The Pools' investment return was to result principally from the interest received on the securities in the Pools. Leverage enabled the Pools to purchase more securities to generate increased interest income. This strategy was profitable as long as the Pools were able to maintain a positive spread between the long-term interest rate received on the securities and the short-term interest rate paid on the funds obtained through reverse repurchase agreements.

b. The Pools' Portfolio

11. During 1993 and 1994, the Treasurer, using reverse repurchase agreements, leveraged the Participants' deposits to amounts ranging from 158% to over 292% of the amounts deposited. As of the end of June 1994, the Pools held $19.8 billion in securities, with approximately $7.2 billion in Participant deposits and about $12.6 billion in reverse repurchase agreements, resulting in leverage of approximately 274%.

12. Many of the Pools' securities were derivative securities, comprising from 27.6% to 42.2% of the Pools' portfolio and from 31% to 53% of the Commingled Pool's portfolio. In particular, the Pools were heavily invested in derivative instruments known as inverse floaters, which paid interest rates inversely related to the prevailing market interest rate. Inverse floaters are negatively affected by a rise in interest rates.

c. The Rise in Interest Rates During 1994 and its Effect on the Pools

13. The composition of the Pools' portfolio made it sensitive to interest rate changes. As interest rates rose, the market value of the Pools' securities fell, and the interest received on the Pools' inverse floaters also declined. Thus, the Treasurer's investment strategy was profitable so long as interest rates, including the cost of obtaining funds through reverse repurchase agreements, remained low, the market value of the Pools' securities did not decline, and the Pools had the ability to hold securities to maturity. Indeed, the Treasurer's 1992-93 Financial Statement for the Pools stated that the investment strategy was "predicated on interest rates to continue to remain low for a minimum of the next three years."

From April 1992 through 1993, U.S. interest rates remained low and relatively stable. Due to the low interest rates and the Pools' investment strategy, the Pools earned a relatively high yield of approximately 8%. Beginning in February 1994, interest rates began to rise. This rise in interest rates resulted in: (1)
14.an increase in the cost of obtaining funds under reverse repurchase agreements; (2) a decrease in the interest income on inverse floaters; (3) a decrease in the market value of the Pools' debt securities; (4) collateral calls and reductions in amounts obtained under reverse repurchase agreements; and (5) a decrease in the Pools' yield.

2. Orange County's Bankruptcy

15. On December 6, 1994, Orange County and the Pools each filed a petition for Chapter 9 bankruptcy (the petition filed on behalf of the Pools was later dismissed). The petitions followed the County's public disclosure on December 1, 1994, that the Pools had suffered a "paper" loss of approximately $1.5 billion on an investment portfolio of $20.6 billion. Between mid-December 1994 and January 20, 1995, the County liquidated the Pools' securities portfolio. Ultimately, the Pools realized a loss of about $1.7 billion on Participants' deposits of $7.6 billion, a loss of approximately 22.3%.

3. The Municipal Securities Offerings

a. Description of the Taxable Offerings

16. In 1993 and 1994, Anaheim, Irvine, and the Four Districts conducted a total of twelve taxable note offerings. The purpose of these offerings was to invest the proceeds in the Pools for profit. All of these notes were repaid in full and on time.

17. Anaheim's two offerings were: the 1993 $66 Million Notes, issued on April 8, 1993; and the 1994 $95 Million Notes, issued on April 5, 1994. These offerings represented a significant portion of Anaheim's annual budget of $245 million. Irvine's two offerings were: the 1993 $60 Million Notes, issued on May 6, 1993; and the 1994 $62.455 Million Notes, issued on July 27, 1994.

18. The Four Districts issued a total of $200 million in taxable notes on June 23, 1993, and another $200 million on June 14, 1994. In both 1993 and 1994, Irvine USD issued $54.575 million in notes; Newport-Mesa USD issued $46.96 million; NOCCCD issued $56.285 million; and OC Board issued $42.18 million. The proceeds of the 1993 Four Districts' offerings were invested in Specific Investments with the County Treasurer. The proceeds of the 1994 Four Districts' offerings were invested directly into the Commingled Pool.

b. The Omissions Regarding Investment of Proceeds

19. The Official Statements for these offerings contained very similar disclosures. In the section entitled "Purpose of Issue," the Official Statements for eight of the offerings represented that the proceeds of each offering would provide funds to meet the issuer's current fiscal year expenditures, including current expenses, capital expenditures, investment and reinvestment and the discharge of other obligations or indebtedness of the issuer. The Official Statements for three offerings (Anaheim's two offerings and Irvine's 1993 offering) failed to include the phrase "investment and reinvestment" in the description of the purpose of the issuance. In addition, a separate section of the Official Statements, entitled "Security for the Notes and Available Sources of Repayment," represented that the offering proceeds would be deposited into a repayment account.[2] A third section, "Deposit and Investment of Repayment Fund," stated that the repayment account would be invested as permitted by state law.

20. The disclosure in the Official Statements was misleading because it omitted the material information that the intended purpose of the debt offerings was to invest

the note proceeds into the Pools for profit. Furthermore, the Official Statements misleadingly recited information typically used in tax and revenue anticipation note offerings, which are another type of municipal securities offering, such as statements that the taxable notes were issued "in anticipation of the receipt of taxes, revenue and other moneys" to be received by the issuer.

21. The Official Statements failed to disclose any information about the investment of the note proceeds in the Pools. Specifically, the Official Statements failed to disclose that:(1) the Pools' investment strategy was predicated upon the assumption that prevailing interest rates would remain at relatively low levels; (2) the Pools' use of leverage through reverse repurchase agreements was constant, high, and a major part of the Pools' investment strategy; and (3) the Pools had a substantial investment in derivative securities, including inverse floaters.

22. The Official Statements also failed to disclose the risks of the investment strategy. In particular, the Official Statements failed to disclose that rising interest rates would have a substantial negative impact on the Pools in several respects: (1) the Pools' cost of obtaining funds under reverse repurchase agreements would increase; (2) the Pools' interest income on the inverse floaters would decrease; (3) the Pools' securities would decline in market value; (4) as the value of the securities fell, the Pools would be subject to collateral calls and reductions in loan amounts obtained under reverse repurchase agreements; (5) the Pools' earnings would decrease; and (6) the Pools would suffer losses of principal at certain interest rate levels.

23. The proceeds of the Four Districts' 1993 taxable notes were invested in Specific Investments with the County Treasurer. The Official Statements for these offerings similarly failed to disclose the risks of this investment, including the high degree of leverage due to the use of reverse repurchase agreements, and the effect that increasing interest rates would have on this investment.

24. In addition, the Official Statements for the 1994 offerings omitted to disclose certain material information concerning the Pools' declining investment results to date. In particular, the Official Statements failed to disclose that as a result of rising interest rates in 1994: (1) the Pools' cost of obtaining funds had increased while the income earned from inverse floaters had decreased; (2) the Pools had suffered substantial market losses in the overall value of the portfolio; and (3) the Pools had suffered losses on the reverse repurchase transactions through collateral calls and reductions in loan amounts, which in turn, had a negative impact on liquidity.

4. The Role of the Respondent in the Offerings

25. Rauscher Pierce underwrote eleven of the offerings: Anaheim's 1993 taxable offering; Irvine's two taxable offerings; and the eight offerings conducted by the Four Districts. In addition, the firm was the financial adviser for Anaheim's 1994 taxable offering. With the exception of the two Irvine offerings, Ough participated in drafting the Official Statements for the offerings and also approved the final versions of these documents on behalf of Rauscher Pierce. Horler participated in drafting the Official Statements for the Irvine offerings and also approved the final versions of the documents on behalf of Rauscher Pierce.

5. The Knowledge of the Respondent

26. As discussed below, Rauscher Pierce (through Ough and Horler) knew that the proceeds of the taxable offerings were to be invested in the Pools for profit. Rauscher Pierce also knew or should have known certain information about the County Treasurer's investment strategy, the risks of that strategy and, for the 1994 offerings, the Pools' declining investment results. Rauscher Pierce's knowledge about the Pools' strategy and related risks increased during the course of the offerings.

27. For all of the taxable offerings, Rauscher Pierce and, with respect to the two Irvine offerings, Horler, knew that the purpose of the offerings was to invest the proceeds in the Pools for profit. With regard to the 1993 Four Districts' offerings, Ough knew that the proceeds were to be invested by the County Treasurer, but did not know specifically how the Treasurer intended to invest the proceeds. Ough failed to make a reasonable inquiry concerning the Pools for any of the offerings in 1993. Prior to the 1994 offerings, Ough knew that the offering proceeds would be invested in the Pools for profit.

28. Before the issuance of Irvine's 1993 taxable notes, Horler reviewed the Pools' portfolio as of March 31, 1993. This document set forth the Pools' securities holdings, categorized by type. From this information, Horler knew that the Pools were leveraged. Horler also knew or should have known that the Treasurer employed reverse repurchase agreements to obtain a higher rate of return, and that the value of the investments held by the Pools would be at risk in a period of rising interest rates. Horler subsequently conveyed the March 31, 1993 Pool's portfolio, draft Official Statement, and other marketing materials to the firm's Fixed Income Commitment Committee. This committee then notified Horler that the firm would underwrite the Irvine 1993 taxable notes.

29. In November 1993, Ough and Horler each received and reviewed the Treasurer's 1992-93 Financial Statement, which Horler subsequently distributed to others at Rauscher Pierce. In this report, the Treasurer stated that the Pools' investment strategy involved the use of leverage of approximately two to one and structured or floating rate securities, including inverse floaters, and was predicated on interest rates remaining low over the next three years. The report further advised that if interests rates were to rise, the overall performance of the Pools would decline.

30. By May 1994, before the Four Districts' 1994 offerings, Ough knew or should have known that: the Pools' investment strategy entailed a high degree of leverage through the use of reverse repurchase agreements; the Pools' portfolio included substantial amounts of inverse floaters; and the Pools' performance would decline if interest rates were to rise. Ough also knew or should have known that concerns had been expressed about the maturity length of the portfolio, recent collateral calls and the Treasurer's ability to meet future collateral calls if interest rates continued to rise.

31. Before Irvine's 1994 offering, Horler also knew that interest rates had been rising in the spring and summer of 1994 and knew from newspaper articles that it was reported that the Pools had suffered some loss in value as a result of rising interest rates.

E. RESPONDENT WILLFULLY VIOLATED SECTIONS 17(a)(2) AND (3) OF THE SECURITIES ACT AND SECTION 15B(c)(1) OF THE EXCHANGE ACT AND MSRB RULE G-17

32. As a result of the conduct described above, Rauscher Pierce acted negligently, willfully violating Sections 17(a)(2) and (3) of the Securities Act, which prohibit, in the offer or sale of any securities, "obtain[ing] money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading," and "engag[ing] in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser"; and willfully violating Section 15B(c)(1) of the Exchange Act and MSRB Rule G-17, which requires that "In the conduct of its municipal securities business, each broker, dealer, and municipal securities dealer shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice."

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions specified in Respondent's Offer.

ACCORDINGLY, IT IS ORDERED that:

A. Pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, Respondent shall cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and (3) of the Securities Act, Section 15B(c)(1) of the Exchange Act, and MSRB Rule G-17.

B. IT IS FURTHER ORDERED that Respondent shall, within thirty (30) days of the entry of this Order, pay a civil money penalty in the amount of $500,000 to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Comptroller, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Alexandria, VA 22312-0003; and

(D) submitted under cover letter that identifies Dain Rauscher as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Karen Matteson, Senior Trial Counsel, Pacific Regional Office, Securities and Exchange Commission, 5670 Wilshire Boulevard, Suite 1100, Los Angeles, CA 90036.

By the Commission.
Jonathan G. Katz
Secretary

Footnotes

[1] The findings herein are not binding on anyone other than Respondent.

[2] According to the Official Statements, the issuers pledged the invested funds (the note proceeds plus funds equal to the estimated interest on the notes) to secure repayment of the taxable notes. The Official Statements also represented that, if the pledged funds were insufficient to pay principal and interest, the issuers would satisfy any deficiency with other moneys lawfully available to repay the notes in the respective issuer's general fund attributable to the fiscal year in which the notes were issued.

http://www.sec.gov/litigation/admin/33-8121.htm

In the Matter of Kenneth D. Ough, Securities Act Release No. 8141, Exchange Act Release No 46736, A.P. File No. 10922 (October 29, 2002).

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that a cease-and-desist proceeding be, and hereby is, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Kenneth D. Ough ("Ough" or "Respondent").

II.

In anticipation of the institution of this proceeding, Respondent has submitted an Offer of Settlement (the "Offer"), which the Commission has determined to accept. Solely for the purpose of this proceeding and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of this proceeding, and the findings contained in Section III.B. below, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceeding, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934 ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

A. Summary

1. Ough was an investment banker employed by Rauscher Pierce Refsnes, Inc. ("Rauscher Pierce"), now known as RBC Dain Rauscher Incorporated, which was either the underwriter or the financial adviser to the issuer in the ten securities offerings that are the subject of this Order. The subject offerings were conducted in 1993 and 1994 by issuers located in Orange County, California ("Orange County" or the "County") and totaled over $560 million. The issuers were: the City of Anaheim, the Irvine Unified School District ("Irvine USD"), the Newport-Mesa Unified School District ("Newport-Mesa USD"), the North Orange County Community College District

("NOCCCD"), and the Orange County Board of Education ("OC Board") (the latter four collectively, the "Four Districts").

2. The offerings were conducted to issue taxable notes. These notes were issued for the purpose of investing the proceeds in the Orange County Investment Pools ("Pools") and generating profits therefrom. The securities were sold to investors using Official Statements, which were the documents that should have provided investors with all material information upon which they could rely to make an informed investment decision. The Official Statements were materially misleading because they omitted to disclose that the offering proceeds would be invested in the Pools and the risks of that investment. In addition, the Official Statements for the six 1994 offerings omitted material information on the Pools' declining investment results.

3. Kenneth Ough participated in drafting these Official Statements and approved the final versions of these documents. At that time, Ough knew or should have known material information about the Pools. Ough should have known that, by omitting to disclose this material information, the Official Statements for all the transactions were misleading. As a result, Ough violated Sections 17(a)(2) and (3) of the Securities Act and Section 15B(c)(1) of the Exchange Act and Municipal Securities Rulemaking Board ("MSRB") Rule G-17.

B. Respondent

4. **Kenneth D. Ough** resides in Post Falls, Idaho, and, at the time of the offerings, was a Senior Vice President with Rauscher Pierce. Ough was the lead investment banker for nine of the taxable offerings and the financial adviser for one of the taxable offerings.

C. Related Party

5. **RBC Dain Rauscher Incorporated** is registered with the Commission as a broker-dealer (File No. 8-45411) and is based in Minneapolis, Minnesota. During the relevant time period, Rauscher Pierce was registered with the Commission as a broker-dealer (File No. 8-27271). Subsequently, Rauscher Pierce merged into Dain Rauscher Incorporated on January 3, 1998. Dain Rauscher Incorporated was then acquired by the Royal Bank of Canada on January 10, 2001, and currently operates as its wholly owned subsidiary, RBC Dain Rauscher Incorporated.

D. Facts

1. The Orange County Investment Pools

6. The Pools operated as an investment fund managed by the Orange County Treasurer-Tax Collector ("County Treasurer" or "Treasurer"), Robert Citron. As Orange County school districts, the Four Districts were mandatory Pool Participants because state law required them to deposit their funds with the County Treasurer; Anaheim, a city within Orange County, was a voluntary Pool Participant. As of December 6, 1994 (the date the County and the Pools filed bankruptcy petitions), the Pools held approximately $7.6 billion in Participant deposits, which the Treasurer had leveraged to an investment portfolio with a book value of over $20.6 billion.

7. The Commingled Pool was the principal investment pool and consisted of $6.126 billion in Participant deposits. The proceeds from eight of the offerings that are the subject of this Order were deposited into the Commingled Pool. The proceeds from the remaining two offerings were invested in Specific Investments.

a. The Pools' Investment Strategy

8.From at least April 1992 until December 1994, the Treasurer's investment strategy for the Pools involved: (1) using a high degree of leverage by obtaining funds through reverse repurchase agreements on a short-term basis (less than 180 days); and (2) investing the Participants' deposits and funds obtained through reverse repurchase agreements in debt securities (issued by the United States Treasury, United States government-sponsored enterprises, and highly-rated banks and corporations) with a maturity of two to five years, many of which were derivative securities. On April 27, 1995, the Treasurer pled guilty in California state court to six felony counts, including making false and misleading statements about the Pools.

9. The Pools' investment return was to result principally from the interest received on the securities in the Pools. Leverage enabled the Pools to purchase more securities to generate increased interest income. This strategy was profitable as long as the Pools were able to maintain a positive spread between the long-term interest rate received on the securities and the short-term interest rate paid on the funds obtained through reverse repurchase agreements.

b. The Pools' Portfolio

10. During 1993 and 1994, the Treasurer, using reverse repurchase agreements, leveraged the Participants' deposits to amounts ranging from 158% to over 292% of the amounts deposited. As of the end of June 1994, the Pools held $19.8 billion in securities, with approximately $7.2 billion in Participant deposits and about $12.6 billion in reverse repurchase agreements, resulting in leverage of approximately 274%.

11. Many of the Pools' securities were derivative securities, comprising from 27.6% to 42.2% of the Pools' portfolio and from 31% to 53% of the Commingled Pool's portfolio. In particular, the Pools were heavily invested in derivative instruments known as inverse floaters, which paid interest rates inversely related to the prevailing market interest rate. Inverse floaters are negatively affected by a rise in interest rates.

c. The Rise in Interest Rates During 1994 and its Effect on the Pools

12. The composition of the Pools' portfolio made it sensitive to interest rate changes. As interest rates rose, the market value of the Pools' securities fell, and the interest received on the Pools' inverse floaters also declined. Thus, the Treasurer's investment strategy was profitable so long as interest rates, including the cost of obtaining funds through reverse repurchase agreements, remained low, the market value of the Pools' securities did not decline, and the Pools had the ability to hold securities to maturity. Indeed, the Treasurer's 1992-93 Financial Statement for the

Pools stated that the investment strategy was "predicated on interest rates to continue to remain low for a minimum of the next three years."

13. From April 1992 through 1993, U.S. interest rates remained low and relatively stable. Due to the low interest rates and the Pools' investment strategy, the Pools earned a relatively high yield of approximately 8%. Beginning in February 1994, interest rates began to rise. This rise in interest rates resulted in: (1) an increase in the cost of obtaining funds under reverse repurchase agreements; (2) a decrease in the interest income on inverse floaters; (3) a decrease in the market value of the Pools' debt securities; (4) collateral calls and reductions in amounts obtained under reverse repurchase agreements; and (5) a decrease in the Pools' yield.

2. Orange County's Bankruptcy

14. On December 6, 1994, Orange County and the Pools each filed a petition for Chapter 9 bankruptcy (the petition filed on behalf of the Pools was later dismissed). The petitions followed the County's public disclosure on December 1, 1994, that the Pools had suffered a "paper" loss of approximately $1.5 billion on an investment portfolio of $20.6 billion. Between mid-December 1994 and January 20, 1995, the County liquidated the Pools' securities portfolio. Ultimately, the Pools realized a loss of about $1.7 billion on Participants' deposits of $7.6 billion, a loss of approximately 22.3%.

3. The Municipal Securities Offerings

a. Description of the Taxable Offerings

15. In 1993 and 1994, Anaheim and the Four Districts conducted a total of ten taxable note offerings. The purpose of these offerings was to invest the proceeds in the Pools for profit. These notes received the highest rating from the major bond rating agencies. All of these notes were repaid in full and on time.

16. Anaheim's two offerings were: the 1993 $66 Million Notes, issued on April 8, 1993; and the 1994 $95 Million Notes, issued on April 5, 1994. These offerings represented a significant portion of Anaheim's annual budget of $245 million.

17. The Four Districts issued a total of $200 million in taxable notes on June 23, 1993, and another $200 million on June 14, 1994. In both 1993 and 1994, Irvine USD issued $54.575 million in notes; Newport-Mesa USD issued $46.96 million; NOCCCD issued $56.285 million; and OC Board issued $42.18 million. The proceeds of the 1993 Four Districts' offerings were invested in Specific Investments with the County Treasurer. The proceeds of the 1994 Four Districts' offerings were invested directly into the Commingled Pool.

b. The Omissions Regarding Investment of Proceeds

18. The Official Statements for these offerings contained very similar disclosures. In the section entitled "Purpose of Issue," the Official Statements for eight of the offerings represented that the proceeds of each offering would provide funds to meet the issuer's current fiscal year expenditures, including current expenses, capital expenditures, investment and reinvestment and the discharge of other obligations or

indebtedness of the issuer. The Official Statements for Anaheim's two offerings failed to include the phrase "investment and reinvestment" in the description of the purpose of the issuance. In addition, a separate section of the Official Statements, entitled "Security for the Notes and Available Sources of Repayment," represented that the offering proceeds would be deposited into a repayment account.[1] A third section, "Deposit and Investment of Repayment Fund," stated that the repayment account would be invested as permitted by state law.

19. The disclosure in the Official Statements was misleading because it omitted the material information that the intended purpose of the debt offerings was to invest the note proceeds into the Pools for profit. Furthermore, the Official Statements misleadingly recited information typically used in tax and revenue anticipation note offerings, which are another type of municipal securities offering, such as statements that the taxable notes were issued "in anticipation of the receipt of taxes, revenue and other moneys" to be received by the issuer.

20. The Official Statements failed to disclose any information about the investment of the note proceeds in the Pools. Specifically, the Official Statements failed to disclose that:(1) the Pools' investment strategy was predicated upon the assumption that prevailing interest rates would remain at relatively low levels; (2) the Pools' use of leverage through reverse repurchase agreements was constant, high, and a major part of the Pools' investment strategy; and (3) the Pools had a substantial investment in derivative securities, including inverse floaters.

21. The Official Statements also failed to disclose the risks of the investment strategy. In particular, the Official Statements failed to disclose that rising interest rates would have a substantial negative impact on the Pools in several respects: (1) the Pools' cost of obtaining funds under reverse repurchase agreements would increase; (2) the Pools' interest income on the inverse floaters would decrease; (3) the Pools' securities would decline in market value; (4) as the value of the securities fell, the Pools would be subject to collateral calls and reductions in loan amounts obtained under reverse repurchase agreements; (5) the Pools' earnings would decrease; and (6) the Pools would suffer losses of principal at certain interest rate levels.

22. The proceeds of the Four Districts' 1993 taxable notes were invested in Specific Investments with the County Treasurer. The Official Statements for these offerings similarly failed to disclose the risks of this investment, including the high degree of leverage due to the use of reverse repurchase agreements, and the effect that increasing interest rates would have on this investment.

23. In addition, the Official Statements for the 1994 offerings omitted to disclose certain material information concerning the Pools' declining investment results to date. In particular, the Official Statements failed to disclose that as a result of rising interest rates in 1994: (1) the Pools' cost of obtaining funds had increased while the income earned from inverse floaters had decreased; (2) the Pools had suffered substantial market losses in the overall value of the portfolio; and (3) the Pools had suffered losses on the reverse repurchase transactions through collateral calls and reductions in loan amounts, which in turn, had a negative impact on liquidity.

4. The Role of the Respondent in the Offerings

24. Rauscher Pierce underwrote nine of the offerings: Anaheim's 1993 taxable offering and the eight offerings conducted by the Four Districts. In addition, the firm was the financial adviser for Anaheim's 1994 taxable offering. Ough participated in drafting the Official Statements for the offerings. Rauscher Pierce retained counsel to advise it concerning its disclosure obligations. Ough approved the final versions of these documents on behalf of Rauscher Pierce.

5. The Knowledge of the Respondent

25. As discussed below, Ough knew that the proceeds of the taxable offerings were to be invested in the Pools for profit. Ough also knew or should have known certain information about the County Treasurer's investment strategy, the risks of that strategy and, for the 1994 offerings, the Pools' declining investment results. Ough's knowledge about the Pools' strategy and related risks increased during the course of the offerings.

26. With regard to the 1993 Four Districts' offerings, Ough knew that the proceeds were to be invested by the County Treasurer, but did not know specifically how the Treasurer intended to invest the proceeds. Ough failed to make a reasonable inquiry concerning the Pools for any of the offerings in 1993. Prior to the 1994 offerings, Ough knew that the offering proceeds would be invested in the Pools for profit.

27. In November 1993, Ough received the Treasurer's 1992-93 Financial Statement. In this report, the Treasurer stated that the Pools' investment strategy involved the use of leverage of approximately two to one and structured or floating rate securities, including inverse floaters, and was predicated on interest rates remaining low over the next three years. The report further advised that if interests rates were to rise, the overall performance of the Pools would decline.

28. By May 1994, before the Four Districts' 1994 offerings, Ough knew or should have known that: the Pools' investment strategy entailed a high degree of leverage through the use of reverse repurchase agreements; the Pools' portfolio included substantial amounts of inverse floaters; and the Pools' performance would decline if interest rates were to rise. Ough also knew or should have known that concerns had been expressed about the maturity length of the portfolio, recent collateral calls and the Treasurer's ability to meet future collateral calls if interest rates continued to rise. Ough's failure to disclose this information was not intentional.

E. Respondent Violated Sections 17(a)(2) and (3) of the Securities Act and Section 15B(c)(1) of the Exchange Act and MSRB Rule G-17

29. As a result of the conduct described above, Ough acted negligently, violating Sections 17(a)(2) and (3) of the Securities Act, which prohibit, in the offer or sale of any securities, "obtain[ing] money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading," and "engag[ing] in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser"; and violating Section 15B(c)(1) of the Exchange Act and MSRB Rule G-17, which requires that "In the conduct of its municipal securities business, each broker, dealer, and municipal securities dealer shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice."

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions specified in Respondent's Offer.

Accordingly, **IT IS HEREBY ORDERED:**

Pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, that Respondent shall cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and (3) of the Securities Act, Section 15B(c)(1) of the Exchange Act, and MSRB Rule G-17.

By the Commission.
Jonathan G. Katz
Secretary

Endnotes

[1] According to the Official Statements, the issuers pledged the invested funds (the note proceeds plus funds equal to the estimated interest on the notes) to secure repayment of the taxable notes. The Official Statements also represented that, if the pledged funds were insufficient to pay principal and interest, the issuers would satisfy any deficiency with other moneys lawfully available to repay the notes in the respective issuer's general fund attributable to the fiscal year in which the notes were issued.

http://www.sec.gov/litigation/admin/33-8141.htm

FINANCIAL ADVISORS

Administrative Proceedings – Commission Decisions

In the Matter of Kevin G. Quinn, A.P. File No. 3-10098, Initial Decision No. 186 (July 27, 2001) (initial decision of administrative law judge).

Appearance: David L. Kornblau and Fredric D. Firestone for the Division of Enforcement, Securities and Exchange Commission.

Thomas J. McGonigle and Laura Hutchinson of McGuire, Woods, Battle & Booth, for Respondent Kevin G. Quinn.

Before: Robert G. Mahony, Administrative Law Judge

I. INTRODUCTION

The Securities and Exchange Commission (Commission) initiated this proceeding by an Order Instituting Proceedings (OIP) on November 17, 1999, against Kevin G. Quinn (Quinn or Respondent) pursuant to Section 8A of the Securities Act of 1933

(Securities Act) and Sections 15(b)(6) and 21C of the Securities Exchange Act of 1934 (Exchange Act).

A hearing was held in Washington, D.C., May 16 through 19, 2000. Closing arguments were held on February 22, 2001. The Division of Enforcement (Division) called six witnesses, including Quinn. Respondent called one witness. The record includes seventy-nine exhibits in evidence from the Division and forty-nine from Respondent.[1]

The findings and conclusions herein are based on the record, my observation of the witnesses, all arguments and proposals of fact and law, as well as the relevant statutes and regulations. Preponderance of the evidence was applied as the standard of proof. See Steadman v. SEC, 450 U.S. 91 (1981). All arguments, proposed findings and conclusions put forth by the parties were considered and those consistent with this decision were accepted.

Allegations and Arguments

The OIP alleges that Quinn violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, during a March advance refunding conducted in part by Quinn's employer, Alex. Brown & Sons, Inc. (Alex Brown) for the Commonwealth of Pennsylvania (Commonwealth or Pennsylvania). The allegedly fraudulent scheme consisted of the incomplete disclosure to the Commonwealth of a fee-splitting arrangement by which Alex Brown shared substantial revenue from the transaction with another securities firm, Arthurs Lestrange & Co., Inc. (Arthurs Lestrange), and by making false statements about the mark-up Alex Brown charged on the securities it sold to the Commonwealth in order to increase the mark-up from 4.5 basis points to 45 basis points.

Quinn contends that the evidence fails to support the allegations. Quinn argues that the fee-splitting arrangement was disclosed to the Treasurer's Office of the Commonwealth (Treasurer's Office) orally and in writing and that the undisclosed percentages of the fee split were immaterial. Furthermore, the mark-up was continuously contemplated to be in the millions of dollars, or 45 basis points, regardless of any confusion about how to express the calculation. Quinn also argues that the Treasurer's Office was provided all relevant information in a timely fashion regarding the amount of the mark-up. In addition, the decision-makers at the Treasurer's Office never objected to the price of the securities or the mark-up.

The Division seeks a civil penalty of at least $50,000, a censure and suspension from association with a broker or dealer for one year, and a cease and desist order. Quinn asserts that the proceeding should be dismissed.

II. SUMMARY OF THE EVIDENCE

Respondent Kevin G. Quinn

Quinn graduated from Lowell College in 1976. He attended the University of Maryland Law School and Business School, where he received a law degree and a master's degree in business administration in 1979. After passing the bar in 1979, Quinn accepted an associate's position with the law firm Miles & Stockbridge in

Baltimore, Maryland. In October 1982, Quinn left Miles & Stockbridge to join Alex Brown in an investment banking capacity, where he worked in the public finance department from 1982 to 1994. In 1993, he became a managing director of Alex Brown and was in charge of its public finance department from 1990 to February 14, 1994. (Tr. 676-77; Amended Stip., ¶ 1.)

In February 1994, Quinn and Alex Brown had differences of opinion about the direction the public finance department would take. Quinn resigned on February 28, 1994, effective April 7, 1994. (Tr. 677, 680, 697, 752; Div. Exs. 37, 39.) On May 2, 1994, Quinn began work at A. Webster Dougherty (A. Webster), an investment firm, as its new president. (Tr. 138, 753-55.) A. Webster ceased operations in December 1994. (Tr. 781-82.)

Henry Sciortino

Henry Sciortino (Sciortino) joined the Treasurer's Office in 1989. Sciortino's educational background includes a bachelor's degree in history from Niagara University, and a master's degree in urban studies, which included the study of finance, from Occidental College. Sciortino has other continuing education credits and licenses that include real estate, various types of insurance, and the necessary credentials for a Series 7 license in securities. (Tr. 242-43.)

After graduate school, Sciortino took positions as city manager and redevelopment authority director of Monessen, Pennsylvania. For seven years he ran the day-to-day business operations of these offices. He then spent two years as the chief investment officer for the City of Pittsburgh, Pennsylvania, followed by one and a half years as the assistant city treasurer and then city treasurer. Sciortino managed the day-to-day activity of all city tax collection efforts, and was treasurer of the school district and the water and sewer authority. He also had oversight responsibility of 5,000 city employees' benefits. Sciortino also sat on the pension board on behalf of the city and was responsible for $1.4 billion in combined budget and cash flow activities for the city, the school district, and the water and sewer authority. (Tr. 242-45.)

In December 1988, Sciortino received a call from Patrick McCarthy (McCarthy), who introduced himself as a lawyer heading up soon-to-be Pennsylvania Treasurer Catherine Knoll's (Knoll) transition team. McCarthy discussed the possibility of Sciortino becoming the deputy state treasurer for the administration and the chief financial officer for the Commonwealth. Subsequently, Sciortino accepted the position and moved to Harrisburg, Pennsylvania. (Tr. 245-46.)

In March 1991, Sciortino became the deputy treasurer for finance, and the chief investment officer for the Commonwealth. His financial responsibilities included managing the funds settlement division, which settled all trades of the pension funds, and any activity that involved the exchange of money for the Commonwealth, including clearing trades. The portfolio he managed ranged from $3 to $8 billion. Sciortino reported directly to Executive Deputy Treasurer Seymore Heyison (Heyison), and Knoll. Sciortino's tenure with the Treasurer's Office ended on May 31, 1995. (Tr. 246-47.)

Michael Arpey

Michael Arpey (Arpey) became assistant counsel to the Treasurer's Office in January 1990, and was subsequently promoted to general counsel. Arpey graduated from St. Lawrence University in 1985, and the Dickinson School of Law in 1988. (Tr. 99-101.) While serving as general counsel for the Treasurer's Office, Arpey's duties included managing the short term investment pool for the Commonwealth, a pool of liquid assets, which includes tax receipts, pension funds, and other assets. Arpey also supervised the contracts and legal issues pertaining to the investment activity, and reviewed all contracts as well as audit issues associated with those contracts. As general counsel, Arpey reported to Heyison. (Tr. 102, 104-05.)

Arthur Heilman

Arthur Heilman (Heilman) has worked for the Commonwealth for thirty-three years. His educational background includes a bachelor's degree and post-graduate work at the University of Virginia in economics; post-graduate work at the University of Pennsylvania in public administration; and completion of the state and local government program for senior governmental managers at the John F. Kennedy School of Government at Harvard University. Heilman was the director of the bureau of revenue, cash flow and debt in the Governor's Office of the Commonwealth (Governor's Office) during the March advance refunding that is the subject of this proceeding. Heilman has reviewed at least seventy to seventy-five bond issues and 150 or more financing proposals, and made recommendations to his superiors. No state bond issues have been completed over his objection. Heilman reported to Budget Secretary Michael Hershock (Hershock), who in turn reported to the governor. (Tr. 183-85.)

Howard Corner

Howard Corner (Corner) was the senior vice president and manager of the Philadelphia office of Arthurs Lestrange in March 1994. (Tr. 37, 42.) Corner attended Bethany College and Duquesne University. He served in the U.S. Marine Corps from 1968 to 1974. (Tr. 35-36.) Corner has over thirty years experience in public finance. (Tr. 36, 73.) Corner had participated in hundreds of municipal bond issues for Pennsylvanian issuers and dozens of advance refundings. (Tr. 36-39.) Corner proposed the advance refunding that is the subject of this proceeding.

Arthurs Lestrange, headquartered in Pittsburgh, Pennsylvania, was the financial advisor to the Governor's Office for the advance refunding. The Philadelphia office of Arthurs Lestrange was a banking office with the sole focus of originating, structuring, and underwriting municipal bond issues or acting as a financial advisor to government entities. Barbara Williams (Williams), an analyst, worked with Corner out of the Philadelphia office. Corner's superior, Michael Bova (Bova), worked out of the Pittsburgh office. (Tr. 42, 44.)

Michael Meteer

Michael Meteer (Meteer), a resident of New York City, worked at Alex Brown from June 1992 until July 1997. Meteer attended the University of Pennsylvania and received a bachelor's degree in economics with a major in finance and real estate. In early 1994, Meteer was a quantitative analyst in the public finance department headed by Quinn. He was responsible for sizing and calculating the numbers for bond issues. During his employment, Meteer worked on fifteen to twenty advance refundings. (Tr. 459-63.)

Seymore Heyison[2]

Heyison, the executive deputy treasurer, was considered a micro-manager and a tough negotiator. His style made the Treasurer's Office a difficult place to work. He was responsible for every activity in the Treasurer's Office. (Tr. 247-48, 339-40.) Heyison was in strict control of the information flow in and out of the Treasurer's Office. He reviewed all correspondences Sciortino received, except for junk mail. Most of the time, Sciortino had to clear "return calls" with Heyison before making them including routine business. (Tr. 341.)

Patrick McCarthy[3]

McCarthy, a Philadelphia-based attorney, headed Knoll's transition team in 1988, and was Knoll's close political advisor. (Tr. 105, 245.) McCarthy's law firm had a contractual relationship with the Treasurer's Office to provide legal advice, as "outside general counsel," "on the broad array of matters that would come before the Treasurer's Office." (Tr. 181.) The contractual arrangement provided McCarthy access to the Treasurer's Office, but Arpey also believed that McCarthy's strong personal and political relationship with Knoll and Heyison gave him access as well. (Tr. 180-82.) McCarthy was considered to be the number two person in the Treasurer's Office, and he held himself out as such. (Tr. 110-11.) Even when contracts lapsed, McCarthy's activities were consistent with them. McCarthy and Heyison were the decision-makers for the office, and both Arpey and Sciortino recognized McCarthy to be their superior. (Tr. 110, 181, 250.) McCarthy was not an employee of the Commonwealth, but they understood that he was standing in the shoes of Heyison and was to be involved in every decision. (Tr. 106, 250.)

Arpey testified that McCarthy was in the office at least once a week and spoke with him and Heyison on a daily basis. (Tr. 106.) Their discussions covered all topics, including personnel matters, program development, and the selection of investment banking firms and other vendors to be used by the Treasurer's Office. (Tr. 109-10.) Arpey could not recall any instances in which information was not given to McCarthy for his personal review. (Tr. 109.) Sciortino viewed McCarthy similarly, and testified that:

Mr. McCarthy was a constant fixture at [the Treasurer's Office] either in person or on the telephone constantly working alongside of Mr. Heyison, asking questions, giving direction, wanting to know how things were working, what we could change, what policies we might implement . . . [in] an administrative standpoint and a political standpoint, [and] positive for . . . [Knoll's] reputation.

(Tr. 249-50.)

The Commonwealth of Pennsylvania

The Constitution of the Commonwealth gives joint authority to the governor, the treasurer, and the auditor general to issue Commonwealth debt. Each of the three officials is elected independently. (Tr. 126, 186, 260-61.)

The Governor's Office usually takes the lead in bond transactions, and entertains proposals for bond issues. (Tr. 186.) The Governor's Office determines whether there is an advantage to proceeding with an advance refunding and also determines what specific securities should be refunded. As part of this determination, the office looks at cash flow in relation to managing the budget of the Commonwealth. Heilman was the point person in the Governor's Office for an advance refunding. (Tr. 262.) Budget Secretary Hershock and the Governor's Chief of Staff James Brown (Brown) were his superiors. (Tr. 46, 184, 429.)

The Treasurer's Office, as the escrow agent of all the funds of the Commonwealth, holds the securities of any advance refundings conducted by the Commonwealth. (Tr. 126.) As custodian for the securities, the Treasurer's Office develops the process by which the securities are structured and purchased for the escrow side of an advance refunding. (Tr. 261-62.) Sciortino had primary responsibility for overseeing these activities. (Tr. 126.) Arpey, as general counsel, had a limited role of insuring that documents produced by bond counsel for issues were accurate and properly prepared for the treasurer's signature. (Tr. 102-03.)

Alex Brown Selected as Financial Advisor to Treasurer's Office

In June 1993, the Treasurer's Office decided to solicit for a financial consultant/investment advisor. (Div. Ex. 18 at PA 001562-63.) Three firms submitted responses to the Request For Proposal (RFP). McCarthy and Heyison chose Alex Brown in Baltimore, Maryland, because it had the greatest depth of organization and experience, and was already doing the same type of business for another governmental entity. (Tr. 119-20.) McCarthy favored Alex Brown because it was geographically close, and in the past, the Treasurer's Office had positive experiences with Quinn.[4] (Tr. 120.)

Sciortino objected because Alex Brown was outside of Pennsylvania and other applicants had better credentials. However, Heyison and McCarthy's decision was submitted to the treasurer and approved. (Tr. 260.) On September 17, 1993, Quinn signed a $115,000 service purchase contract for Alex Brown to provide financial advisor services. (Tr. 117-18, 258-59, 520-21; Div. Ex. 18 at PA 001561.) Alex Brown was expected to provide reports associated with the short term investment pool, performance analyses, technical assistance for structuring of targeted investments, and structuring guidance on the debt issuances. (Tr. 122-23.) Exhibit B of the service purchase contract was titled "Contractor Integrity Provisions." It prohibited side arrangements to the service purchase contract. The service purchase contract also stated that, "the contractor shall maintain the highest standards of integrity in the performance of this agreement." (Tr. 124-25; Div. Ex. 18 at PA 001584.)

Quinn understood that Alex Brown was expected to maintain the highest standards of integrity in the performance of its duties for the Commonwealth, and that Alex Brown had a fiduciary duty to the Treasurer's Office. Thus, advice given to the

Treasurer's Office would be based on the interests of the Commonwealth, not Alex Brown's interests or his own personal interests. Quinn also recognized that he had a duty to disclose all facts that would be material to the decisions that the Treasurer's Office made in relation to the engagements under the service purchase contract. However, Quinn believed that most of the functions performed under the service purchase contract did not include a fiduciary dimension. (Tr. 523-25.)

The March Advance Refunding

Corner, at Arthurs Lestrange, recommended the advance refunding.[5] (Tr. 43, 189; Resp. Ex. 3.) He constantly monitored the Commonwealth's outstanding general obligation debt for advance refunding opportunities. (Tr. 43.) In early fall of 1993, Corner identified an opportunity for the Commonwealth to refund a significant amount of its outstanding debt. (Tr. 45.) Williams put together the technical and financial information. She analyzed the advance refunding plan and Corner oversaw and advised her on different ideas in terms of structure, options and sensitivity analyses. (Tr. 44-45.)

Corner then presented the potential advance refunding plan to Heilman. (Tr. 45, 189.) Up to this time, the Commonwealth had completed approximately five or six advance refundings, so Heilman was familiar with the process of the bond issuance and the creation of the escrow account. (Tr. 187-88.) Heilman liked the idea and Corner became the main contact at Arthurs Lestrange in proceeding with the advance refunding. (Tr. 45-47, 190.)

After considering different advance refunding scenarios, Heilman wrote to Hershock and recommended that the Commonwealth proceed with an advance refunding using Arthurs Lestrange as its financial advisor. (Tr. 46-47, 191; Resp. Ex. 26.) Heilman's recommendation was accepted and, in November, Arthurs Lestrange was appointed financial advisor for the advance refunding. (Tr. 47, 191.) Arthurs Lestrange would be paid a financial advisory fee of $210,000 as determined by a set fee schedule. (Tr. 49-50, 193; Amended Stip., ¶ 11.) Arthurs Lestrange's appointment as a financial advisor to the Governor's Office was unrelated to Alex Brown's financial advisor service purchase contract with the Treasurer's Office.

By letter dated January 5, 199[4], Bova suggested to Brown that the Commonwealth begin its search for an escrow agent for the advance refunding.[6] (Div. Ex. 22.) Arthurs Lestrange believed "it would be less costly and more efficient" and would "enable the team (Arthurs Lestrange as Financial Advisor and the designated escrow agent) to have the advance refunding(s) structured and ready . . . in the position to enter the market at will." The following day, Bova sent an information copy to Heilman. The cover letter suggested that it would be prudent for the Commonwealth to appoint an escrow agent "now in the event that the market conditions change and permit more than the current refunding to be completed in the first phase." (Div. Ex. 22.)

Thereafter, during a telephone call with Quinn on January 27, 1994, McCarthy advised that the Commonwealth planned to commence an advance refunding of over $1 billion in general obligation debt and was in need of an escrow agent.[7] (Tr. 379, 572-73.) McCarthy estimated that the escrow agent would receive a $0.70 per bond financial advisory fee and a 3 to 5 basis point escrow agent fee.[8] (Tr. 644-45.) However, McCarthy advised Quinn that Alex Brown would have to split the escrow fee 60/40, with sixty percent going to Arthurs Lestrange. McCarthy also advised that Alex Brown would have to assume all risk on the transaction. (Tr. 591-92.) Quinn and McCarthy tentatively calculated that the escrow agent fee would be between $3,066,000 and $5,110,000. (Div. Ex. 28, Resp. Ex. 35.)

Quinn believed that the offer was on a "take-it-or-leave-it" basis and was not negotiable. (Tr. 592.) He discussed the offer with the president of Alex Brown, Mayo Shattuck (Shattuck), the following morning. (Tr. 563-64.) Without asking for a risk analysis, Shattuck approved the deal. (Tr. 564.) Quinn testified that Shattuck did not ask for a risk analysis because Alex Brown had done extensive analysis in relation to other advance refundings and was comfortable in making a decision. (Tr. 564-65, 569.) However, this was the first time Alex Brown shared fees when it was the firm selling the escrow securities. (Tr. 569, 595.) Nevertheless, Shattuck agreed that it looked like a good arrangement and that Quinn should accept the offer, although Alex Brown did not know what revenues Arthurs Lestrange would add to the fee split pool. (Tr. 563-65.) Quinn then contacted McCarthy, who instructed him to get in touch with Bova at Arthurs Lestrange and Sciortino at the Treasurer's Office.[9] (Div. Ex. 79 at 564-65.)

When Sciortino learned that Heyison and McCarthy selected Alex Brown, he objected. Sciortino believed that the Commonwealth could effectively provide the same services. The Investment Center was a full-service center that was capable of buying the securities for the escrow account, and the Commonwealth would have the funds for the purchase because $1 billion in tax payments would be received between March 15 and March 30.[10] (Tr. 129-30, 263-65, 334.) Sciortino could not understand why they were farming out the work. (Tr. 265.)

Sciortino testified about a variety of possible escrow options including state and local government series bonds (SLGs), which are specific securities issued by the U.S. Treasury Department. They are custom made to fit advance or current refunding situations that need escrow securities. Other options included open-market purchasing "in-house," open-market purchasing by competitive bid, and open-market purchasing by negotiated bid. If open markets were better than SLGs, then buying "in-house" was the option that the Treasurer's Office had through the Investment Center. In open-market purchasing by competitive bid, someone on behalf of the Treasurer's Office would seek competitive bids from other firms and take the best-priced bid. In open-market purchasing by negotiated bid, Alex Brown would go out as a principal, and negotiate and purchase the securities for a price, and then resell the securities to the Commonwealth for a predetermined mark-up.[11] According to Sciortino, the first three options would have resulted in no more compensation to Alex Brown than that identified in the financial advisor service purchase contract. The fourth option, open-market purchasing by negotiated bid, which Heyison and McCarthy pursued, would pay Alex Brown a mark-up.[12] (Tr. 272-74; Div. Ex. 80.)

Sciortino also believed that it was a conflict of interest for Alex Brown to act in the capacity of escrow agent while already under contract as the treasurer's financial advisor. (Tr. 264.) However, he agreed that the escrow agent activities were independent of the financial advisor services already being provided and not covered in the financial advisor service purchase contract.[13] (Tr. 369.)

Knoll, Heyison, and McCarthy listened to Sciortino's arguments concerning the conflict of interest, but rejected them and proceeded with Alex Brown. (Tr. 370.) McCarthy and Heyison told Sciortino that Knoll felt comfortable with Alex Brown and that the decision was final. (Tr. 265.) Based on Quinn's advice, open-market purchasing by negotiated bid was chosen by McCarthy and Heyison because Quinn was a professional who, along with Alex Brown, had far more experience and understanding of the process than the Treasurer's Office. (Tr. 276.)

Quinn negotiated with the Treasurer's Office concerning the level of the mark-up on the escrow securities.[14] (Tr. 285, 505.) Sciortino thought a fair mark-up for the escrow securities was 1/32, approximately 3 basis points or 0.0003125. (Tr. 281, 370-71.) He believed that the Commonwealth was prepared to buy the securities no matter what, so there was no abnormal risk involved in the transaction. (Tr. 281-82.)

During these negotiations, Quinn took notes. (Resp. Ex. 41A.) These notes indicated that on February 7, 1994, Quinn proposed a mark-up of "$5/bond" for the escrow securities and "5 BP" for the forward supply contract, and that Sciortino preferred "$4/bond" for the escrow securities, making no mention of the forward supply contract.[15] His notes further indicated that on February 15 the mark-up negotiation was finalized at "$4.5/bond" for the escrow securities and "4.5 BP" for the forward supply contract. (Tr. 682-86; Resp. Ex. 41A.)

When Sciortino checked with McCarthy and Heyison, Sciortino expressed his view that 1/32, or approximately 3 basis points, was a fair mark-up. (Tr. 281.) McCarthy and Sciortino debated this and the fact that Quinn made a counteroffer at 5 basis points.[16] (Tr. 281, 283.) McCarthy settled the debate at 4.5 basis points citing that Alex Brown and Quinn were the professionals who knew what they had to recover and what the risks were. (Tr. 285-86, 373.) Since McCarthy and Heyison were in agreement, and because Quinn already knew what the Treasurer's Office was going to accept, Sciortino thought it was best not to fight for a lower mark-up. (Tr. 285, 375-76.) It was McCarthy and Heyison's decision; Sciortino could not authorize or bind the Commonwealth. (Tr. 372-73.)

On February 18, 1994, Bova sent a letter to Brown advising of the pooling and apportioning of the fees. (Div. Ex. 34.) The letter states:

This is to inform you that Arthurs Lestrange as Financial Advisor, and Alex Brown, as Escrow Agent, intend to pool and then mutually apportion their respective compensation for serving as Financial Advisor and Escrow Agent on the upcoming refunding. The efforts so far by each firm have been so inextricably integrated with the other firm that we are, in effect, working as partners on a day-to-day basis.

On a deal this size, with its significant complexity and critical-timing issues, close professional cooperation by the entire Commonwealth team (the issuer's overall financial advisor and the issuer's technical support - the escrow agent) will only serve to maximize benefits for the issuer.

(Div. Ex. 34.) The letter was copied to Heilman, Sciortino, and Quinn. (Div. Ex. 34.)

Corner alerted Heilman that he would receive a copy of the Bova letter. Arthurs Lestrange's intention "puzzled" Heilman. The letter discussed the intention of Arthurs

Lestrange and Alex Brown to pool their efforts and share fees. Heilman discussed the letter with Brown, but not with Sciortino. Brown said that he did not know anything about it and that Heilman should not do anything about it. (Tr. 200-02.) Heilman did not pursue it any further. (Tr. 202, 211.) However, in his investigative testimony of April 3, 1997, Heilman testified that he checked with Brown who told Heilman that he was aware of the fee split and approved it. (Tr. 212.)

Sciortino did not believe he received the letter although it was copied to him. (Tr. 269, 385.) He testified that he first learned of a fee split on June 13, 1994, in a conference call with Heyison and Doug Carter, Quinn's successor at Alex Brown, concerning a second advance refunding. (Tr. 269-70.) A copy of Sciortino's handwritten notes from the conference call reflects that the 60/40 fee split was discussed. Sciortino testified that, at that time, he did not understand the relevance of a 60/40 fee split as it related to the June advance refunding. (Tr. 270-71; Div. Ex. 53.) Previous to this, he only recalls Heilman mentioning a "joint venture" during the course of the March advance refunding. (Tr. 269, 386.)

Quinn received a copy of the letter disclosing the fee split arrangement. Quinn never provided additional information to the Governor's Office, or the Treasurer's Office. He believed that the Bova letter appropriately disclosed to the Governor's Office and the Treasurer's Office the fee arrangement between Alex Brown and Arthurs Lestrange. (Tr. 596-99; Div. Exs. 32, 33.)

As part of its escrow agent responsibilities, Alex Brown responded to questions that the Treasurer's Office had concerning the advance refunding. (Tr. 531-32; Div. Exs. 30, 35.) A memorandum dated February 7, 1994, from Quinn to Sciortino, reviewed "the relative advantages of structuring an escrow comprised of open-market U.S. Treasury obligations for the State's advance refunding issue on a `negotiated' versus `competitive' basis." Quinn identified Alex Brown "as the State's advisor and escrow structuring agent." (Div. Ex. 30.) Quinn testified that this memorandum should only be viewed as "some information on alternative ways in which the transaction could've been done." Quinn believed he was only providing information in writing that had already been agreed upon. Recommending an approach was not the purpose of the memorandum. (Tr. 533-34.)

A memorandum dated February 22, 1994, from Quinn to Sciortino, stated that Alex Brown as escrow agent to the Treasurer's Office believed that the risk of non-delivery of the securities would be reduced if the securities were purchased by Alex Brown and then re-sold to the Commonwealth. (Tr. 277-78.) The memorandum concluded that this was "the approach which [Alex Brown] recommend[ed] that the State adopt." (Div. Ex. 35.) Again, Quinn believed that this memorandum "confirm[ed] a decision that had already been made," because it articulated a position that was consistent with what the Commonwealth had done in other advance refundings since 1990. (Tr. 536.) This memorandum also disclosed that the escrow agent would secure a forward supply contract and the reasons therefor. (Div. Ex. 35.) See infra note 15.

Since Alex Brown was selling the open-market securities to the Commonwealth, Meteer took part in calculating the mark-up. Two or three weeks before the pricing of the escrow securities, Meteer, Dan Curry (Curry), and Quinn discussed the mark-up, and concluded that the mark-up would be 4.5 basis points.[17] Meteer and Curry then began a preliminary run on the escrow securities. During this process of entering the securities into the computer model, Meteer was not clear on whether the mark-up was 4.5 basis points of the reduction in yield or 4.5 basis points on the purchase price of the securities. Quinn, however, stated that the mark-up was on the purchase price of the securities. Meteer and Quinn also discussed the dollar amount of the mark-up when Meteer advised that 4.5 basis points was not producing the million dollar amount that Quinn had contemplated. (Tr. 474-79.)

Quinn concluded that Meteer and Curry would use 0.0045 because that was Quinn's agreement with the Commonwealth. Meteer testified that when he mentioned to Quinn that 0.0045 was 45 basis points, Quinn did not react. Meteer was sent back to his desk with the instruction that 0.0045 was to be used, because the mathematical result of the mark-up was to be in the millions. When the preliminary bidding for the securities was done, Meteer marked up the purchase price by 0.0045, or 45 basis points. (Tr. 477-79.)

On March 16, 1994, the escrow securities pricing date, there was significant involvement among Alex Brown, Arthurs Lestrange, and the Commonwealth.[18] On that day three bids for the refunding bond issue were received around 11:00 a.m. Arthurs Lestrange reviewed and tabulated the bids to make sure they were accurate. Around noon the winning bid figures were transferred to Alex Brown with the actual pricing and the arbitrage yield. Alex Brown then bid for the escrow securities and, based on the actual arbitrage yield of the successful bid, they structured the escrow account so that it did not exceed the arbitrage yield of the refunding bonds. Alex Brown then transferred back to Arthurs Lestrange an actual escrow price. Arthurs Lestrange fine-tuned the bond issue to an exact size with the amounts of the maturities. This information was then passed on to Peat Marwick in Texas for verification. Around 4:00 p.m., Arthurs Lestrange received verification and the successful bidder of the refunding bonds was contacted and awarded the bonds. (Tr. 64-65; Resp. Ex. 8.)

Also on March 16, 1994, Sciortino drove to the Alex Brown office in Baltimore, Maryland.[19] (Tr. 286, 480.) Although he had wanted to arrive by 11:00 a.m., Sciortino got lost and called Quinn for directions. He arrived at 12:00 or 12:15 p.m. (Tr. 367, 392, 737; Resp. Ex. 10.) During his visit, Sciortino waited for the information from the refunding side of the transaction and observed some of the escrow securities purchases. (Tr. 287.) At Quinn's request, Meteer met with Sciortino to review the escrow securities before Alex Brown locked in the price.[20] They were alone at the meeting. (Tr. 480-82.) The review included the portfolio that Alex Brown had purchased, the mark-up, and the resulting cost to the Commonwealth. (Tr. 482.)

Throughout this discussion, Meteer reviewed a two-page document with Sciortino. (Tr. 481-82; Resp. Ex. 1.) The first page of the document was printed at 2:12 p.m. and the second page was printed at 2:42 p.m. (Tr. 490-91.) The pages were numbered 1 and 2 by Meteer. (Tr. 491.) Meteer testified that he used the first sheet to show Sciortino the securities Alex Brown was buying, and to demonstrate that multiplying that amount by "1.0045," or 45 basis points, resulted in the upper limit of the mark-up that Alex Brown and the Commonwealth had agreed to. (Resp. Ex. 1.) Meteer wrote down the basis points and the resulting total. (Tr. 481, 483.) Meteer further testified that he reviewed the numbers with Sciortino and that Sciortino understood them. (Tr. 491.) Sciortino also wrote down the mark-up amount of $1,782,141, and the underwriter's discount of $4.00 per bond, or 40 basis points. (Tr. 742; Resp. Exs. 11 at PA 002057-59, 13.) In his investigative testimony, Sciortino stated that he wrote the amount on the day of the pricing, but at the hearing he stated that he wrote it sometime later. (Tr. 410-12.) Meteer received Sciortino's approval of the figures and the purchase was locked in. If Sciortino had withheld his permission, the transaction would not have occurred and "all hell would have broken loose."[21] (Tr. 491-92.)

During the investigation and the hearing, Sciortino provided a variety of reasons for his presence at Alex Brown, none of which related to the mark-up. He stated that he was there as requested by McCarthy to represent the Commonwealth and oversee the bidding and structuring of the escrow securities. (Tr. 287, 393, 480.) It was standard practice for the Commonwealth to visit the offices of the companies with which it worked, as a form of due diligence. Having never been to Alex Brown's office, Sciortino thought this was a good opportunity. (Tr. 393-94.) Sciortino wanted to see the process of purchasing escrow securities. (Tr. 287.)

In his investigative testimony, Sciortino stated that he visited Alex Brown to make sure that it did the escrow securities purchase "right," because there were certain firms that the Commonwealth did not want to do business with, which the traders at Alex Brown would not have been aware of.[22] (Tr. 394.) In investigative testimony taken on November 19, 1997, Sciortino stated that he was at Alex Brown to check on what it charged the Commonwealth for the escrow securities. (Tr. 395-96.) Then, in investigative testimony taken on March 13, 1998, Sciortino stated his purpose was to determine whether or not there was sufficient escrow securities to defease the issue and to obtain a verification report. However, that report was not ready until 6:00 p.m., well after the time Sciortino left. (Tr. 396.) Also, Sciortino was unable to clearly recall other events that day. He was unsure about whether he went trout fishing, to the office, or home upon leaving Alex Brown. (Tr. 397-99.)

On March 17, 1994, the day after the escrow securities pricing, Heilman sent a memorandum to Hershock in the Governor's Office and the auditor general summarizing the results of the bond issuance of the previous day. (Tr. 216; Resp. Ex. 12.) In the memorandum, Heilman stated that, "The sale . . . could not have gone much better than it did." (Tr. 216; Resp. Ex. 12.) The transaction was believed to have saved the Commonwealth over $10 million with a present value of $12.7 million. (Tr. 216-17.) Heilman's memorandum did not express a specific opinion on the mark-up fees because, at that time, he was unaware of them. (Tr. 229.)

The following day when Sciortino received the list of escrow securities that were purchased on behalf of the Commonwealth, he gave the list to an analyst in his office to examine the relative price and costs of purchasing them.[23] (Tr. 289.) After making an initial examination, the analyst advised Sciortino that the price to be paid by the Commonwealth was "way out of line." (Tr. 289.) According to Sciortino, the analyst concluded that the mark-up was excessive at $1.8 million or about 45 basis points. When Sciortino was told that the mark-up was 45 basis points, he became "unhappy" and rechecked the numbers with the analyst to make sure they were accurate. (Tr. 291, 414.) Once Sciortino was comfortable with the conclusions, he notified Quinn that the securities had been marked up ten times the amount previously agreed to. Quinn replied that Sciortino's calculations were inaccurate because it was 4.5 basis points. (Tr. 292.)

Sciortino also reported the excessive mark-up to Heyison and McCarthy. (Tr. 293, 423.) Sciortino stated that based upon the spreadsheet from the analyst, they had evidence that the mark-up was 45 basis points instead of 4.5 basis points. (Tr. 293.) Heyison questioned the accuracy of Sciortino's numbers and asked him to check them again. Ultimately, Heyison agreed to look into the matter. (Tr. 293, 425.) McCarthy also questioned whether Sciortino had done the calculations correctly and suggested that the numbers did represent a mark-up of 4.5 basis points. McCarthy also agreed to look into the matter. (Tr. 293-94.)

Sciortino also personally notified Knoll, and explained to her the difference between 45 and 4.5 basis points by providing a numeric example of the difference between 179,000 and 1.79 million. Sciortino's action of notifying Knoll agitated Heyison and he forbade Sciortino to ride in the car alone with Knoll after this incident. (Tr. 423-26.)

On March 30, 1994, the advance refunding closed when the banking firms transferred the escrow securities to the Commonwealth. (Tr. 294-95.) Sciortino did not make an effort to stop the closing, even though the mark-up issue remained unsettled. (Tr. 295.) To stop the closing would have caused a significant negative impact on the Commonwealth's ability to borrow in the future. It would have also caused problems with the Commonwealth's credit rating, and decreased its credibility in the marketplace. (Tr. 296.) Comparatively, the risk in causing the transaction to fail and the fact that Sciortino had reported it, caused Sciortino to not attempt to stop the closing. Sciortino assumed that the overall transaction would be successful financially. (Tr. 296.)

Sciortino believed that he could pursue the possibility of getting a refund from Alex Brown for what he believed was an excessive mark-up. Sciortino wanted the difference between the actual mark-up and what he believed they had agreed to originally. He pursued it with Heyison, Arpey, and also McCarthy. Sciortino was told repeatedly that the Treasurer's Office, meaning Heyison, was considering the issue. Sciortino was to "get out of it, go back and do [his] job and [Heyison] would handle that aspect of the transaction." (Tr. 296-97.)

At the time of closing, Heilman was unaware of any dispute over the mark-up amount. (Tr. 205.) The following day, March 31, 1994, Heilman sent a memorandum to Hershock and Sciortino titled, "Summary of First Series of 1994 Refunding." (Resp. Ex. 17.) In the memorandum, Heilman stated that "[t]he sale went well for us and it also went well for the underwriters making the issue a win for all." (Resp. Ex. 17.) In general, Heilman had the same opinion on the advance refunding the day after the pricing and the day after the closing. (Tr. 217.) Heilman also mentioned in the memorandum that the market had been turbulent during the advance refunding, making the purchase much more difficult. He provided highlights of the purchase with final numbers prepared by Arthurs Lestrange. (Tr. 218; Resp. Ex. 17.)

On April 4, 1994, Heilman sent a memorandum titled, "Results of Negotiated Changes to Issuance Costs" to Brown and Hershock in the Governor's Office. (Resp. Ex. 29.) Heilman summarized the final negotiated issuance costs in the first series of 1994 advance refunding bonds. The last paragraph indicated that "[Alex Brown] was not paid a specified fee but apparently was allowed a mark-up on the escrow. I have not been able to find out that amount." (Resp. Ex. 29.)

The Amended Stipulation articulates the results of the March advance refunding:

Alex Brown paid a total of $396,562,554.88 for the Escrow Securities (including accrued interest). Alex Brown sold [them] to the Commonwealth at a total price of $398,344,695.52 (including accrued interest). Alex Brown's mark-up on its sale of the Escrow Securities to the Commonwealth was $1,782,140.70. Alex Brown's mark-up represents 0.0045 (rounded off to the nearest 0.0001) times the price it paid for the Escrow Securities.

Alex Brown also received a "Forward Supply Fee" of $194,000 as part of the March 1994 refunding. Alex Brown calculated the Forward Supply Fee as 4.5 basis points, or 0.00045, times certain cash flows totaling $431,335,000. The fee was then rounded down to the nearest $1,000.

In addition to the mark-up on the Escrow Securities and the Forward Supply Fee, Alex Brown received $418,316.40 (the "Repo Spread") in the March 1994 refunding as a result of a Treasury Repo transaction. (Alex Brown borrowed funds to purchase the Escrow Securities on March 14, 1994, which the firm owned until the refunding transaction closed on March 30, 1994. The Repo Spread represents the difference between the interest accrued on the Escrow Securities during the period and Alex Brown's borrowing costs during this period.)

As the [Governor's Office's] financial advisor in the March 1994 refunding, Arthurs Lestrange & Company, Inc., received a financial advisory fee of $210,000.

Pursuant to an agreement between the two firms, Alex Brown and Arthurs Lestrange pooled and split their fees on the transaction. Arthurs Lestrange received 60 percent, or $1,562,674.26, of the pooled fees, and Alex Brown received 40 percent, or $1,041,782.84.

(Amended Stip., ¶¶ 8-12.)

<u>Aftermath of the March Advance Refunding</u>

In June 1994, in preparation for the second part of the advance refunding, Arpey reviewed the forward supply contract from the March advance refunding which showed that the Commonwealth paid a fee in the March advance refunding for the forward supply contract. He called Sciortino, who was trout fishing, on his cell phone to determine if a similar arrangement had been made for the upcoming June advance refunding. (Tr. 135, 305-06, 356-59.)

Arpey asked Sciortino what Alex Brown was going to charge for the forward supply contract in the second advance refunding. Sciortino told him that there would not be a charge, because it was all-inclusive in the mark-up that was negotiated. (Tr. 307.) Sciortino believed that it would be exactly the same as the March advance refunding, a single charge of 4.5 basis points and the predetermined financial advisor service purchase contract fee. (Tr. 135, 307, 360.) Although stating that he was not aware that Alex Brown had received a fee, Sciortino did admit that he was aware that the forward supply contract was a separate fee not included in the mark-up. (Tr. 307, 360, 376-78.)

Quinn, who was no longer working for Alex Brown, was conferenced into the call. (Tr. 159, 307, 360.) Quinn, Sciortino, and Arpey became involved in a heated discussion.

(Tr. 135-36.) Quinn stated that Sciortino was aware of the forward supply contract. (Tr. 307-08.) Sciortino said that he was not. (Tr. 308.) Quinn stated that he had sent a memorandum to Sciortino about the forward supply contract prior to the escrow securities pricing day. (Tr. 360-61.) When Sciortino denied seeing the memorandum, Arpey went into Sciortino's office and found it. (Tr. 361; Resp. Ex. 10.) Still Sciortino claimed to had never seen the memorandum because that was the day he was in Baltimore.[24] (Tr. 361.) The memorandum discussed the forward supply contract, not the mark-up on the escrow securities. (Tr. 176.) Arpey described the memorandum's contents to Sciortino, and Sciortino concluded that the Commonwealth had been deceived. (Tr. 159.)

Although not fully appreciating the fact that there were separate fees for the forward supply contract and the escrow securities, Arpey brought the excessive mark-up issue to the attention of Heyison and McCarthy. (Tr. 137-38, 164, 177.) He asserted that the Treasurer's Office should recoup the money from Alex Brown. (Tr. 138.) McCarthy and Heyison decided that it would be best to recoup the money prospectively, from Alex Brown during future business transactions. (Tr. 138.) They also instructed Arpey not to pursue the issue; McCarthy and Heyison would take care of it. (Tr. 164.) There is no evidence that they ever did.

Thereafter, Quinn called McCarthy because he was concerned that the Treasurer's Office was not happy with the March advance refunding. (Tr. 767.) Arpey and Sciortino's telephone call was the first time that a possible problem was mentioned to Quinn. (Tr. 770.) Quinn requested that McCarthy call him if there was a problem. (Tr. 767-69.) McCarthy called sometime later and advised that since Alex Brown could not find the information on the March advance refunding, Quinn should prepare a memorandum and attach whatever documents he still had. (Tr. 769; Resp. Exs. 40, 40A.) Quinn went through some of his old material and found a final draft of the forward supply contract with the distribution list and a copy of the settlement page for the fees associated with the transaction. (Tr. 769.) He sent the material to McCarthy and further suggested that his assistant from Alex Brown would have diskettes with all of the other memoranda regarding the transaction. (Tr. 769; Resp. Ex. 40.)

The first time Heilman found out there was a disagreement with the March advance refunding was August 22, 1994. (Tr. 225.) At an August 22, 1994, meeting, attended by Heyison, Sciortino, and Heilman, a discussion was held regarding the difference between a 4.5 and a 45 basis point mark-up with the conclusion that the Treasurer's Office was charged an excessive mark-up on the escrow securities purchased in the March advance refunding. (Tr. 225-26.) Heyison and Sciortino did not explain to Heilman why it took them until August 22 to raise the issue or bring this mistake to Heilman's attention. They did not decide on any course of action. (Tr. 227-28.)

In late July or early August 1994, McCarthy mentioned to Quinn that Arpey was still "hung up" about the forward supply contract. (Tr. 772.) Quinn wanted to meet with Arpey, Sciortino, and Heyison to clear up the matter, with the hopes that he could offer the services of his new firm, A. Webster. (Tr. 773.) The meeting was arranged and then rescheduled for August 24, the day of Heyison's birthday party. (Tr. 773.)

After the party, Sciortino, Arpey, Heyison, McCarthy, and Quinn went to Heyison's office. (Tr. 312.) When the basis point dispute was raised, it was a rehashing of the two positions. (Tr. 145.) According to Sciortino, Quinn quietly and calmly argued that the Treasurer's Office miscalculated the mark-up and maintained that the escrow securities mark-up was intended to be 4.5 basis points. (Tr. 146, 318.) In contradiction, Quinn testified at the hearing that the meeting did not involve any discussion that included 45 basis points, dollar amounts, or escrow securities mark-ups, rather the conversation concerned the forward supply contract. (Tr. 778.) Quinn also testified that Sciortino did not speak at the meeting. (Tr. 778.) When the meeting ended Quinn had a sense that the issue had been smoothed over and any misunderstanding was now a closed matter. (Tr. 778-79.)

III. FINDINGS OF FACT AND CONCLUSIONS OF LAW

The Division alleges that Quinn violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, collectively known as the antifraud provisions, because he failed to "fully and accurately" disclose to the Treasurer's Office the 60/40 fee split arrangement between Alex Brown and Arthurs Lestrange, and "looked the other way" when Arthurs Lestrange provided the Governor's Office with a description of the arrangement that the Division alleges is materially misleading. The Division also alleges that, in furtherance of the scheme, Quinn made materially false statements about the mark-up by continuing to affirm that the escrow securities mark-up was 4.5 basis points after having knowledge that it was closer to 45 basis points.

Section 17(a) of the Securities Act prohibits using the mails or instruments of interstate commerce in the offer or sale of securities to employ any device, scheme, or artifice to defraud; use false statements or omissions of material fact to obtain money or property; or engage in any transaction, practice or course of business which is or would operate as a fraud or deceit upon a purchaser.

Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, make it unlawful for any person, directly or indirectly, in connection with the purchase or sale of any security to make an untrue statement or omission of material fact; use any device, scheme or artifice to defraud; or engage in any act practice or course of business which operates or would operate as a fraud or deceit upon any person.

For liability to attach under the antifraud provisions, omissions or misstatements must be material. The test for materiality is whether there is a substantial likelihood that a reasonable investor would consider the information important to the investment decision, and would view it as having significantly altered the total mix of available information. See Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988); TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). Materiality is a mixed question of law and fact, dependent on the circumstances at the time of the alleged misstatement. See Ganino v. Citizens Utils. Co., 228 F.3d 154, 162, 165 (2d Cir. 2000).

Scienter is a required element under Section 17(a)(1) of the Securities Act, Section 10(b), and Rule 10b-5 of the Exchange Act, but not Sections 17(a)(2) and 17(a)(3) of the Securities Act.[25] See Aaron v. SEC, 446 U.S. 680, 697 (1980). The Supreme Court has defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976). The scienter requirement is also satisfied by showing that the respondent acted recklessly, defined as "an extreme departure from the standards of ordinary care . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." Meyer Blinder, 50 S.E.C. 1215, 1229-30 (1992) (quoting Sunstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977)); see also Hollinger v. Tital Capital Corp., 914 F.2d 1564, 1568-69 (9th Cir. 1990).

"Fraud or deceit presupposes the superior knowledge of one party over another." SEC v. Coffey, 493 F.2d 1304, 1313 (6th Cir. 1974) (citing Myzel v. Fields, 386 F.2d 718, 739 (8th Cir. 1967)); see also Chelsea Assocs. v. Rapanos, 376 F.Supp. 929, 939-40 (E.D. Mich. 1974) ("A fundamental purpose, common to securities regulation statutes, is to [establish] a philosophy of full disclosure . . . and to achieve a high standard of business ethics in the securities industry."). The antifraud provisions "make sure that buyers of securities get what they think they are getting and that sellers of securities are not tricked into parting with something for a price known to the buyer to be inadequate or for a consideration known to the buyer not to be what it purports to be." Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930, 943 (2d Cir. 1984). "No doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices." Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477 (1977).

The Escrow Agreement and Fee Split

The OIP charges that Quinn engaged in a scheme to defraud by failing to "fully and accurately" disclose the 60/40 fee split to the "Commonwealth." It further charges that Quinn "looked the other way" when Bova wrote to the Governor's Office that Alex Brown and Arthurs Lestrange intended to pool and split their fees, because the letter did not specifically state the percentage of the fee split or that McCarthy required Alex Brown to split the fee as a condition of being named escrow agent.

The treasurer and the governor each has a role in advance refundings. The Governor's Office decides if it is advantageous to proceed with an advance refunding, and the Treasurer's Office, as escrow agent for the Commonwealth, holds the securities of any advance refunding conducted by the Commonwealth. (Tr. 186, 261-62.) In this case, the Governor's Office accepted Arthurs Lestrange's recommendation of conducting an advance refunding and looked to the Treasurer's Office to obtain the escrow securities. (Tr. 43, 47, 189, 191, 194-95; Div. Ex. 22.)

The evidence establishes that the Treasurer's Office had a long-standing relationship with McCarthy, and the staff at the Treasurer's Office relied on his direction and decisions. McCarthy was recognized as having authority "very similar to Mr. Heyison's which was everything from hiring and firing, to making decision on the smallest of items to the largest of items." (Tr. 109-10, 249-50.) On occasion, through a separate agreement between Alex Brown and McCarthy's law firms, Quinn received work from the Treasurer's Office through McCarthy. (Tr. 579; Div. Ex. 75; Amended Stip., ¶¶ 3-5.)

On January 27, 1994, McCarthy advised Quinn that the Commonwealth planned to commence an advance refunding of over $1 billion in general obligation debt and was in need of an escrow agent. (Tr. 379, 572-73.) In offering Alex Brown the position of escrow agent, McCarthy instructed Quinn that Alex Brown would have to split the escrow fee 60/40, with sixty percent going to Arthurs Lestrange, and assume all of the risk involved in the transaction. (Tr. 591-92.) McCarthy made the offer of a 60/40 fee split, as a "take-it-or-leave-it" proposition. (Tr. 592.) After discussions with the president of Alex Brown, Quinn accepted the offer from McCarthy. (Tr. 563-65; Div. Ex. 79 at 564-65.)

Since Quinn knew of the relationship between McCarthy and the Treasurer's Office and had previously received work from the Treasurer's Office through McCarthy, I find that it was reasonable for Quinn to believe that McCarthy was speaking on behalf of the Treasurer's Office in making the offer to be the escrow agent for the advance refunding. When the offer was made, it was reasonable for Quinn to believe that all of the terms related to him by McCarthy, including the requirement to split the fee with Arthurs Lestrange, were terms that the Treasurer's Office was well aware of.

The allegation of "look[ing] the other way" relates to the letter Bova wrote to the Governor's Office on February 18, 1994, advising that Alex Brown and Arthurs Lestrange would pool, and then apportion, their fees from the advance refunding. The letter did not mention the percentage of the apportionment or that McCarthy had conditioned the offer of escrow agent on the fee split. Quinn, along with Sciortino and Heilman, was copied on the letter. (Div. Ex. 34.) Quinn testified that he believed the letter was sufficient and I credit his testimony. (Tr. 596-99.) Further, while it is not clear what "look[ing] the other way" may mean as to Quinn in this proceeding, there is no evidence to support a finding that Quinn had an obligation to the Governor's Office to comment on the letter or add any additional detail.[26]

I conclude that there is no evidence that Quinn intentionally withheld any information about becoming the escrow agent from the Treasurer's Office or the Governor's Office, or that he did so recklessly or negligently. I further conclude that Quinn had no duty to disclose additional information to the Governor's Office.

Mark-Up of the Escrow and Forward Supply Contract

The OIP also charges that Quinn made materially false statements about the basis points used to compute the mark-up.

I find that the negotiations about the mark-up were to determine an agreed upon amount of money that Alex Brown would be paid for its services as escrow agent as well as an additional amount for the forward supply contract.

Quinn and McCarthy's initial discussion on January 27, 1994, contemplated a fee in the millions of dollars, as indicated by Quinn's notes. They estimated the escrow fee would be approximately between $3,066,000 and $5,110,000 on an advance refunding of approximately $1 billion. The fee for the escrow agreement was estimated to be 3 to 5 basis points. (Div. Ex. 28, Resp. Ex. 36.)

On February 5, 1994, Quinn spoke with Bova in an effort to ascertain the aggregate amount of their revenues and the potential fee split from the transaction. Using the range of figures from his conversation with McCarthy, Quinn's notes reflected a bond issue size of approximately $1 billion. He stated that the notation for the escrow mark-up "4.5 BD" referred to "per bond" rather than "4.5 BP" meaning basis points. The expected amount of the mark-up was in the millions, at $4,600,620. I find that this amount equals a mark-up of 45 basis points or $4.50 per bond. (Tr. 514-19; Div Ex. 29.)

Two days later, on February 7, 1994, Quinn spoke with Sciortino and discussed the mark-up on the securities escrow and the forward supply contract.[27] Quinn's notes indicated that he proposed "$5/bond" for the escrow mark-up and "5 BP" for the forward supply contract. Sciortino proposed "$4/bond" but did not mention the forward supply contract. This calculation showed that Quinn expected the escrow mark-up to be in the millions. (Resp. Ex. 41A.) Quinn's notes reflect a subsequent conversation with Sciortino on February 15 that indicates "Henry [was] ok at 4.5 bond + 4.5 BP on [the forward supply contract]." (Resp. Ex. 41A.)

Two or three weeks before the pricing date of March 16, 1994, Meteer testified that Quinn told him that the escrow mark-up would be calculated by using 4.5 basis points. In doing a preliminary analysis, Meteer was unclear as to whether this was to be 4.5 basis points of the reduction in yield or on the purchase price of the securities. Meteer also advised that 4.5 basis points would not produce the million dollar mark-up amount that Quinn expected. Quinn responded that the mark-up would be based on the purchase price and further advised Meteer that the mark-up would be 0.0045 because that was the agreement with the Commonwealth. (Tr. 474-77.)

The evidence further demonstrates that over $1.7 million was calculated for the mark-up on the pricing date, March 16. Meteer reviewed a two-page document titled "Escrow Cost" showing Sciortino the securities to be purchased at a 0.0045 mark-up. (Resp. Ex. 1.) According to Meteer, Sciortino understood the mark-up and approved the transaction. (Tr. 491.) Sciortino also wrote down that the mark-up would be $1,782,141, either on the pricing date or sometime thereafter. (Resp. Ex. 11 at PA 002059.) Quinn did not participate in this conversation.

Moreover, Sciortino brought the million dollar mark-up to the attention of Heyison and Knoll the following day. (Tr. 293, 423-26.) Sciortino even used an example to demonstrate his concern. Although Heyison and McCarthy questioned Sciortino's accuracy, both agreed to look into the matter. (Tr. 293-94, 425.)

I conclude that Knoll and Heyison, who were the decision-makers for the Treasurer's Office, as well as McCarthy and Sciortino, knew the dollar amount of the mark-up, which was the material information, at least two weeks prior to the closing and that it was computed on 45 basis points. Therefore, the Treasurer's Office had two weeks to act on the information if it believed that the Commonwealth was being charged an excessive mark-up.

Through the course of the March advance refunding there was unquestionable miscommunication or lack of communication among the parties in two interrelated areas. First, Quinn continued to assert a 4.5 basis points mark-up although continuously calculating a fee in the millions of dollars. Second, the Treasurer's Office did not grasp the significance of two mark-ups, one for the forward supply contract and one for the escrow securities. The forward supply contract had a mark-up of 4.5 basis points. (Resp. Ex. 10 at PA 002018-32.) The escrow securities, the subject of this proceeding, had a mark-up of 45 basis points.

This interrelated confusion, however, does not disturb the legal conclusions contained herein. The intended result of the escrow securities mark-up was consistently and continuously in the millions of dollars, regardless of anyone's confusion about 4.5 or 45 basis points. Further, the Treasurer's Office's lack of awareness as to the 4.5 basis points mark-up in the forward supply contract raised an inference that the Treasurer's Office did not distinguish between the forward supply contract and the escrow securities mark-up. Wherever the confusion lay, it does not modify my conclusion that the Treasurer's Office was in possession of the material information concerning the March advance refunding.

Accordingly, there is no credible evidence that Quinn omitted or misrepresented any material information regarding the March advance refunding with the intent to defraud the Commonwealth, nor did he act recklessly or negligently within the meaning of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

IV. RECORD CERTIFICATION

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), I certify that the record includes the items set forth in the record index issued by the Secretary of the Commission on June 15, 2001.

V. ORDER

IT IS ORDERED that the proceeding against Respondent Kevin G. Quinn is hereby DISMISSED.

This order shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that rule, a petition for review of this initial decision may be filed within 21 days after service of the decision. It shall become the final decision of the Commission as to each party who has not filed a petition for review pursuant to Rule 360(d)(1) within 21 days after service of the initial decision upon him, unless the Commission, pursuant to Rule 360(b)(1), determines on its own initiative to review this initial decision as to any party. If a party timely files a petition for review, or the Commission acts to review as to a party, the initial decision shall not become final as to that party.

Robert G. Mahony
Administrative Law Judge

Footnotes

[1] Citations to exhibits offered by the Division and Respondent, to the transcript of the hearing, and to the Amended Stipulation will be noted as "(Div. Ex. __.)," "(Resp. Ex. __.)," "(Tr. __.)," and "(Amended Stip., ¶ __.)" respectively.

[2] Information concerning Heyison, now deceased (1996), was derived primarily from the testimony of Arpey and Sciortino.

[3] McCarthy did not testify at the hearing. His involvement in the events in question was derived from witness testimony and exhibits.

[4] In or about June 1991, Quinn was introduced to Patrick McCarthy, . . . [who] was described to Quinn as a well-connected, politically active individual who could be a

helpful resource in developing business for Alex Brown.

McCarthy told [Quinn] that he assisted investment banking firms in getting public finance assignments. McCarthy stated that he was a very close friend of the Treasurer of Pennsylvania and her Deputy Treasurer [, Heyison], and that, for a fee, he would promote the use of Alex Brown by the Treasurer's Office. McCarthy proposed that Alex Brown pay his law firm a percentage of the revenues Alex Brown received for assignments obtained as a result of McCarthy's efforts.

Quinn obtained his boss's approval to accept McCarthy's proposed percentage-based fee arrangement. In July 1991, Alex Brown agreed to pay McCarthy's law firm 20 to 25 percent of the gross revenues earned by Alex Brown's Public Finance Department and 20 to 25 percent of the net revenues realized by the firm's Sales, Trading and Underwriting Department on assignments McCarthy secured for the firm. Under this arrangement, McCarthy assisted Alex Brown in obtaining assignments from the Commonwealth of Pennsylvania and other municipal entities beginning in approximately August 1991.

(Amended Stip., ¶¶ 3-5.) From 1991 through February 1994, McCarthy's law firms collectively received over $369,000 through this arrangement. (Tr. 579; Div. Ex. 75.)

[5] When interest rates fall, states and local authorities can reduce their debt burden by issuing "advance refunding" bonds. In an advance refunding, the municipality issues refunding bonds at the interest rate prevailing at the time of the offering. The bond proceeds are placed in escrow, invested (typically in U.S. Treasury securities), and used to pay off the municipality's previously issued, higher interest rate debt as it becomes due. The securities placed in the escrow are termed "escrow securities."

(Amended Stip., ¶ 6.)

When an escrow is developed, it is typically made up of component pieces of various U.S. Treasury securities, varying in date and yield, making a complete package that will produce enough cash to defease the bonds when they are callable. (Tr. 195-96.) However, proceeds from the escrow are restricted to the arbitrage yield on the new issue so that the issuer cannot make money on the transaction. (Tr. 39-40, 196.) The maturing escrow securities and the interest earned thereon should be sufficient to pay the debt on the bonds when they are callable. (Tr. 40.)

[6] Although Heilman had expected Arthurs Lestrange to do the escrow work, he received a call from Heyison stating that the Treasurer's Office would take the responsibility for the escrow securities. (Tr. 194-95.) Arthurs Lestrange's analyses would provide the necessary information to the Treasurer's Office to pay off the bonds that were being advance refunded, but Arthurs Lestrange would not have any other interaction with the Treasurer's Office. (Tr. 51-52.)

[7] As time went on, interest rates started to increase to where it was not financially beneficial to refund some of the bonds. (Tr. 379-80.) Furthermore, it was determined that the advance refunding should be broken into two parts. The first advance refunding in March 1994 was for approximately $300 million. (Tr. 380.) A second advance refunding would be conducted in June 1994.

[8] A basis point is one one-hundredth of one percent, or 0.0001.

[9] Neither party provided documentation memorializing the agreement between Alex Brown and the Commonwealth for the March advance refunding.

[10] In 1989, the Treasurer's Office was ill equipped to handle all of the financial activities of a $3.5 to $4 billion portfolio of the Commonwealth. (Tr. 248.) With an Investment Center, the Commonwealth would not duplicate activities and, in turn, save taxpayers' money. (Tr. 249.) Knoll took on the mission of dedicating a portion of the finance building to finance activities. (Tr. 248.) The result was a high-tech, state-of-the-art, fully capable Investment Center with computer and telephone connections that could handle the Commonwealth's investment activities, clearing activities, banking activities, and the wiring of funds in and out of the Commonwealth. (Tr. 130, 248-49.) It brought all of the financial operations of the Treasurer's Office into one place. (Tr. 130-31.)

[11] The mark-up is the revenue or commission a firm receives for handling the securities transaction. (Tr. 466.) A mark-up is added to the purchase price of the escrow securities prior to reselling the same securities to the user. (Tr. 466.) Meteer testified to two methods to derive the mark-up. With a reduction-in-the-yield method, the parties determine a number by which they want to reduce the yield and then adjust the purchase price of the securities such that it will accomplish the reduction in the yield. With a percentage-of-the-purchase-price method, the parties negotiate a percentage by which the purchase price for the escrows will be multiplied. The parties then "do the math" by applying that percentage to the purchase price of the securities. (Tr. 467.) In the latter method, the percentage could be indicated through the use of basis points or an amount per bond.

[12] Sciortino sought information from Quinn on the relative advantages of structuring an escrow in a negotiated versus competitive basis and Quinn provided a letter, dated February 7, 1994, advising that the negotiated basis was the most advantageous. (Tr. 274-75; Div. Ex. 30.) The letter did not persuade Sciortino. (Tr. 275.)

[13] Quinn testified that the escrow agent function undertaken by Alex Brown in the March advance refunding was neither pursuant to nor covered by the financial advisor service purchase contract. "It was an engagement to broker securities in connection with the transaction that already [had] been defined many months before I was contacted to become involved." The escrow agent activities were distinct from financial advisor duties. (Tr. 538.)

Quinn also testified that the relationship between Alex Brown and the Commonwealth concerning the advance refunding transaction was so obviously an isolated activity, that it would only insult the intelligence of the individuals in the Treasurer's Office to clarify it. (Tr. 542.) Accordingly, Quinn never explicitly stated that Alex Brown was working in two different capacities. (Tr. 543.) The Treasurer's Office knew it.

[14] On February 5, 1994, before discussing the mark-up of the escrow securities with Sciortino, Quinn spoke with Bova. (Tr. 514, 519.) Quinn testified that his notes, which incorporate information that McCarthy had provided previously, read "4.5 BD" referring to "per bond" rather than "4.5 BP" referring to "basis points." The fees written by Quinn while in conversation with Bova indicate a financial advisor fee of $817,888, or $0.80 per bond times the issue size, and a mark-up of $4,600,620, or $4.50 per bond times the issue size. (Div. Ex. 29.) The mark-up was based on an

estimated cost of $1,022,360,000 for the securities. This fee is the result of using 45 basis points. (Tr. 517-20.)

[15] The purpose of the forward supply contract is to "optimize the efficiency of the refunding escrow." This determined how the bond proceeds would be invested during the gaps between when the escrow securities matured and when the payments were due on the original bonds. (Tr. 599-600.) The Commonwealth intended to sell the right to invest the bond proceeds during the gaps to an investment firm through the forward supply contract. (Tr. 599-601.) On March 30, 1994, Quinn sent a letter to Knoll advising that it was prudent to enter into such an agreement. (Tr. 537; Div. Ex. 43.)

[16] Quinn testified at the hearing that he negotiated a mark-up of $5 per bond, not 5 basis points. (Tr. 682-85.)

[17] Meteer was responsible for the structuring of the securities for the escrow, and Curry was responsible for the bidding out of the forward supply contract. (Tr. 473-74.)

[18] On the previous day, March 15, Sciortino received a document by facsimile with the subject title "Commonwealth of Pennsylvania Refunding - Escrow Obligations," which provided information on the forward supply contract fee, which was an additional fee to the mark-up on the escrow securities. (Resp. Ex. 10.) The document included a "Draft of Float Contract Bid Form," which stated under "Fee" that "[a] fee equal to 4.50 basis points will be delivered to Alex Brown upon closing. This amount is in addition to the target amount shown in Exhibit B." Exhibit B detailed the "Summary of Bonds Refunded and Escrow Requirements." (Resp. Ex. 10 at PA 002018-32.)

[19] On March 15, the day before the pricing, Sciortino spoke to Quinn and stated that he wanted to come to Baltimore to observe and supervise the pricing process regarding the escrow securities and the awarding of the forward supply contract. Quinn thought it was a good idea for Sciortino to be there. (Tr. 734-35.)

[20] Typically, Meteer did not meet with the client on the day of pricing on issues concerning the escrow side of the transaction. (Tr. 481.) He did not recall ever having a senior banker request him to have a meeting to go over the escrow securities. (Tr. 481.)

[21] At the hearing, Sciortino did not recall meeting with Meteer separately, or discussing the mark-up with him. (Tr. 289, 399.) He testified that he met Meteer, spoke to him briefly, and otherwise observed Meteer going "in and out of the conference room." (Tr. 400, 405.) Sciortino did not recall receiving a two-page document on the mark-up from Meteer, nor did he believe that they discussed the mark-up. (Tr. 288-89.)

[22] Sciortino had discussed with Quinn the people who were approved to do trades with the Commonwealth and Heyison had added and subtracted people. Sciortino provided a final list to Quinn. (Tr. 394-95.)

[23] Because the Treasurer's Office is the custodian for the Commonwealth, it is standard practice to compare transaction results with analyses of hypothetical results as if the Treasurer's Office had conducted the transaction itself. Information databases can identify prices of other escrow securities purchased on the day Alex

Brown purchased the escrow securities for the Commonwealth. (Tr. 290-91.) Although not precise, an analyst can calculate a price range, a high and a low, for the escrow securities purchased that day and compare it to the action that was taken by Alex Brown. (Tr. 291.)

[24] There is no evidence to suggest that the memorandum was not facsimiled on March 15, 1994, the day before Sciortino went to Baltimore, as reflected by the facsimile date stamp. Sciortino's handwritten directions to Baltimore are on the first page of this memorandum. When presented with this evidence Sciortino stated that he only had the first sheet with him in Baltimore. (Tr. 367-68.)

[25] A finding of negligence is adequate to establish a violation of Sections 17(a)(2) and 17(a)(3) of the Securities Act. See Jay Houston Meadows, 52 S.E.C. 778, 785 & n.16 (1996), aff'd, 119 F.3d 1219 (5th Cir. 1997); see also SEC v. Steadman, 967 F.2d 636, 643 & n.5 (D.C. Cir. 1992) (citing Aaron v. SEC, 446 U.S. 680, 701-02 (1980)); Newcome v. Esrey, 862 F.2d 1099, 1102 n.7 (4th Cir. 1988).

[26] The Division contends that Quinn violated his fiduciary duty to fully disclose all material facts to the Treasurer's Office. This duty, according to the Division, arose under the financial advisor service purchase contract between Alex Brown and the Treasurer's Office. However, both Sciortino and Quinn testified that the escrow arrangement was separate from the financial advisor service purchase contract. (Tr. 369, 538-39.) This testimony is uncontradicted and I credit it to support my conclusion that the escrow agent relationship was separate and distinct from the financial advisor service purchase contract. Therefore, the agreement to apportion the escrow agent fees did not "trigger" any provision of the financial advisor service purchase contract. There is also no evidence that Alex Brown and Arthurs Lestrange did not complete all the work or not accept all the risk required of them as the Treasurer's Office's escrow agent and Governor's Office's financial advisor, respectively. Since Alex Brown was the only escrow agent, it was responsible for all the risk of the position.

[27] Sciortino's testimony is not credible with respect to several important events. First, he did not recall getting a copy of the February 18, 1994, letter from Bova to the Governor's Office; then he denied getting the March 15, 1994, facsimile until it was found in his office and he was shown his handwriting on the first page. He also denied meeting alone with Meteer on the pricing date and he tried to explain his reasons for being at Alex Brown for reasons that had nothing to do with the mark-up. These were times at which important information was brought to his attention that he denies receiving. I do not credit his testimony on these matters. In contrast, Sciortino was quick to point out to the decision-makers in the Treasurer's Office that he received information about a possible mark-up overcharge the day after the pricing date.

http://www.sec.gov/litigation/aljdec/id186rgm.htm

In the Matter of Kevin G. Quinn, Securities Act Release No. 8020, Exchange Act Release No. 44879, A.P. File No. 3-10098 (September 28, 2001) (finality order).

I.

In these proceedings ordered pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Sections 15(b)(6) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Respondent Kevin G. Quinn has submitted an Offer of Settlement ("Offer") which the Securities and Exchange Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission or in which the Commission is a party, Quinn consents to the entry of this Order and admits the jurisdiction of the Commission with respect to the matters set forth in this Order.

II.

On the basis of Quinn's Offer, **IT IS ORDERED** that the Order of the Administrative Law Judge DATED May 16, 2001 is hereby VACATED and the motions discussed in the Order are denied; and

Notice is hereby given, pursuant to Rule 360(e) of the Commission's Rules of Practice, that the initial decision of the administrative law judge[1] has become the final decision of the Commission. The order contained in the decision dismissing the proceedings against Kevin G. Quinn is hereby declared effective.

By the Commission.
Jonathan G. Katz
Secretary

Footnote

[1] Kevin G. Quinn, Initial Decision Release No. 186 (July 27, 2001).

http://www.sec.gov/litigation/admin/33-8020.htm

In the Matter of Joseph P. Galluzzi, A.P. File No. 3-10209, Initial Decision Release No. 187 (August 7, 2001) (initial decision of administrative law judge).

BACKGROUND

The Securities and Exchange Commission (Commission or SEC) instituted this proceeding on May 25, 2000, pursuant to Section 15(b)(6) of the Securities Exchange Act of 1934 (Exchange Act). The Order Instituting Proceedings (OIP) alleges that from 1985 to 1996, Joseph P. Galluzzi (Galluzzi or Respondent) was associated with Gibraltar Securities Co. (Gibraltar), a registered broker and dealer. he OIP also claims that in 1998 the United States District Court for the District of New Jersey convicted Galluzzi of twenty-six felony counts of mail fraud, wire fraud, bribery, and using facilities in interstate commerce to commit bribery. The OIP further alleges that in 1999, in a civil action brought by the Commission, the same court permanently enjoined Galluzzi from violating Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5. The OIP was issued to determine whether the allegations were true and, if so, what, if any, administrative sanctions would be in the public interest.

The criminal indictment and the civil injunctive action both arose out of Galluzzi's activities with brokers and dealers involved in underwriting municipal securities. At issue were charges that Galluzzi abused his positions as financial consultant to the Board of Chosen Freeholders of Essex County, financial consultant to Essex County, and financial consultant to the Irvington Municipal Council for his personal gain, through receipt of bribes and kickbacks, which deprived those entities of his honest services relating to several municipal bond and financing projects.

Procedural History

Galluzzi received the OIP on June 1, 2000. The parties initially attempted to reach a settlement, but those negotiations were not successful. Galluzzi advised that he intended to appear pro se.

I established a deadline of October 2, 2000, for Galluzzi to file his answer to the OIP. I then extended that deadline to October 16, 2000, at Galluzzi's request. See Orders of September 11, 2000, and September 27, 2000. When no answer was received by the extended due date, I ordered Galluzzi to show cause why he should not be held in default. See Order of October 17, 2000. On October 28, 2000, Galluzzi submitted a letter which, liberally construed, constituted both his late-filed answer to the OIP and his response to the order to show cause. I accepted the late-filed answer and declined to hold him in default. See Order of November 7, 2000.

The Division then notified Galluzzi of the size and location of its investigative files, and informed him when those files would be available for inspection and copying. See Order of November 7, 2000; Rule 230 of the Commission's Rules of Practice, 17 C.F.R. § 201.230. The Division also identified the materials it proposed to withhold on the grounds of privilege (Letter from Sheldon Mui to Galluzzi, dated November 16, 2000).

Inspection and copying was complicated by the fact that Galluzzi is incarcerated at the Federal Prison Camp in Allenwood, Pennsylvania. Accordingly, I granted Respondent extra time to complete his inspection and copying, and I monitored the progress of his efforts in three telephonic prehearing conferences. See Orders of November 17, 2000, December 18, 2000, and January 16, 2001.

By letter dated January 20, 2001, Galluzzi challenged the Division's claim of privilege as to the withheld documents. I construed Respondent's letter as a motion to compel the production of documents, and I established a schedule for the Division to file an affidavit and pleading in opposition to the motion to compel production. See Orders of January 29, 2001, and February 8, 2001. The Division's opposition to the motion to compel, dated March 23, 2001, consisted of a declaration from Sheldon Mui, the Division's counsel of record; an amended privilege log; the certification of Ralph J. Marra, Jr., an Assistant United States Attorney who was the prosecutor in Galluzzi's criminal trial; and a memorandum of law. As grounds for its opposition, the Division invoked the work product privilege, the attorney-client privilege, the deliberative process privilege, the law enforcement privilege, and Rule 230(b)(ii) of the

Commission's Rules of Practice. The Division also stated that it had reviewed the documents listed on its privilege log under the doctrine of Brady v. Maryland, 373 U.S. 83 (1963), and found no exculpatory materials.

On April 4, 2001, Respondent replied to the Division's opposition with a declaration, a memorandum of law, and a chart of rebuttal. After considering the parties' pleadings, I found the Division's invocation of privilege to be well supported.[1] With one exception, I declined to order the Division to produce the challenged documents for inspection and copying. See Order of April 11, 2001.

The Division then sought and received leave to file a motion for summary disposition (Prehearing Conference of April 17, 2001, at Tr. 36-40). See Rule 250 of the Commission's Rules of Practice, 17 C.F.R. § 201.250. The Division filed its motion for summary disposition on May 22, 2001.

I held a telephonic prehearing conference with the parties on June 1, 2001. At that conference, I reviewed the Division's motion with Respondent in an effort to determine which allegations in the OIP he contested and which allegations he did not contest. I also apprised him of the issues his opposition should address. I noted that Commission decision makers must follow Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979), aff'd on other grounds, 450 U.S. 91 (1980), when considering sanctions in the public interest, and I encouraged Galluzzi to address the Steadman factors in his opposition. I also stressed that, if Galluzzi wished an in-person oral hearing, he should so state in his opposition (Prehearing Conference of June 1, 2001, at Tr. 24-25, 32).

My Order of June 1, 2001, emphasized the same things. With respect to a hearing, that Order provided:

[I]f [Respondent] wishes an in-person oral hearing, he should so state in his opposition. He should identify when and where he prefers to hold such a hearing. He should identify the prospective witnesses he wishes to call. He should provide their names and addresses, as well as a brief summary of each witness's expected testimony.

This was consistent with earlier notice I had given Respondent about stating whether he desired a hearing and whether he intended to call witnesses (Prehearing Conference of April 17, 2001, at Tr. 39-40, 42). Respondent filed his opposition to the Division's motion for summary disposition on July 9, 2001, and the Division filed its reply on July 26, 2001. Galluzzi did not request an in-person hearing. Nor did he identify any prospective witnesses. I conclude that Galluzzi has waived his opportunity for an in-person hearing.

The Standards For
Summary Disposition

Rule 250(a) of the Commission's Rules of Practice provides that, after a respondent's answer has been filed and documents have been made available to that respondent for inspection and copying, a party may make a motion for summary disposition of any or all allegations of the OIP with respect to that respondent. The facts of the pleadings of the party against whom the motion is made shall be taken as true, except as modified by stipulations or admissions made by that party, by uncontested affidavits, or by facts officially noted pursuant to Rule 323 of the Commission's Rules of Practice, 17 C.F.R. § 201.323.

Rule 250(b) of the Commission's Rules of Practice requires the hearing officer promptly to grant or deny the motion, or to defer decision on the motion. The hearing officer may grant the motion for summary disposition if there is no genuine issue with regard to any material fact and the party making the motion is entitled to a summary disposition as a matter of law.

By analogy to Rule 56 of the Federal Rules of Civil Procedure, a factual dispute between the parties will not defeat a motion for summary disposition unless it is both genuine and material. See Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 247-48 (1986). Once the moving party has carried its burden, "its opponent must do more than simply show that there is some metaphysical doubt as to the material facts." Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 586 (1986). The opposing party must set forth specific facts showing a genuine issue for hearing and may not rest upon the mere allegations or denials of its pleadings. At the summary disposition stage, the hearing officer's function is not to weigh the evidence and determine the truth of the matter, but rather to determine whether there is a genuine issue for hearing. See Anderson, 477 U.S. at 249.

FINDINGS OF FACT AND CONCLUSIONS OF LAW

The documents attached to the Division's motion involve matters that may be officially noticed under Rule 323 of the Commission's Rules of Practice. Based on those documents, the Division has established, and Respondent has not contested, the following facts.

From June 28, 1985, through January 11, 1996, Galluzzi was associated with Gibraltar, a broker and dealer (Declaration of Sheldon Mui in Support of Motion for Summary Disposition, dated May 21, 2001 (Mui Declaration), Exhibit F (NASD Business Records)).

On January 9, 1997, a federal grand jury in the United States District Court for the District of New Jersey handed down a twenty-six count superceding indictment against Galluzzi. The indictment charged Galluzzi with fourteen counts of mail fraud in violation of 18 U.S.C. §§ 1341 and 1346; two counts of wire fraud in violation of 18 U.S.C. §§ 1343 and 1346; five counts of bribery in violation of 18 U.S.C. § 666; and five counts of using a facility in interstate commerce to commit bribery in violation of 18 U.S.C. § 1952 (Mui Declaration, Exhibit A (Superceding Indictment)).

On April 24, 1998, a jury found Galluzzi guilty on all counts of the superceding indictment (Mui Declaration, Exhibit B (Judgment of Conviction)). On September 10, 1998, Judge William H. Walls sentenced Galluzzi to ninety months imprisonment and ordered him to pay $350,000 in restitution. On May 28, 1999, the United States Court of Appeals for the Third Circuit affirmed Galluzzi's conviction and sentence (Mui Declaration, Exhibit E (unpublished Memorandum Opinion)). The United States Supreme Court denied Galluzzi's petition for a writ of certiorari. Galluzzi v. United States, 528 U.S. 1048 (1999).

On January 9, 1997, the Commission filed a civil complaint against Galluzzi in the United States District Court for the District of New Jersey. As relief, the Commission sought a permanent injunction from future violations of Section 10(b) of the Exchange Act and Rule 10b-5, as well as disgorgement of ill-gotten gains (Mui Declaration, Exhibit C (Complaint)). The Commission subsequently filed a motion for summary judgment on the basis of Galluzzi's criminal conviction. It argued that because the conduct alleged in the complaint was the basis for the criminal conviction, Galluzzi was collaterally estopped from relitigating those issues. Galluzzi filed a response to the summary judgment motion.

On September 14, 1999, Judge Walls issued an opinion granting the Commission's motion for summary judgment in the civil injunctive action (Mui Declaration, Exhibit D (Opinion)). On October 20, 1999, Judge Walls issued his final judgment (Mui Declaration, Exhibit G (Final Judgment)). The judgment permanently enjoined Galluzzi from violations of Section 10(b) of the Exchange Act and Rule 10b-5. It also ordered Galluzzi to pay disgorgement of $258,382, plus prejudgment interest.

Respondent's Opposition
To The Division's Motion

Galluzzi raises several arguments in his opposition to the Division's motion for summary disposition, but they are insufficient to establish that there are contested genuine and material issues of fact or law.

First, Galluzzi contends that the United States Attorney denied him due process in the criminal case by refusing to provide him with all of the materials that the Commission had gathered during its investigation and turned over to the prosecution. Galluzzi presented a similar claim before the Third Circuit on the direct appeal of his criminal conviction. That court found no merit to the argument (Mui Declaration, Exhibit E (Memorandum Opinion at 9-10)). Moreover, the Commission does not permit criminal convictions to be collaterally attacked in its administrative proceedings. See Ira William Scott, 53 S.E.C. 862, 866 (1998); William F. Lincoln, 53 S.E.C. 452, 455-56 (1998). Galluzzi also relies on United States v. LaSalle Nat'l Bank, 437 U.S. 298 (1978), a case arising under the Internal Revenue Code, for the proposition that an administrative agency cannot use its civil investigative powers to investigate criminal conduct. However, LaSalle is not applicable to the Commission's investigations under SEC v. Dresser Indus., Inc., 628 F.2d 1368, 1376-80 (D.C. Cir. 1980) (en banc).

Galluzzi next contends that the criminal case and the civil injunctive case lacked an "identity of issues." He observes that the criminal conviction involved mail fraud, wire fraud, and bribery, but not any securities law violations. In the civil injunctive action, the Commission claimed that, because the same conduct alleged in the injunctive complaint formed the basis for the criminal charges of which Galluzzi had already been convicted, Galluzzi should be collaterally estopped from relitigating those issues. Judge Walls accepted that argument and granted summary judgment to the Commission (Mui Declaration, Exhibit D (Opinion at 4-7)). Galluzzi elected not to appeal the district court's determination. He nonetheless argues in this administrative proceeding that the district court was wrong.

After Judge Walls issued his opinion in the civil injunctive proceeding, decisions by two courts of appeal have addressed the Commission's ability to invoke the doctrine of offensive collateral estoppel when a civil injunctive action follows a criminal conviction. See SEC v. Monarch Funding Corp., 192 F.3d 295 (2d Cir. 1999) (rejecting the Commission's argument that the same acts by which an individual obstructed justice established the elements of securities fraud in a subsequent civil injunctive case); SEC v. Zandford, 238 F.3d 559 (4th Cir. 2001) (reversing a district court decision which held that a criminal conviction for wire fraud established all facts necessary to satisfy the elements of the Commission's securities fraud claim), petition for cert. filed, (U.S. July 25, 2001) (No. 01-147). If Galluzzi believes that Monarch Funding and/or Zandford afford him a fresh basis for reopening the civil injunctive action, he must present such arguments to the appropriate tribunal. He cannot challenge the outcome of the civil injunctive case in this administrative forum. See Martin R. Kaiden, 70 SEC Docket 439, 453 & n.39 (July 20, 1999); cf. Elliott v. SEC, 36 F.3d 86, 87 (11th Cir. 1994); Blinder, Robinson & Co. v. SEC, 837 F.2d 1099, 1108 (D.C. Cir. 1988).

Galluzzi also asserts that the Commission "took great liberties" with the facts when presenting its memorandum in support of summary judgment to the district court in the civil injunctive action. This proceeding is not the appropriate place to challenge the propriety of the injunctive action. Cf. Charles Phillip Elliott, 50 S.E.C. 1273, 1276-77 (1992), aff'd, 36 F.3d 86 (11th Cir. 1994).

Finally, Galluzzi contends that, without the civil injunctive action, no sanction would be possible in this administrative proceeding. This claim is unfounded. Galluzzi has been convicted, within ten years of the commencement of this proceeding, of felonies that involve violations of 18 U.S.C. §§ 1341 and 1343. Such offenses are specifically identified in Section 15(b)(4)(B) of the Exchange Act as a basis for action under Section 15(b)(6)(A)(ii) of the Exchange Act. If the civil injunctive action had never been brought, the criminal conviction alone would still offer sufficient grounds for instituting this administrative proceeding.

The Public Interest

Early in this proceeding, the Division expressed the view that the sanction it sought, an order barring Galluzzi from associating with a broker or dealer, would also encompass a bar on association with a municipal securities dealer (Prehearing Conference of November 17, 2000, at Tr. 3). See Sections 3(a)(18) and 3(a)(32) of the Exchange Act (definition of terms). Some months later, the Division stated that it was not seeking a collateral bar, but only a bar from association with a broker or dealer (Prehearing Conference of April 17, 2001, at Tr. 36).

No bar on association with a municipal securities dealer is possible in this proceeding. In Dan King Brainard, 47 S.E.C. 991, 1001 n.31 (1983), the Commission held there was no basis to bar a respondent from association with a municipal securities dealer because the proceeding was not instituted pursuant to Section 15B(c)(4) of the Exchange Act, which authorizes the Commission to sanction persons associated with a municipal securities dealer. After Brainard, the Commission interpreted Section 15(b)(6) of the Exchange Act as permitting a wide range of collateral bars. See Meyer Blinder, 53 S.E.C. 250, 254 n.12 (1997). However, such collateral bars are now foreclosed by Teicher v. SEC, 177 F.3d 1016 (D.C. Cir. 1999), cert. denied, 529 U.S. 1003 (2000). In any event, the Division has never shown that Galluzzi was associated with a municipal securities dealer. The most severe sanction possible in this case is a bar on association with a broker or dealer, and the only issue remaining for decision is whether that sanction is warranted in the public interest.

Under Steadman, 603 F.2d at 1140, there are six factors to consider: (1) the egregiousness of the respondent's actions; (2) the isolated or recurrent nature of his infractions; (3) the degree of scienter involved; (4) the sincerity of the respondent's assurances against future violations; (5) the respondent's recognition of the wrongful nature of his conduct; and (6) the likelihood that the respondent's occupation will present opportunities for future violations.

Galluzzi's conviction of twenty-six felonies was egregious. Those felonies involved deliberate, knowing violations of the law and they required premeditation and planning. In the criminal case, Judge Walls found that Galluzzi compounded his underlying misconduct by obstructing justice through perjurious statements. He therefore imposed an upward adjustment of Galluzzi's sentence. The United States Court of Appeals for the Third Circuit affirmed this adjustment (Mui Declaration, Exhibit E (Opinion at 10-15)).

Galluzzi's criminal violations were not isolated; rather, they occurred over a lengthy period. Although Galluzzi's conviction was affirmed on appeal, he has refused to recognize the wrongful nature of his conduct and continues to insist that he was wronged. He has not expressed any remorse for his criminal violations.

Galluzzi has stated that he has no intention of associating with a broker or dealer in the future, and no concern about being barred from any business that requires a Commission license (Prehearing Conference of November 17, 2000, at Tr. 4, 19; Prehearing Conference of April 17, 2001, at Tr. 46). While he has pledged not to violate the securities laws in the future, the absence of a bar would enable him to do so.

I am aware of no mitigating evidence and no rehabilitation evidence in this case. Considering the Steadman factors in their entirety, the public interest plainly warrants the relief sought by the Division.

ORDER

It is ordered that:

1. The Division of Enforcement's motion for summary disposition is granted.

2. The prehearing conference scheduled for September 5, 2001, is cancelled.

3. Joseph P. Galluzzi is barred from association with any broker or dealer.

This order shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that Rule, a petition for review of this initial decision may be filed within twenty-one days after service of the decision. It shall become the final decision of the Commission as to each party who has not filed a petition for review pursuant to Rule

360(d)(1) within twenty-one days after service of the initial decision upon him, unless the Commission, pursuant to Rule 360(b)(1), determines on its own initiative to review this initial decision as to any party. If a party timely files a petition for review, or the Commission acts to review as to a party, the initial decision shall not become final as to that party.

James T. Kelly
Administrative Law Judge

Footnote

[1] The process of requiring the Division to justify its invocation of privilege resulted in the release to Galluzzi of several additional documents. See Order of April 11, 2001, at nn.1-2.

http://www.sec.gov/litigation/aljdec/id187jtk.htm

In the Matter of Joseph P. Galluzzi, Exchange Act Release No. 46405, A.P. File No. 3-10209 (August 23, 2002).

APPEARANCES:	Joseph P. Galluzzi, pro se.
	Wayne M. Carlin, Mark Schonfeld, Kay Lackey, Peter Pizzani, and Sheldon Mui, for the Division of Enforcement.
Appeal filed:	September 12, 2001
Last brief received:	March 15, 2002

I.

Joseph P. Galluzzi, formerly associated with Gibraltar Securities Co., a registered broker-dealer, appeals from the decision of an administrative law judge. The law judge found that Galluzzi had been convicted of mail fraud and bribery, among other offenses, and enjoined from future violations of Section 10(b) of the Securities Exchange Act of 1934 [1] and Rule 10b-5 thereunder.[2] The law judge barred Galluzzi from association with a broker or dealer. We base our findings on an independent review of the record, except with respect to those findings not challenged on appeal.

II.

On January 9, 1997, a grand jury handed down a 26-count Superseding Indictment against Galluzzi. The indictment charged Galluzzi with fourteen counts of mail fraud;[3] two counts of wire fraud;[4] five counts of bribery;[5] and five counts of using a facility in interstate commerce to commit bribery.[6] On April 24, 1998, Galluzzi was found guilty by a jury on all counts.[7] Sentencing hearings were held on September 9 and 10, 1998, and an order of Judgement and Conviction was entered on September 18, 1998. The court sentenced Galluzzi to 90 months of incarceration on ten of the mail fraud counts, one of the wire fraud counts, and the bribery counts. The sentence was to be served concurrently with a sentence of 60 months of incarceration imposed for the remaining wire fraud count and the counts for use of a facility in interstate commerce to commit bribery, and concurrently with an 80 month sentence on the remaining four mail fraud counts.[8] Galluzzi also was ordered to pay restitution of $350,000 and a special assessment of $1,300. In setting Galluzzi's sentence, the District Court made an upward adjustment pursuant to applicable federal sentencing guidelines based on its finding that Galluzzi had obstructed justice by providing false testimony to Commission staff.

On January 9 1997, the Commission filed a complaint against Galluzzi alleging violations of Exchange Act Section 10(b) and Rule 10b-5 thereunder and seeking an injunction against future violations of those provisions. On October 21, 1999, Galluzzi was enjoined based on the Commission's motion for summary judgement and ordered to pay $258,382 in disgorgement plus prejudgement interest.[9]

The District Court found that, during the 1980s and 1990s, Galluzzi was a consultant to various municipal and county governments in the State of New Jersey. The court further found that Galluzzi received several hundred thousand dollars in undisclosed bribes and "kickbacks" from firms seeking to underwrite municipal securities offerings by these governments. Galluzzi did not appeal from the injunctive action.

On May 28, 1999, the United States Court of Appeals for the Third Circuit affirmed Galluzzi's criminal conviction.[10] The Third Circuit stated that "Galluzzi used his professional position to defraud Irvington and Essex County of his services as an unbiased and impartial advisor." The Third Circuit also expressly affirmed the District Court's finding that Galluzzi had given false testimony.

On May 25, 2000, the Commission instituted this proceeding against Galluzzi seeking a bar based on both the criminal conviction and the injunction. By order dated November 7, 2000, the law judge directed the Division to provide Galluzzi access to the Division's investigative files, pursuant to Commission Rule of Practice 230.[11] In addition, the Division was directed to provide a list of any materials it intended to withhold from Galluzzi pursuant to Rules of Practice 230(b) and (c).[12] The law judge subsequently found that the Division properly claimed privilege for all but one of the 132 documents for which the Division asserted privilege.

On May 22, 2001, the Division, with leave of the law judge, filed a motion for summary disposition pursuant to Rule of Practice 250.[13] On June 1, 2001, the law judge issued an order setting a date by which Galluzzi was to file his opposition to the Division's motion. In that order, the law judge stated that, if Galluzzi, who was pro se, wanted an "in-person hearing, he should so state in his opposition," and identify prospective witnesses to be called. The law judge also discussed with

Galluzzi, during prehearing conferences in April and June 2001, the implications of the Division's motion and, among other things, directed Galluzzi to address what sanction, if any, was in the public interest. Although Galluzzi filed a response to the Division's motion for summary disposition, he neither requested a hearing nor identified prospective witnesses.

On August 7, 2001, the law judge granted the motion for summary disposition, finding that there were no "contested genuine and material issues of fact or law."[14] The law judge also held that Galluzzi waived his opportunity for an in-person hearing.[15] The law judge further held that there was "no mitigating evidence and no rehabilitative evidence in this case."[16] The law judge concluded that "the public interest plainly warrants the relief sought by the Division," i.e., a bar from the industry.

III.

A. Galluzzi has not challenged the law judge's holding regarding waiver of the hearing. We find that the law judge properly granted summary disposition. Sections 15(b)(6)(A)(ii) and (iii) of the Exchange Act[17] authorize the Commission to impose sanctions in the public interest against any person associated with a broker-dealer who, among other things, was (a) convicted within 10 years of certain enumerated crimes including securities fraud, mail fraud, and wire fraud, or (b) enjoined from any conduct in connection with the purchase or sale of a security. Galluzzi does not dispute that he was convicted of mail fraud and wire fraud or that he was enjoined from conduct in connection with the purchase or sale of a security.[18]

Galluzzi, rather, asserts that there were errors in the District Court's decision in the injunctive proceeding.[19] Galluzzi claims that the District Court misapplied the doctrine of collateral estoppel in granting the Commission staff's motion for summary judgement based on Galluzzi's criminal conviction because securities fraud, the basis of the injunctive action, was not charged in the criminal proceeding.

As an initial matter, the District Court's opinion in the injunctive action stated that "Galluzzi does not dispute that the SEC is entitled to summary judgement on its § 10(b) claim." In any event, a party cannot challenge his injunction or criminal conviction in a subsequent administrative proceeding.[20] Galluzzi had the opportunity to challenge the District Court's decisions by appealing to the appropriate United States Court of Appeals. He appealed his conviction, but the Court of Appeals ruled against him. Galluzzi did not appeal the injunctive action.[21] He cannot re-litigate the issues adjudicated by the District Court here.[22]

B. Galluzzi contends that he was denied due process because the Commission's staff denied him access to documents in its files that were shared with the United States Attorney's office that prosecuted the criminal case against him. According to Galluzzi, "[t]he blatant, coordinated unprotected providing of documents by the S.E.C. to the U.S. Attorney [which was] compounded by denying the defendant discovery of this same material, [constitutes] AGENCY BAD FAITH" (emphasis in original).[23] For example, Galluzzi argues that his Fifth Amendment right against self-incrimination was violated because the Division forwarded "privileged" depositions taken by the Division in June and July 1995 to the Office of the U.S. Attorney which were used against Galluzzi in the criminal proceeding.[24]

Galluzzi raised similar claims of government bad faith before the Third Circuit in connection with the appeal of his criminal conviction. The Third Circuit found no merit in his claim that the cooperation between the Division's staff and the U.S. Attorney's office was improper, noting among other things that "Galluzzi does not specify how he was prejudiced by the government's conduct [nor] identify . . . specific conduct by the government that took advantage of the parallel proceeding . . . ."[25] Galluzzi has similarly failed to specify before us how he was prejudiced by the staff's actions.

Galluzzi argues that the Commission should reverse the law judge's decision regarding access to the Division's files and grant him access without restriction. We find no support for Galluzzi's claim that he was improperly denied discovery of Division files. Following the institution of administrative proceedings,[26] the Division provided Galluzzi's representative[27] access to its investigative files, except for 132 documents the Division claimed were protected from disclosure by privilege. Each of the purportedly privileged documents was identified, along with the applicable claimed privilege, in a written "privilege log" that the Division provided to Galluzzi. Galluzzi subsequently sought disclosure of all of the 132 documents. In response, the law judge directed the Division to file an affidavit and a pleading in support of the claimed privileges.

The Division opposed Galluzzi's document request based on Galluzzi's failure to establish that the documents had any relevance to the issues in the case or that the production of the documents was likely to lead to the production of evidence that would be relevant.[28] The Division further contended that the documents were protected from disclosure by one or more privileges, including the work product doctrine[29] and the attorney-client privilege.[30] A Division staff member also executed a declaration, under penalty of perjury, detailing the nature of the documents, and the circumstances under which they were created and maintained, to support the Division's claims of privilege. The law judge denied Galluzzi's discovery request except as to one document, which the Division subsequently provided to Galluzzi.[31]

Although Galluzzi characterizes the Division's claims of privilege as the "ultimate fiction," he fails to establish a basis for rejecting them as to any document. Nor does he suggest how the undisclosed documents are relevant to the matters at issue in this proceeding, i.e., the fact of his conviction and injunction and the public interest in excluding him from the securities industry. Under the circumstances, there is no basis for disturbing the law judge's determination.

IV.

In determining the need to impose sanctions, we are guided by the following factors:

[T]he egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations.[32]

Galluzzi's misconduct was extensive and evidenced a high degree of scienter. Over several years, he abused his position of public trust as a financial adviser to various local governments by accepting hundreds of thousands of dollars in bribes and kickbacks in return for help in steering official public business to certain securities firms. Galluzzi also was found to have obstructed the staff's investigation by giving false testimony. The District Court expressly found, in granting the injunction, that the Commission "allege[d], and defendant [did] not deny, that Galluzzi made material misstatements and omissions with scienter in connection with the purchase or sale of securities."[33] As a result of his actions, Galluzzi was sentenced to several years in prison, ordered to pay over one half million dollars in disgorgement and restitution, and enjoined from future violations of antifraud provisions of the securities laws.

Galluzzi continues to insist that he is a victim of government misconduct. Galluzzi's failure to acknowledge guilt or show remorse indicates to us that we cannot expect rehabilitation in the near future. Although Galluzzi is not currently licensed,[34] there is no assurance that he will not try to reenter the securities business.[35] Under the circumstances, we believe that it is appropriate in the public interest that he be barred.

An appropriate order will issue.[36]

By the Commission (Chairman PITT and Commissioners GLASSMAN, GOLDSCHMID, and CAMPOS); Commissioner ATKINS not participating.

Jonathan G. Katz
Secretary

In the Matter of Joseph P. Galluzzi, Exchange Act Release No. 46405, A.P. File No. 3-10209 (August 23, 2002).

ORDER IMPOSING REMEDIAL SANCTION

On the basis of the Commission's opinion issued this day, it is ORDERED that Joseph P. Galluzzi be, and he hereby is, barred from association with any broker or dealer.

By the Commission.
Jonathan G. Katz
Secretary

Footnotes

[1] 15 U.S.C. § 78j(b).

[2] 17 C.F.R. § 240.10b-5.

[3] 18 U.S.C. §§ 1341 and 1346.

[4] 18 U.S.C. §§ 1343 and 1346.

[5] 18 U.S.C. § 666.

[6] 18 U.S.C. § 1952.

[7] U.S. v. Galluzzi, Case Number 96-640 (D.N.J. April 24, 1998).

[8] Galluzzi is currently serving his sentence at the Federal Prison Camp in Allenwood, Pennsylvania.

[9] SEC v. Galluzzi, Civ. No. 97-76 (D.N.J. Oct. 21, 1999). In granting the injunction, the District Court, which had also presided over Galluzzi's criminal trial, stated that "[t]he underlying factual allegations of the SEC's complaint are the same as those of the indictment."

[10] U.S. v. Galluzzi, Case No. 98-6351 (3d Cir. May 28, 1999), cert. denied, 528 U.S. 1048 (1999).

[11] 17 C.F.R. § 201.230(a). Rule 230(a) requires the Division to make its investigative files available to opposing parties. The Division represented that they made approximately 97 boxes of materials available to Galluzzi's representative.

[12] 17 C.F.R. §§ 201.230(b) and (c). Rule 230(b) authorizes the Division to withhold documents from its investigative files that are "privileged" or that constitute "attorney work product" and will not be offered in evidence. See nn. 28, 29, infra. Rule 230(c) authorizes the law judge to order the Division to provide opposing parties with a list of documents that have been withheld.

[13] 17 C.F.R. § 201.250. Under Rule of Practice 250, a motion for summary disposition may be granted "if there is no genuine issue with regard to any material fact and the party making the motion is entitled to a summary disposition as a matter of law." 17 C.F.R. § 201.250(b).

[14] Joseph P. Galluzzi, Initial Dec. Rel. No. 187 (Aug. 7, 2001), 75 SEC Docket 1729, 1733.

[15] We recently upheld a bar, which had been imposed on a respondent who had been convicted of securities fraud, based on a motion for summary disposition, finding that "[a]bsent extraordinary mitigating circumstances, such an individual cannot be permitted to remain in the securities industry." John S. Brownson, Exchange Act Rel. No. 46161 (July 3, 2002), __SEC Docket ____. Summary disposition is equally appropriate under the circumstances of this case, even if Galluzzi had not waived a hearing before the law judge.

[16] Id. at 1735.

[17] 15 U.S.C. §§ 78o(b)(6)(A)(ii) and (iii).

[18] See Charles Phillip Elliott, 50 S.E.C. 1273, 1274 (1992)(conviction and injunction "each serves as an independent basis, if the public interest warrants, to bar [respondent] from association with any broker or dealer"), aff'd, 36 F.3d 86 (11th Cir. 1994)(per curiam).

[19] Galluzzi also asks that the Commission "initiate" action to terminate the injunction. We decline to do so.

[20] See, e.g., Demitrios Julius Shiva, 52 S.E.C. 1247, 1249 (1997) (rejecting attempts to challenge basis for injunction and noting that "we have long refused to permit a respondent to re-litigate issues that were addressed in a previous civil

proceeding against the respondent"). See also Blinder, Robinson & Co. v. SEC, 837 F.2d 1099, 1108 (D.C. Cir. 1988) (holding that issues that could have been adjudicated in prior injunctive proceeding could not be relitigated in appeal of subsequent administrative proceeding), cert. denied, 488 U.S. 869 (1989).

As discussed further below, Galluzzi also challenges the validity of certain allegations made in the criminal indictment and the validity of his criminal conviction because of what he claims was improper cooperation between the Division's staff and the U.S. Attorney. Galluzzi's conviction is equally immune to attack in this proceeding. See, e.g., Ira W. Scott, 53 S.E.C. 862, 866 (1998) (rejecting respondent's claim that he had been "'wrongfully convicted'" and holding that "'[a] criminal conviction cannot be collaterally attacked in an administrative proceeding.'") (quoting William F. Lincoln, 53 S.E.C. 452, 455 (1998)); Alexander V. Stein, 52 S.E.C. 296, 301 (1995) (respondent in administrative proceeding could not challenge validity of underlying conviction).

[21] Galluzzi asserts in his brief that "Petitioner's avenues of appeal are still open and actively being pursued." Although Galluzzi concedes that the "direct appeal" of his conviction was denied, he claims vaguely that he is still appealing "the sentencing." The Division represented in its brief that the Division was "unaware of any pending appeals," and Galluzzi does not substantiate his claim of pending appeals. In any event, the pendency of an appeal does not preclude us from acting to protect the public interest. See Charles Phillip Elliott, 50 S.E.C. at 1276 (declining to delay derivative administrative proceeding pending appeal of underlying conviction).

[22] See Shiva, 52 S.E.C. at 1249 ("The doctrine of collateral estoppel precludes this Commission from reconsidering . . . factual issues that were actually litigated and necessary to the Court's decision to issue the injunction.").

[23] Galluzzi states that he is not seeking "to re-litigate his criminal conviction, but to unveil to the Commission the unethical action, by the Division, which [is] totally against the public interest." As discussed, Galluzzi is barred from challenging his criminal conviction here.

[24] Galluzzi also complains that, during settlement negotiations in the injunctive proceeding, Division staff members "threatened" him by stating that, if Galluzzi did not agree to the Division's proposed settlement, the Division would move for summary judgement. When Galluzzi refused, the Division, in Galluzzi's words, "followed through with [its] threat, filed a Motion for Summary Judgement, and was successful." Such action, according to Galluzzi, caused him "irreparable harm" because it resulted in denying him access to Commission files. We see nothing improper in the Division's actions. Moreover, here, as noted above, Galluzzi was given access to boxes of materials. See n.11, supra.

[25] It has been held that "[e]ffective enforcement of the securities laws requires that the SEC and Justice be able to investigate possible violations simultaneously." SEC v. Dresser Industries, Inc., 628 F.2d 1368, 1377 (D.C. Cir. 1980), cert. denied, 449 U.S. 993. Moreover, the securities laws "explicitly empower the SEC to investigate possible infractions of the securities laws with a view to both civil and criminal enforcement, and to transmit the fruits of its investigations to Justice in the event of potential criminal proceedings." Id. at 1376.

[26] Galluzzi also argues that the Division improperly denied him access to its investigative files, pursuant to Commission Rule of Practice 230, prior to the institution of proceedings when it provided him with a draft "order instituting proceedings" in connection with settlement negotiations. However, the Rules of Practice are applicable only after the institution of proceedings.

[27] Galluzzi, by that time, was incarcerated and unable to review the documents himself.

[28] See 17 C.F.R. § 201.230(b)(iv) (hearing officer may grant leave to withhold documents "as not relevant to the subject matter of the proceeding").

[29] The work product doctrine "protects trial preparation materials from discovery." Jeff Anderson, The Work Product Doctrine, 68 Cornel L. Rev. 760, 762 (1983). See also Hickman v. Taylor, 329 U.S. 495, 512 (1947) ("the general policy against invading the privacy of an attorney's course of preparation is so well recognized and so essential to an orderly working of our system of legal procedure that a burden rests on the one who would invade that privacy to establish adequate reasons to justify production").

[30] See, e.g., Fisher v. U.S., 425 U.S. 391, 403 (1976)("Confidential disclosures by a client to an attorney made in order to obtain legal assistance are privileged.").

[31] The law judge found the Division's "invocation of privilege to be well supported." The law judge therefore found it unnecessary to consider the Division's alternative ground that the documents were not relevant.

[32] Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979), aff'd on other grounds, 450 U.S. 91 (1981).

[33] Galluzzi specifically challenged this finding by the District Court before the law judge. As is discussed, he is collaterally estopped from doing so.

[34] Galluzzi states that he "surrendered" his NASD Series 7 and Series 63 licenses in 1996.

[35] Although Galluzzi objects to a bar on appeal, at some points before the law judge Galluzzi appeared to accept the propriety of a bar. For example, during one of the pre-hearing conferences, after the Division had raised the possibility of moving for summary disposition, Galluzzi stated that he "had no concern about being barred from" any business activity that "requires an SEC license."

[36] We have considered all of the arguments advanced by the parties. We reject or sustain them to the extent that they are inconsistent or in accord with the views expressed herein.

http://www.sec.gov/litigation/opinions/34-46405.htm

<u>In the Matter of RBC Dain Rauscher Incorporated, as successor to Rauscher Pierce Refsnes, Inc.</u>, Securities Act Release No. 8121, Exchange Act Release No. 46346, A.P. File No. 3-10863 (August 13, 2002).

See "UNDERWRITERS" section.

<u>In the Matter of Wheat, First Securities, Inc. f/k/a First Union Capital Markets Corp. and Teressa L. Cawley</u>, Exchange Act Release No. 48378, A.P. File Nos. 3-9688 and 3-9794 (August 20, 2003).

APPEARANCES: Michael K. Wolensky and Steven H. Lang, of Kutak Rock, for Wheat, First Securities f/k/a First Union Capital Markets Corp.

Thomas Tew and Daniel S. Newman, of Tew Cardenas Rebak Kellogg Lehman DeMaria & Tague, LLP, for Teressa L. Cawley.

Christian R. Bartholomew, John C. Mattimore, and Kerry A. Zinn, for the Division of Enforcement.

Appeal filed: January 21, 2000

Briefing completed: May 9, 2000

Oral argument: April 23, 2003

I.

Wheat, First Securities, Inc., formerly known as First Union Capital Markets Corporation ("First Union"), [1] a registered broker-dealer that conducted a municipal securities business, [2] and Teressa Cawley, a registered municipal securities principal and former First Union assistant vice-president and manager of First Union's public finance operations in Miami, Florida, appeal from anadministrative law judge's decision. [3] The Division of Enforcement appeals, seeking modification of the sanctions imposed against First Union and Cawley.

The law judge determined that First Union and Cawley engaged in unfair, dishonest, and deceptive practices while First Union served as a financial advisor to Broward County, Florida, with respect to three advance bond refundings. The law judge found, as relevant here, that First Union and Cawley deceived the County when they failed to disclose to County representatives at the closing of the first refunding, and First Union failed to disclose at the closing of the third refunding, fees paid to a consultant. The law judge found that this conduct violated Municipal Securities Rulemaking Board ("MSRB") Rule G-17 [4] and Section 15B(c)(1) of the Securities Exchange Act of 1934. [5]

The law judge suspended Cawley for three months from association with any broker, dealer, or municipal securities dealer. The law judge ordered Cawley and First Union to cease and desist for three years from violating the provisions that they were found to have violated. The law judge imposed civil penalties of $15,000 on Cawley and $20,000 on First Union. The law judge required First Union to disgorge its revenues on the first and third transactions, which amounted to $92,740.31 and $21,753, respectively, plus prejudgment interest. We base our findings on an independent review of the record, except with respect to those findings not challenged on appeal.

II.

A. Cawley Opens Miami Office for First Union

In February 1992, First Union had a public finance operation in North Carolina and Georgia, but had no presence in South Florida. In an effort to enter the Florida market, First Union hired Cawley to build a public finance business in Miami. She became the registered municipal securities principal for First Union's Miami office. [6] The office consisted of Cawley; her secretary and administrative assistant, Ann-Jeannette Jean-Baptiste; a municipal analyst, Orlando R. Cruz, Jr.; and two other employees. Cawley managed the Miami office from March 1992 until her resignation in April 1994.

B. First Union Hires Consultants

In April 1993, with the approval of senior management, Cawley sought to retain outside consultants to help First Union develop a public finance business. [7] Cawley had learned, as part of her investigation of the South Florida political scene, that the use of consultants was "fairly commonplace." Cawley also had learned that without the assistance of consultants it would take First Union substantially longer to make inroads in the market. As a result, Cawley sought to retain people who would "assist First Union in getting its name out in the business, . . . in meeting people, [and in] being introduced to the right decision makers."

That same month, Cawley contacted and retained Ronald L. Book. Cawley knew that Book was a preeminent South Florida lawyer and lobbyist, and that he had access to the Broward County commissioners and other public officials.

Cawley testified at the hearing that she met with Book in April 1993 and discussed the terms of his employment with First Union, including compensation. According to Cawley, Book told her that he received fees of $25,000 for similar work. Cawley informed Book that First Union could pay him only $2,000 per month, but she hoped to raise his compensation as soon as it became feasible.

In his investigative testimony, Book said that he did not recall discussing any dollar amount with Cawley. [8] A June 22, 1994, memorandum, [9] written by municipal analyst Cruz, stated that the parties informally had agreed that Book would receive a 20% contingency fee based on the business he secured for First Union, in addition to a $2,000 monthly retainer. [10]

The law judge found that Cawley's testimony both with respect to Book's compensation and in general lacked credibility. The law judge stated that "[Cawley] contradicted herself and was contradicted by unimpeachable documentary and testimonial evidence on numerous occasions and, on a number of matters on which she testified, she could not supply any expected details that would substantiate her testimony." The law judge noted that, when confronted with her contradictory investigative testimony, Cawley repeatedly insisted that her memory had improved over time, and that she now remembered "exactly the sequence of events." We see no basis to disagree with the law judge's credibility findings. [11]

C. Broward County Selects First Union as Financial Advisor

In the midst of Cawley's efforts to hire consultants, Broward County issued a "Request for Letters of Interest" ("RLI"), dated April 5, 1993, seeking proposals from firms interested in serving as its financial advisor for the issuance of refunding bonds. [12] Broward County sought a financing team to review its outstanding bond issues to determine potential refunding candidates. It proposed to refund those bonds that resulted in a net present value savings of three percent of the refunded principal. The RLI requested that all proposals include the particular firm's recommended approach for the refundings. The RLI identified fourteen outstanding bond issues that the County was considering refunding.

Cawley knew that the position of a financial advisor was not as lucrative as that of the senior managing underwriter on the refundings. However, Cawley understood that, in Broward County,First Union had to become a financial advisor before the County would consider First Union for the underwriter position.

The Broward County Commission Selection/Negotiation Committee for the financial advisor position consisted of five officials, all of whom had a political connection to Book. Book admitted at the hearing that he had a "long-time friendship" with Commissioner Scott Cowan, who was Chairman of the Committee, [13] and that he had relationships with the other Committee members.

On May 6, 1993, First Union submitted its proposal, signed by Cawley, recommending for refunding several of the specified bond issues. The proposal discussed each of the recommended issues in detail and the savings to be achieved by the County in refunding the bonds. On May 12, 1993, the Committee members reviewed all proposals and identified their top five choices, which included First Union. On May 21, 1993, the Committee notified First Union that it ranked first among the presenters.

D. The Financial Advisory Agreement

On June 3, 1993, Cawley executed a Financial Advisory Agreement (the "Agreement") on First Union's behalf. The Broward County Commission approved and executed the Agreement on June 8, 1993. As part of the Agreement, First Union warranted that it had "not employed or retained any company or person, other than a bona fide employee working solely for [First Union], to solicit or secure this Agreement, and that [it had] not paid or agreed to pay any person, company, corporation, individual, or firm, other than a bona fide employee working solely for [First Union], any fee, commission, percentage, gift, or other consideration contingent upon or resulting from the award or making of this Agreement." For breach or violation of this warranty, the County had "the right to terminate the Agreement without liability at its discretion, to deduct from the contract price, or otherwise recover, the full amount of such fee, commission, percentage, gift, or consideration."

Cawley understood that this provision required First Union to disclose to the County the identity of any person who assisted First Union in securing the Agreement so that the County could disclosethis fact to the State of Florida. Cawley believed that the provision applied to a disclosure concerning a "finder" or intermediary under Florida law. [14] Cawley testified that she believed the warranty did not apply to First Union because Book was not a finder and had not assisted First Union in securing the Agreement. Cawley testified further that her belief was based, in part, on a May 1, 1993, opinion letter from outside counsel. [15]

Book contradicted Cawley's assertions that he did not assist First Union in obtaining the Agreement. Book testified that he gave First Union and Cawley "very good direction at how to respond to the RLI." Book further testified that "[he] guided [First Union] in how to respond in pursuit of that business," and that this was "what [he] did to help First Union get the business." Cawley's supervisor testified, consistently with Book, that he understood from Cawley that Book assisted First Union in its efforts to obtain the Agreement with Broward County.

E. The Bond Refundings

First Union acted as a financial advisor to the County on three bond refunding transactions:

$134,895,000 Water and Sewer Utility Revenue Refunding Bonds, Series 1993, which closed on September 2, 1993;

$92,440,000 General Obligation Refunding Bonds, Series 1993, which closed on October 5, 1993; and

$36,255,000 Tourist Development Tax Special Revenue.

Refunding Bonds, Series 1994, which closed on June 30, 1994.

First Union had recommended in its proposal the refunding of each of these bond issues. First Union received a total of $175,654 in fees for its services.

F. Book Registers to Lobby for First Union in Broward County

On June 3, 1993, the same day that Cawley, acting on behalf of First Union, executed the Agreement, Book filed with the County a Lobbyist Registration Statement. The Statement indicated that Book was registering to lobby on "general matters[,] including municipal bond finance." Although he did not disclose his employer's name, as requested in the Statement, Book admitted at the hearing that he had registered to lobby for First Union in Broward County.

G. Book Executes Consulting Agreement with First Union

First Union sent the consulting agreement to Book under cover letter dated June 22, 1993. Book admitted that he received it on or about that date, and then executed and returned the agreement to First Union. The agreement was dated May 1, 1993, the purported starting date of his employment. Book agreed to provide, among other things, "advice and counsel on matters relating to various municipal bond offerings." At the hearing, however, Book was unable to recall specific matters that he had performed for First Union. First Union agreed to pay Book $1,000 for May 1993 and

$2,000 for each month thereafter, [16] although it could increase his compensation if he spent more time on First Union matters. The agreement provided for a six-month term, unless renewed by the parties, and in fact lasted about one year.

Cawley testified that she first discussed hiring Book with her superiors in a conference call in late April 1993. Cawley admitted at the hearing, however, that her 1993 calendar did not contain any notation about the April conference call. None of her superiors could recall a conference call having taken place.

Cawley also obtained from outside counsel an opinion letter, dated May 1, 1993, on the legality of underwriters hiring consultants, and a form agreement to execute with proposedconsultants. [17] Cawley testified that she modified the form contract, executed the contract as modified, and forwarded the contract to her supervisor, who approved it on or about May 1, 1993. Cawley claimed that Book executed the contract during the second or third week of May 1993, before he began performing services for First Union.

Cawley's testimony, however, is controverted by evidence demonstrating that the opinion letter and Book's formal consulting agreement were drafted and executed in June 1993, after First Union had obtained the financial advisor position with Broward County. The date of the opinion letter, May 1, 1993, fell on a Saturday. Outside counsel testified that he ordinarily did not work on Saturdays and did not recall writing the opinion letter on a Saturday. Moreover, outside counsel's time sheets reflect that he billed two hours to First Union on June 7, 1993, for researching and evaluating "finders issues," and another hour on June 14, 1993, for preparing the written opinion letter and standard agreement. [18] Cawley's 1993 calendar confirms that she placed a call to outside counsel on June 7, 1993, the date of the first billing entry, and another on June 15, 1993, the day after the second billing entry.

H. First Union's Payments to Book

For May through September 1993, First Union paid Book $9,050. On October 15, 1993, Cawley amended the Book agreement and increased Book's compensation to $7,700 per month for October through December 1993. On October 18, 1993, the County paid First Union $92,740.31 relating to the first refunding. In December 1993, First Union paid Book $23,150 for the period October through December 1993.

On November 9, 1993, the County paid First Union $61,160.69 on the second refunding transaction. Book testified that he knew of only two "deals" between First Union and the County, referring to the first and third transactions. There is no evidence that Book was paid in connection with the second bond refunding.

On January 6, 1994, Cawley extended Book's agreement from January to March 1994, at a reduced rate of $2,000 pr month. Shortly after that, she raised Book's monthly retainer to $3,750 for February and March 1994. [19] On April 19, 1994, Cawley resigned from her position at First Union.

The following chart summarizes First Union's payments to Book from May 1993 through March 1994:

Relevant Dates	Books' Invoices	First Union's Payments
May 1993	$1,000	
June-September 1993 at $2,000 per month	$8,000	
		$9,050*
October 1993	$7,700	
November 1993	$7,750	
December 1993	$7,700	
		$23,150
January 1994	$2,000	
February 1994	$3,750	
March 1994	$3,750	
		$9,500
	Total:	$41,700

* Includes reimbursement of Book's costs.

I. Cruz's Memoranda Confirm Book's Payment Arrangement

Cruz replaced Cawley and became responsible for the Broward County relationship. Cruz participated in finalizing the third refunding. On June 20, 1994, Cruz received a telephone call from Book, who stated that he "wanted to get paid for Broward." Cruz asked Book, "[W]hich deal?." Book replied, "the last deal," referring to the third transaction. Cruz asked Book about his fee arrangement with First Union. According to Cruz, Book told him that it was "[$]2,000 plus the 20 percent" of First Union's profits on the transaction. Cruz told Book he would look into the matter and contact him. Book testified that he did not recall this conversation with Cruz, but he would not deny that it took place.

After this conversation, Cruz called Cawley, who confirmed the 20% plus $2,000 arrangement. [20] Cruz also contacted his superior and told him that Cawley had confirmed Book's payment arrangement. Cruz was asked to investigate the matter and write a memorandum.

On June 22, 1994, Cruz wrote his superior a memorandum stating, in pertinent part:

On June 20, 1994, I received a call from Mr. Ronald L. Book inquiring as to how we would settle our accounts with him. Mr. Book served as our consultant for about one year and was instrumental in securing our position as financial advisor for Broward County.

He informed me that the arrangement he had with First Union was a monthly retainer of $2,000 plus 20% of the profits. In looking through the files, I did not find this agreement in the contract, however, I did find invoices that were for substantially more than $2,000 (his monthly retainer). I believe that this was a good faith agreement and not a written agreement.

Cruz testified that he tried to be as accurate as possible in writing this memorandum. Cruz stated that "[t]here was no doubt in [his] mind" that everything he wrote was true. Cruz believed that Book was "influential" in First Union's receipt of the financial advisor position because "prior to Mr. Book [First Union] had no bond business in Broward County and after[wards] [it] did."

On or about June 30, 1994, Cruz received an invoice from Book for $4,350 for services "related to Broward financing and other matters." On July 29, 1994, the County paid First Union $21,753 on the third refunding transaction.

On August 9, 1994, with secretary Jean-Baptiste's assistance, Cruz prepared a second memorandum concerning First Union's arrangement with Book. The memorandum stated that Book's "invoices have never been paid through our legal department. Apparently, [Book] was never retained as legal counsel." [21] It stated further that "[First Union's] contractual relationship [with Book] establishes him as a consultant and lobbyist, an expertise for which he is well-known in South Florida." The memorandum recited the terms of the agreement and its amendments. It indicated that the increase in Book's compensation to $7,700 per month for October through December 1993 was "directly related to work with BrowardCounty." The memorandum stated that "Mr. Book's efforts were a great force behind [First Union's] award" of the Agreement. [22]

On October 3, 1994, First Union paid Book's $4,350 invoice. [23]

J. Broward Files Bond Disclosure Forms

As part of the closing documents for each of the refundings, the County's bond counsel was required to file bond disclosure forms, known as "BF Forms," with the Florida Division of Bond Finance. Item 11 of the BF Forms required a listing of "[a]ny fee, bonus, or gratuity paid in connection with the bond issue, by any underwriter or financial consultant to any person not regularly employed or engaged by such underwriter or consultant." [24] For the first two refundings, Item 11 of the BF Forms stated "[n]one." For the third refunding, two firms engaged by the underwriter were listed, but Book was not.

The County's bond counsel for the first two refundings stated that the standard procedure, followed in these transactions, was to send the completed BF Forms and other closing documents to all of the participants in the transaction for their corrections two weeks before the closing of a transaction. [25] The parties were given theopportunity to review the documents at the pre-closing, typically the day before the closing, and then again at the closing of the bond issue. Any party could request a change to a document at any time.

Cawley testified that she was familiar with the BF Forms. She saw the BF Form filed with the first refunding. Cawley was unsure whether she had seen the BF Form filed with the second refunding. Her 1993 calendar indicates that she attended the pre-closings and closings for the first two refundings.

Cawley took Item 11 at "face value" and understood it to mean, "Did the financial consultant pay anybody that doesn't work for them in connection with the deal[?]." Cawley asserted that she did not inform the County that Book should be named under Item 11 of the BF Forms for the first and second refundings because he had done nothing on those transactions.

Cruz and his supervisor represented First Union at the closing of the third refunding. Neither one notified County representatives that Book was involved in that transaction or that Book had made a recent request for payment. Cawley, who was no longer employed by First Union, represented the underwriter on the third refunding. Her 1994 calendar indicates that she attended the pre-closing and closing of that transaction.

III.

MSRB Rule G-17 requires that a municipal securities dealer deal fairly with all persons, and prohibits deceptive, dishonest, and unfair practices. The MSRB has stated that the Rule imposes an obligation to disclose material information. Under this Rule, First Union, acting as a financial advisor, had a fiduciary duty to disclose all material facts concerning the refundings to Broward County, which was acting on behalf of its residents and taxpayers.[26] This obligation included the information explicitly required by the Agreement and closing documents.

The materiality of the information is a prerequisite for liability under Rule G-17. [27] None of the parties disputes that First Union's payment arrangement with Book constituted material information to municipal market participants. The payments were material to the County's decision to select First Union as a financial advisor. The selection of a financial advisor was directly related to the County's sale, and the public's purchase, of the County's securities. Thus, the MSRB has stated that Rule G-17 requires, in connection with the purchase or sale of a municipal security, that a dealer must disclose, at or before the time the transaction occurs, all material facts concerning the transaction and not omit any material facts which would render other statements misleading. [28] First Union, through Cawley, breached its duty whenit failed to disclose to the County its payment arrangement with Book, who was not a First Union employee.

First Union's and Cawley's failure to disclose Book's fees was particularly egregious after they had misled the County as to Book's involvement when they entered into the Agreement. At the time that the Agreement was executed, First Union and Cawley knew that Book was not a bona fide employee working solely for First Union, that Book had been hired to assist them in obtaining the Agreement, and that they had promised to compensate him for his efforts. Notwithstanding this knowledge, First Union and Cawley falsely warranted to the County that they had not hired or paid any person other than a regular First Union employee to solicit the Agreement.

First Union's execution of the formal consulting agreement with Book in late June 1993 further evidenced First Union's and Cawley's concern that their arrangement with Book violated the Agreement's warranty provision. The consulting agreement recited that Book agreed to "employment" by First Union, and "[t]he Firm [Ronald

Book, P.A.]" was "employed by First Union on a regular and ongoing part-time basis." The agreement also purported to pay Book a fixed amount that could be adjusted. First Union's and Cawley's concealment from the County of their intended contingent payments to Book was a continuation of their efforts to hide Book's involvement from the County. We conclude that First Union and Cawley, in her capacity as an associated person of First Union, willfully violated MSRB Rule G-17 in connection with the first bond refunding. [29] Because their conduct contravened an MSRB Rule, we also conclude that First Union willfully violated, and Cawley willfully aided,abetted, and caused [30] First Union's violations of, Exchange Act Section 15B(c)(1).

The law judge determined that First Union and Cawley did not deceive Broward County in connection with the second refunding because they did not pay Book for that transaction, and thus they did not violate MSRB Rule G-17 and Exchange Act Section 15B(c)(1). The Division has not contested these findings on appeal. As a result, we express no view as to the propriety of the law judge's determination that there was no violation with respect to the second bond transaction.

With respect to the third refunding, First Union again deceived the County by failing to inform the County that First Union intended to pay Book a fee in connection with that refunding. Cruz, who represented First Union at the closing, knew that Book was to be paid for that transaction. First Union willfully violated MSRB Rule G-17 and Exchange Act Section 15B(c)(1). [31]

IV.

First Union and Cawley raise a number of arguments against applying MSRB Rule G-17 and Exchange Act Section 15B(c)(1) to their conduct.

A. MSRB Rule G-17

1. First Union and Cawley argue that they were not "acting as" a municipal securities dealer, but "only" as a financial advisor. They assert that MSRB G-17, which applies to the "conduct of [a] municipal securities business," is not applicable to their conduct. However, Rule G-17 does not limit its coverage to those "acting as" municipal securities dealers. Rather, Rule G-17 requires only that the entity be a "municipal securities dealer" or an associated person of the dealer and that the complained-of actions arise "[i]n the conduct of its municipal securities business." [32]

The MSRB has expressly stated that the provision of financial advisory services falls within the scope of a municipal securities business. [33] Consistent with this statement, other MSRB rules refer to financial advisory services as being part of a municipal securities business. MSRB Rule G-1(b)(2), for example, defines a bank's municipal securities dealer activities to include "financial advisory and consultant services for issuers in connection with the issuance of municipal securities." [34] MSRB Rule G-3(b)(i)(B) employs the same language to describe a municipal securities principal's activities. [35] First Union's position, moreover, is contradicted by its compliance manual, which classifies the bank's activities in rendering financial advice as "acting as a municipalsecurities broker-dealer." We conclude that the law judge correctly determined that MSRB Rule G-17 applied to First Union and Cawley.

2. First Union and Cawley argue that it violates due process to apply Rule G-17 to their conduct. Respondents assert that Rule G-17 has not been used before to regulate the financial advisor-issuer relationship, and they did not have adequate notice that their conduct contravened Rule G-17. [36] Due process requires only that the laws be sufficiently specific to "give the person of ordinary intelligence a reasonable opportunity to know what is prohibited." [37] We believe that a reasonably prudent municipal securities dealer would have had fair notice that it is a deceptive, dishonest, and unfair practice for a dealer acting as a financial advisor to fail to inform its client that the advisor retained and paid a lobbyist, particularly when such information was not disclosed at the time of the Agreement and was asked for at the closing of these transactions.

3. First Union and Cawley argue that it violates due process to apply Rule G-17 to their conduct, because the order instituting proceedings ("OIP") did not charge them with breach of their disclosure obligations under federal law. Administra-tive due process is satisfied where the party against whom the proceeding is brought understands the issues and is given an opportunity to meet the charges. [38] Administrative pleadings are "very liberally" construed, and courts grant agencies considerable latitude in interpreting charging documents. [39] The question on review is not solely the adequacy of the particular pleading, but the fairness of the entire proceeding. [40]

Here, the OIP described the false warranty and alleged that First Union and Cawley omitted to disclose to the County the contingency fee paid to Book although the Florida statutes required First Union to file a statement disclosing such a fee. The OIP continued that, as a result of the affirmative misrepresentations and omissions made, First Union was able to serve as financial advisor to the County on the three bond refundings. The OIP further described the misconduct at issue as violations of Rule G-17 by not dealing fairly with all persons and by engaging in deceptive, dishonest, or unfair practices. First Union and Cawley addressed Rule G-17 both in their briefs before the law judge and on appeal. In these circumstances, we find that First Union and Cawley had sufficient notice of the allegations against them.

4. First Union and Cawley argue that it is both unfair and unduly burdensome to competition that MSRB Rule G-17 applies to financial advisors only if they are registered brokers, dealers, or municipal securities dealers, but not to financial advisors who are not so registered. However, Congress made the decision to regulate municipal securities dealers and their associated persons. The MSRB determined that its rules and regulations needed to apply to the full scope of municipal securities activities of these regulated persons. Subjecting municipal securities dealers' advisory activities to Rule G-17's prohibition of deceptive, dishonest, or unfair practices odes not impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act.

5. First Union and Cawley assert that scienter is necessary to establish a Rule G-17 violation, and that the Division failed to show that they acted with an intent to deceive, manipulate, or defraud. Rule G-17 imposes on brokers, dealers, and municipal securities dealers an obligation to deal fairly and not engage in any deceptive, dishonest, or unfair practice. [41] We believe that Rule G-17 requires a showing of at least negligence to establish an unfair practice violation. [42] Even if scienter were required, thatelement is demonstrated by First Union's and Cawley's

intentional misconduct in executing the false warranty and in concealing from the County material information to be disclosed with respect to the refundings.

6. First Union and Cawley argue that MSRB Rule G-23, which regulates certain activities of financial advisors, preempts Rule G-17 and establishes the only disclosure duties for financial advisors. Our order approving the adoption of Rule G-17 described it as an "omnibus fair practice rule" meant to "establish the general standard for conduct of a municipal securities business." [43] We stated that "[t]he other proposed fair practice rules would provide . . . an elaboration upon this general standard, by establishing guidelines for particular subject matters." [44]

We have made it clear that MSRB Rule G-23 was not intended to preempt Rule G-17. Rule G-23 concerns one aspect of the financial advisor-issuer relationship. [45] Rule G-23 addresses primarily the conflict of interest that arises when a municipal securities dealer serves in the dual capacity of financial advisor and underwriter with respect to the same issue of municipal securities. [46] Rule G-23 prohibits a financial advisor from acting as an underwriter in an issue unless the advisor complies with certain provisions. [47] In this case, the Agreement expressly prohibited First Union in its capacity as the County's financial advisor from also serving as an underwriter on the refunding transactions. Rule G-23 is not applicable here.

B. Exchange Act Section 15B(c)(1)

1. First Union and Cawley argue that their conduct leading to the award of the financial advisor position was outside the statuteof limitations period, [48] and could not be considered in deciding, for example, whether they "effected" or "induced or attempted to induce" the bond refundings under Exchange Act Section 15B(c)(1). [49] The statute of limitations, even if applicable, does not operate as an evidentiary bar. We may consider conduct occurring outside the limitations period in evaluating Respondents' activities within the statutory period. [50]

Cawley arranged to hire Book, who was not a regular, full-time First Union employee, to secure the Agreement and promised to pay him a contingent fee for his efforts. Once the Agreement wasobtained, First Union and Cawley continued to advise the County and participate in the refunding transactions while failing to disclose that Book had been hired to obtain the County's business and was going to receive compensation from First Union based on the transactions done under the Agreement. First Union and Cawley knew that First Union would not be paid for its services until after each of the transactions had closed. Their material omissions thus "effect[ed]," or "induce[d] or attempt[ed] to induce," the bond refundings in violation of Rule G-17. [51]

2. First Union and Cawley argue alternatively that Exchange Act Section 15B(c)(1) does not apply because they did not "induce" the refundings. Citing Cawley's hearing testimony, they contend that Broward County had already identified the bonds that it intended to refund when the RLI was issued. They add that the County sought proposals only to decide which of the firms were capable of performing the financial analysis.

The record demonstrates that First Union played a substantial role in inducing the refundings. The County had identified fifteen bond issues as potential candidates for refunding. First Union's May 6, 1993, proposal identified a subset of these bond issues that it recommended for refunding. The County agreed with First Union's proposal and refunded the issues that First Union had recommended.

Moreover, the Agreement expressly stated that First Union would not be paid until each series of bonds was delivered. As a result, First Union and Cawley had a strong incentive to ensure that each refunding was consummated. The success of their efforts was shown by First Union's receipt of $175,654 in fees from the County.

V.

First Union and Cawley raise various evidentiary and procedural objections, none of which has any merit.

A. First Union and Cawley object on hearsay grounds to the admission of the following evidence: (1) Cruz's testimony and memoranda reflecting Book's statement to Cruz concerning his contingency fee arrangement with First Union; (2) Cawley's statement to Cruz confirming this arrangement; and (3) Cruz's memoranda reciting the arrangement with Book. They argue that Cruz's testimony and memoranda were based on speculation and not on personal knowledge.

We have stated repeatedly that hearsay evidence is admissible in administrative proceedings. [52] Under the Commission's Rules of Practice, only irrelevant, immaterial, or unduly repetitious evidence must be excluded. [53] The record shows the probative and reliable nature of this evidence. [54] Book's statement to Cruz concerning his fee arrangement with First Union was confirmed by Cawley's admission to Cruz and by First Union's payment of Book's invoice on the third transaction. Cruz testified that he made every effort to be accurate in his memoranda. [55]

B. First Union and Cawley challenge the exclusion of statements made by Broward County officials to the Division's investigator that the officials were not influenced by Book in awarding the financial advisor position to First Union. As an initial matter, these statements were not relevant since they had no bearing on the issue of whether First Union hired and paid Book. [56] In addition, as the law judge noted, the officials' statements were unreliable. They were not written, signed, or made under oath. There was no showing that any of the officials was unavailable to testify at the hearing. The commissioners who reviewed and voted on First Union's proposal were well-known to respondents and subject to subpoena. The respondents were given the option of calling these officials, but elected not to do so.

C. First Union and Cawley complain about the manner in which the law judge conducted the hearing. At a pre-hearing conference and at the inception of the hearing, the law judge stated that he would permit counsel to confer with their own witnesses following their examination by opposing counsel. Neither First Union nor Cawley objected to the practice until the last day of the hearing when the Division first attempted to invoke the procedure and confer with its investigator after he had been examined by First Union. The law judge denied First Union's objection. We believe that the law judge has wide latitude in regulating the conduct of the proceedings. The law judge did not abuse his discretion. [57]

The law judge also acted within his discretion in allowing the Division to call Cawley's secretary, Jean-Baptiste, to rebut Cawley's testimony. The law judge sought to safeguard First Union's and Cawley's rights by giving them the opportunity to offer testimony in response. They declined to present such testimony.

D. First Union contends that before issuing his decision the law judge engaged in improper ex parte contacts when his law clerk called the Florida Division of Bond Finance and asked questions about the Florida administrative regulation. The Administrative Procedure Act, 5 U.S.C. § 557(d), prohibits ex parte communications relevant to the merits of a proceeding between an "interested person" and an agency decisionmaker. [58] By its terms, § 557(d) applies only to ex parte communications to or from an "interested person." [59] Our own ex parte rules likewise prohibit communications with "interested person[s] outside the agency." [60] First Union has not demonstrated that the Florida Division of Bond Finance employees were "interested persons" with respect to this proceeding. In any event, we have not relied on an analysis of the Florida regulation.

E. First Union and Cawley assert that the law judge admitted into evidence, and made findings concerning, alleged wrongdoing that was not set forth in the Division's order instituting proceedings. They complain that the law judge considered evidence of First Union's arrangement with Book on a North Miami Beach, Florida,transaction that was not the subject of any charge. They also complain that the law judge improperly permitted the Division to introduce evidence of First Union's retention of two other consultants. We have not considered this evidence in our de novo review of this case. [61]

F. First Union and Cawley also find error in the law judge's ruling that the Florida administrative regulation was a "nullity," and in his "unsubstantiated statements" concerning Broward County government. We do not express a view on the merits of either one of these matters. Nor have we considered them in our resolution of this appeal. The law judge's initial decision is not a final decision. [62]

VI.

First Union's and Cawley's failure to disclose to the County their payment arrangement with Book occurred within the five-year limitations period contained in 28 U.S.C. § 2462. [63] The statute of limitations does not bar the enforcement of penalties against First Union and Cawley based on that misconduct.

The Division asserts that the law judge erred when he found the County was not entitled to restitution because it would have had to retain another advisor, so an assessment of disgorgement necessarily constituted a penalty. However, disgorgement isdesigned to deprive a wrongdoer of its ill-gotten gains. [64] Courts have awarded disgorgement without proof of particular damage to any victim. [65] We now turn to the issue of what sanctions are appropriate for First Union's and Cawley's misconduct.

A. Suspension

Exchange Act Sections 15(b)(6) and 15B(c)(4) authorize the Commission to censure, place limitations on, suspend, or bar a person associated with a broker, dealer, or municipal securities dealer when such sanction is in the public interest and the person has, among other things, willfully violated, or aided and abetted a violation of, the federal securities laws, the regulations promulgated under those laws, or

MSRB rules. [66] In determining whether a suspension is in the public interest, we consider the egregiousness of a respondent's conduct, the sincerity of the respondent's assurances against future violations, the respondent's recognition of the wrongfulness of her conduct, and the likelihood that the respondent's occupation will present opportunities for future violations. [67]

Cawley, while representing First Union's interests, engaged in deceptive, dishonest, and unfair conduct, thereby violating MSRBRule G-17 and aiding and abetting First Union's violations of Exchange Act Section 15B(c)(1), when she failed to disclose material information to the County in connection with the first bond closing. The law judge remarked on her lack of candor at the hearing. Cawley has not made any assurances against future violations. Nor has she acknowledged the wrongful nature of her conduct. We agree with the law judge that Cawley's continued activities in the municipal securities business call for external restraint. [68] We conclude that Cawley should be suspended for three months from association with a broker, dealer, or municipal securities dealer.

B. Cease-and-Desist Orders

Exchange Act Section 21C(a) authorizes the Commission to impose a cease-and-desist order on any person who has violated or has caused violations of the federal securities laws. [69] In deciding whether to impose a cease-and-desist order, we consider such factors as "the seriousness of the violation, the isolated or recurrent nature of the violation, the respondent's state of mind, the sincerity of the respondent's assurances against future violations, the respondent's recognition of the wrongful nature of his or her conduct, and the respondent's opportunity to commit future violations. We also consider whether the violation is recent, the degree of harm to investors or the market resulting from the violation, and the remedial function to be served by the cease-and-desist order in the context of any other sanctions being sought in the same proceedings." [70] Before imposing a cease-and-desist order, there must be some likelihood of future violations; however, the risk does not need to be very great. [71] "[I]n the ordinary case and absent evidence to the contrary, a finding of [a] past violation raises a sufficient risk of future violation." [72]

As concluded above, Cawley caused First Union's violation of Exchange Act Section 15B(c)(1) when they engaged for roughly one year in a course of conduct that operated as a deceit. Their conduct misled the County about material information concerning First Union's retention of a lobbyist to secure the County's business. Neither First Union nor Cawley has made assurances against future violations. Both continue to work in the municipal securities business. We conclude that cease-and-desist orders are warranted against them for their violations of Exchange Act Section 15B(c)(1). [73]

The law judge determined that cease-and-desist orders of a limited duration are a sufficient deterrence. The remedy of a cease-and-desist order "requires that a wrongdoer cease his unlawful conduct and desist from such conduct in the future." [74] Consistent with this remedial purpose, our practice has been to impose cease-and-desist orders of unlimited duration.

First Union and Cawley contend that Exchange Act Section 21C does not preclude the entry of a cease-and-desist order of limited duration. Section 21C grants us the authority to craft cease-and-desist orders that assure future compliance with the securities laws. [75] We believe that a cease-and-desist order requiring continued compliance with the requirements of the securities laws achieves this purpose.

First Union and Cawley contend, based on Exchange Act Section 21C's legislative history, [76] that Congress intended our cease-and-desist authority to be similar to that available to other agencies,most notably the bank regulatory agencies. [77] They argue that, because those agencies have placed time limits on cease-and-desist orders, Congress intended for the Commission to do the same. We have stated that the practices of these agencies "do not provide clear guidance," and that their experiences present "an uncertain guide." [78] We observed that the bank regulatory agencies' cease-and-desist authority is "somewhat different from ours. [A banking order] is intended to reverse business practices that may endanger a bank's soundness, whereas ours is intended to prevent resumption of unlawful actions." [79] Accordingly, we do not believe that we are required to limit the duration of cease-and-desist orders under Exchange Act Section 21C.

We see no reason why the order's obligation to obey the securities laws should end in three years. Because we find that a cease-and-desist order is necessary in the public interest, we will order that First Union and Cawley cease and desist from committing or causing any violations or future violations of Exchange Act Section 15B(c)(1), including failing to deal fairly with all persons and engaging in any deceptive, dishonest, or unfair practice under MSRB Rule G-17.

C. Civil Penalties

Exchange Act Section 21B authorizes the Commission to impose civil penalties for willful violations of the Exchange Act or the rules thereunder when such penalty is in the public interest. [80] The law judge decided that First Union's and Cawley's violations warranted second-tier penalties. The Division has not appealed the amount of the second-tier penalties imposed. In view of our findings that First Union and Cawley engaged in deceptive conduct and recklessly disregarded regulatory requirements, we impose a second-tier penalty of $20,000 on First Union and $15,000 on Cawley. [81]

D. Disgorgement

Exchange Act Section 21C(e) authorizes disgorgement in this proceeding. [82] Disgorgement requires a securities law violator to return proceeds causally related to the wrongdoing. [83] The Division has the initial burden of showing that its disgorgement figure reasonably approximates the amount of unjust enrichment. [84] Once the Division makes this showing, the burden then shifts to the respondent to demonstrate that the disgorgement figure is not a reasonable approximation. [85]

The Division established that First Union received $92,740.31 and $21,753 in fees for the first and third refunding transactions, respectively. The Division also established that these payments were causally connected to First Union's wrongdoing. The Division's showing presumptively satisfied its burden of proof. First Union failed to show that the Division's disgorgement figure was an unreasonable approximation of the amount of its ill-gotten gains. First Union did not substantiate or even calculate any reduction to its revenues to arrive at a more realistic figure. [86] Accordingly, we will order First Union to disgorge $114,493.31, representing its revenues from the first and third refunding transactions, plus prejudgment interest. [87]

An appropriate order will issue. [88]

By the Commission (Chairman DONALDSON and Commissioners GLASSMAN, GOLDSCHMID, ATKINS and CAMPOS).

Jonathan G. Katz
Secretary

In the Matter of Wheat, First Securities, Inc. f/k/a First Union Capital Markets Corp. and Teressa L. Cawley, Exchange Act Release No. 48378, A.P. File Nos. 3-9688 and 3-9794 (August 20, 2003).

ORDER IMPOSING REMEDIAL SANCTIONS

On the basis of the Commission's opinion issued this day, it is

ORDERED that Teressa L. Cawley be, and she hereby is, suspended for three months from association with any broker, dealer, or municipal securities dealer, effective at the opening of business on August 29, 2003; and it is further

ORDERED that Teressa L. Cawley and Wheat, First Securities, Inc., f/k/a First Union Capital Markets Corporation, cease and desist from committing or causing any violations or future violations of Section 15B(c)(1) of the Securities Exchange Act of 1934, including failing to deal fairly with all persons and not engage in any deceptive, dishonest, or unfair practice under Rule G-17 of the Municipal Securities Rulemaking Board; and it is further

ORDERED that Teressa L. Cawley pay a civil money penalty of $15,000, and that Wheat, First Securities, Inc., f/k/a First Union Capital Markets Corporation, pay a civil money penalty of $20,000; and it is further

ORDERED that Wheat, First Securities, Inc., f/k/a First Union Capital Markets Corporation, disgorge $114,493.31, plus prejudgment interest, calculated in accordance with the Commission's Rule of Practice 600(b); and it is further

ORDERED that the Division of Enforcement submit to the Commission a proposed disgorgement plan in accordance with Rule ofPractice 610 within 60 days of payment of the amount of disgorgement.

Payment of the civil penalty shall be made within 21 days of the issuance of this order. The civil penalty shall be (a) made by United States postal money order, certified check, bank casher's check, or bank money order; (b) made payable to the Securities and Exchange Commission; (c) mailed or delivered by hand to the Comptroller, 6432 General Green Way, Alexandria, VA 22312; and (d) submitted under cover letter that identifies the particular respondent in these proceedings, as well as the Commission's administrative proceeding file number. A copy of this cover letter and money order or check shall be sent to Teresa J. Verges, Southeast Regional Office, Securities and Exchange Commission, 801 Brickell Avenue, Suite 1800, Miami, FL 33131.

By the Commission.
Jonathan G. Katz
Secretary

Footnotes

[1] First Union, based in Charlotte, North Carolina, was a principal subsidiary of First Union Corporation, a bank holding company. In January 1998, First Union Corporation acquired Wheat, First Securities, Inc. and merged First Union Capital Markets Corporation with Wheat, First Securities, Inc. In September 2001, First Union Corporation merged with Wachovia Corporation. The new Wachovia Corporation provides retail brokerage services under different names, including First Union Securities, Inc., the successor to Wheat First Securities, Inc. In May 2002, Wachovia Corporation's retail brokerage arm became Wachovia Securities.

[2] Under Section 15B(a)(1) of the Securities Exchange Act of 1934, a broker or dealer may not engage in interstate trade in municipal securities unless the broker or dealer registers under that Section or under Exchange Act Section 15, 15 U.S.C. § 78o. See 15 U.S.C. § 78o-4(a)(1) (prohibiting "any municipal securities dealer (other than one registered as a broker or dealer under section 15 of this title) to make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security unless such municipal securities dealer is registered in accordance with this subsection.").

[3] On August 27, 1998, the Commission brought this proceeding against First Union under Sections 15(b), 15B(c), 19(h), and 21C of the Securities Exchange Act of 1934. On December 23, 1998, the Commission charged Cawley under the same provisions. On January 25, 1999, the First Union and Cawley actions were consolidated.

[4] The applicable version of MSRB Rule G-17 provided that, "[i]n the conduct of its municipal securities business, each broker, dealer, and municipal securities dealer shall deal fairly with all persons and not engage in any deceptive, dishonest, or unfair practice." See MSRB Manual (CCH)

¶ 3581 at 4871.

In June 2000, the MSRB amended Rule G-17 by replacing the term "municipal securities business" with the term "municipal securities activities." The MSRB stated that the amendment effected only a technical change to the Rule. Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Municipal Securities Rulemaking Board Consisting of Technical Amendments to Rules A-3, G-15, G-17 and G-18, Exchange Act Rel. No. 42830 (May 25, 2000), 72 SEC Docket 1428, 1429.

[5] Exchange Act Section 15B(c)(1) prohibits a broker, dealer, or municipal securities dealer from "effect[ing] any transaction in," or "induc[ing] or attempt[ing] to induce the purchase or sale of," a municipal security in contravention of any

MSRB rule. 15 U.S.C. § 78o-4(c)(1).

[6] See MSRB Rule G-3(b) (qualification requirements of municipal securities principals), MSRB Manual (CCH) ¶ 3511 at 3271-3.

[7] Cawley's superiors testified that they understood from the outset that consultants were hired to assist First Union in obtaining business. They further testified that they did not think it was a problem for consultants to be paid based on the business that they generated.

[8] At the hearing, Book contradicted his investigative testimony and stated that he "had a standard range of fees." Book elaborated that he "would have had a number, probably in the $25,000 to $50,000 a year range, to have [his] services available." After observing Book's demeanor at the hearing, the law judge found Book's investigative testimony to be more reliable than his hearing testimony. See Michael J. Fee, 50 S.E.C. 1124, 1125 (1992) (upholding administrative law judge's refusal to credit respondent's hearing testimony when it contradicted earlier, sworn investigative testimony), aff'd, 998 F.2d 1002 (3d Cir. 1993) (Table). The law judge observed that Book, who admitted to being Cawley's close personal friend and professional associate, sought to testify in Cawley's favor, but that his "almost total lack of recall" about the specifics of his payment arrangement with First Union and his lack of memory on other matters were "telling."

[9] See discussion infra Section II.I.

[10] The record is unclear whether the 20% arrangement was to be based on First Union's fees, as the law judge found, or on its "profits," as stated in Cruz's June 1994 memorandum. If the arrangement were to be based on "profits," the record is also unclear as to how those "profits" were to be calculated. However, the record supports the finding that the parties informally arranged for Book to receive payments in addition to his monthly retainer as compensation for securing BrowardCounty business.

[11] Credibility determinations by the fact-finder are entitled to considerable weight, and can be overcome only when there is "substantial evidence" for doing so. See Anthony Tricarico, 51 S.E.C. 457, 460 (1993). The record in this case contains no such evidence.

[12] In a typical advance refunding, the municipality issues a new offering of tax-exempt bonds to fund retirement of a pre-existing issue of bonds bearing higher interest rates. SEC v. Rauscher Pierce Refsnes, Inc., 17 F. Supp. 2d 985, 991 n.8 (D. Ariz. 1998). The proceeds of the new bond offering are invested in U.S. Treasury securities and used to pay off the old bonds as they mature. Id.

[13] Cawley admitted at the hearing that she knew in April 1993 that Commissioner Cowan was the Chairman of Broward County's Selection/Negotiation Committee. Cawley denied knowing at the time that she hired Book that he was Commissioner Cowan's close friend. Cawley admitted, however, that she did learn "at some point" of their relationship.

[14] See Fla. Stat. ch. 218.386(1)(a) (defining "finder" to mean "a person who is not regularly employed by, or not a partner or officer of, an underwriter, bank, banker, or financial consultant or adviser and who enters into an understanding with either the issuer or the managing underwriter, or both, for any paid or promised compensation or valuable consideration directly or indirectly, expressly or impliedly, to act solely as an intermediary between such issuer and managing

underwriter for the purpose of influencing any transaction in the purchase of such bonds").

15 See discussion infra Section II.G.

16 Cawley testified that First Union paid Book only $1,000 for May 1993 because he did not begin performing services until the middle of the month. However, Book did not recall receiving half-month payments.

17 The one-page opinion letter recited that First Union sought advice concerning "agreements between various parties and [First Union] for the primary purpose of providing services to First Union, relating to the purchase of municipal bonds and other certificates of indebtedness ("Bonds") from various governmental issuers ("Issuer")."

It is undisputed that outside counsel was unaware of, and gave Cawley no advice regarding, the Agreement or its warranty provision. Outside counsel had no knowledge of First Union's retention of Book.

18 On cross-examination by Cawley's counsel, outside counsel testified that he believed the date on the opinion letter was more accurate than the dates entered on his time sheets because he was a late-biller, and because he would not have back-dated the letter. On re-direct examination, however, outside counsel could not explain why, if he had done the work on or about May 1, 1993, he would have made two separate billing entries in June 1993. Outside counsel acknowledged that someone else could have backdated the letter.

19 The law judge found that some of these fees were for work unrelated to Book's efforts in Broward County.

20 Cawley admitted that Cruz called and asked her if First Union owed Book money, but claimed that he did not mention Broward County. Cawley also admitted that she spoke to Book the next day, but she denied discussing Cruz's call.

21 At the hearing, a First Union Corporation vice president and assistant general counsel confirmed that payments to Book were made through a First Union "business development" account.

22 Cruz testified that, because he did not sign this memorandum, he was unsure whether it had been sent to his superior.

23 In a letter to Commission staff during its investigation of this case, the same First Union Corporation vice president and assistant general counsel who testified before the law judge admitted that Book assisted First Union in obtaining its award of the Agreement. She also admitted that First Union paid Book's $4,350 invoice based on his representation that he was to receive a percentage of First Union's profits on the third refunding.

24 This language was identical to that contained in Fla. Stat. ch. 218.38(1)(c)1 (requiring municipality to file with the Florida Division of Bond Finance on forms prescribed by the Division information regarding "[a]ny fee, bonus, or gratuity paid by any underwriter or financial consultant, in connection with the bond issue, to any person not regularly employed or engaged by such underwriter or consultant") ("the Florida reporting statute").

25 Bond counsel further testified that, in completing the BFForms, he did not rely on any rules promulgated by the Florida Division of Bond Finance. Rather, he was

guided by the plain language of the BF Forms. Bond counsel was unaware of any relationship between First Union and Book.

[26] See, e.g., Order Approving Proposed Rule Change of MSRB Relating to Activities of Financial Advisors, Exchange Act Rel. No. 30258 (Jan. 16, 1992) ("The MSRB . . . believes that the existence of the conflict of interest [faced by a dealer acting as both financial advisor and placement agent on the same issue] is contrary to the fiduciary obligations of municipal securities professionals acting as financial advisors to issuers . . . . "); Notice of Filing of Fair Practice Rules, [1977-1987 Transfer Binder], MSRB Manual (CCH) ¶ 10,030 at 10,377 (Sept. 20, 1977) (stating, in the context of MSRB Rule G-23, that a municipal securities professional serving as financial advisor "acts in a fiduciary capacity as agent" for the state or local governmental unit); In re O'Brien Partners, Inc., Securities Act Rel. No. 7594 (Oct. 27, 1998) (violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act for failure to make full disclosure in breach of fiduciary duty owed as municipal financial advisor).

[27] SEC v. Cochran, 214 F.3d 1261, 1264 n.2 (10th Cir. 2000).

[28] See, e.g., MSRB Interpretation of February 10, 1984, MSRB Manual (CCH) ¶ 3571.24 at 4534.

First Union and Cawley raise numerous claims under Florida law, including the claim that a Florida administrative regulation allegedly implementing the reporting statute relieved them of any duty to report Book's fees on the BF Forms. They do not claim that they were aware of or relied on the regulation at the time of the events at issue. Their asserted compliancewith state law reporting requirements does not abrogate their disclosure obligations under federal law.

[29] See MSRB Rule G-2 (the term "municipal securities dealer" as used in the MSRB's rules refers to and includes its respective associated persons), MSRB Manual (CCH) ¶ 3251 at 3202. Cawley asserts that the Division failed to produce evidence of harm to investors or the marketplace. No such proof is required to establish an MSRB Rule G-17 violation.

[30] The principal elements required to establish Cawley's liability for aiding and abetting are: (1) First Union violated Exchange Act Section 15B(c)(1); (2) Cawley provided "substantial assistance" to First Union; and (3) Cawley rendered such assistance knowingly or recklessly. See Sharon M. Graham, 53 S.E.C. 1072, 1080 (1998), aff'd, 222 F.3d 994, 1000 (D.C. Cir. 2000). Cawley's conduct satisfied these elements.

[31] See Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (a culpable intent is not required in order to find that a wrongdoer acted willfully.). Cawley participated in the third refunding transaction as the principal of the underwriter. The law judge found that Cawley had no obligation to disclose fees intended to be paid by her former employer. The Division has not appealed that determination.

[32] Respondents argue that Exchange Act Section 15B(c)(1) also applies only to persons "acting as" a municipal securities dealer. This section, however, prohibits a municipal securities dealer from violating any MSRB rule. MSRB Rule G-17 applies to a municipal securities dealer acting as a financial advisor.

[33] See Notice of Filing of Fair Practice Rules, [1977-1987 Transfer Binder] MSRB Manual (CCH) ¶ 10,030 at 10,373 (Sept. 20, 1977) (adopting commentator's suggestion to expand scope of proposed Rule G-17 to cover conduct in the

municipal securities business, rather than conduct solely involving transactions in municipal securities; stating that such an expansion is appropriate since "the activities of a municipal securities professional relate not only to transactions actually effected, but to a variety of other matters, including financial and investment advice") (emphasis supplied).

We reject First Union's attempt to narrow the types of financial advisory services covered by MSRB Rule G-17. This Rule applies to all financial advisory services, and not merely to portfolio or escrow investment advice, as urged by First Union.

34 MSRB Rule G-1(b)(2), MSRB Manual (CCH) ¶ 3501 at 3251.

35 MSRB Rule G-3(b)(i)(B), MSRB Manual (CCH) ¶ 3511 at 3271-3.

36 For support, First Union and Cawley cite Upton v. SEC, 75 F.3d 92 (2d Cir. 1996), among other cases. There, the court held that respondent was denied due process because he did not have sufficient notice of a Commission interpretation. Id. at 98. Here, by contrast, we have evaluated First Union's and Cawley's conduct in light of well-established disclosure requirements.

37 Grayned v. City of Rockford, 408 U.S. 104, 108 (1972).

38 See Jonathan Feins, Exchange Act Rel. No. 3-8721 (Sept. 29, 1999), 70 SEC Docket 2116, 2128 and cases cited therein.

39 Id.

40 Id. at 2128-29.

41 The MSRB recently noted that Rule G-17 encompasses two basic principles: an antifraud prohibition and a general duty to deal fairly even in the absence of fraud. The MSRB stated that Rule G-17 "was implemented to establish a minimum standard of fair conduct." Interpretative Notice Regarding Rule G-17, on Disclosure of Material Facts (Mar. 20, 2002).

42 SEC v. Dain Rauscher, Inc., 254 F.3d 852, 856 (9th Cir. 2001) (holding that negligence is the standard for liability underMSRB Rule G-17). See Aaron v. SEC, 446 U.S. 680, 696-97 (1980) (interpreting Section 17(a)(2) of the Securities Act of 1933, which prohibits any person from obtaining money or property "by means of any untrue statement of a material fact or any omission to state a material fact," and Securities Act Section 17(a)(3), which prohibits any person from "engag[ing] in any transaction, practice, or course of business which operates or would operate as a fraud or deceit," to contain no scienter requirement); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 200 (1963) (interpreting Section 206(2) of the Investment Advisers Act of 1940, which prohibits an investment adviser from engaging in any practice which "operates as a fraud or deceit upon any client or prospective client," to contain no scienter requirement).

43 In the Matter of Municipal Securities Rulemaking Board, Order Approving Proposed Rule Change, Exchange Act Rel. No. 15247 (Oct. 19, 1978), 15 SEC Docket 1323, 1324.

44 Id. For this reason, we reject Respondents' similar argument concerning MSRB Rule G-37 (requiring, among other things, that municipal securities dealers record and disclose political contributions) and Rule G-38 (requiring municipal securities dealers to disclose their use of consultants), both of which were approved in 1996 after the events underlying this matter took place. See Order Approving Proposed

Rule Change by the Municipal Securities Rulemaking Board Relating to Consultants, Exchange Act Rel. No. 36727 (Jan. 17, 1996), 61 SEC Docket 254.

[45] See Notice of Filing of Fair Practice Rules, [1977-1987 Transfer Binder], MSRB Manual (CCH) ¶ 10,030 at 10,377 (Sept. 20, 1977) (The MSRB, in considering the adoption of Rule G-23, stated that it addressed only "certain aspects of the conduct of a municipal securities professional acting as a financial advisor.").

[46] Order Approving Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Activities of Financial Advisors, Exchange Act Rel. No. 41217 (March 26, 1999), 69 SEC Docket 1286, 1286.

[47] See MSRB Rule G-23(d), MSRB Manual ¶ 3611 at 5052-53.

[48] The Agreement was executed in June 1993. The Commission's order instituting proceedings was filed against First Union on August 27, 1998, and against Cawley on December 23, 1998.

[49] A person "effects" securities transactions by participating in such transactions "at key points in the chain of distribution." Massachusetts Financial Services, Inc. v. SIPC, 411 F. Supp. 411, 415 (D. Mass.) (defining "effects" in the context of Exchange Act Section 3(a)(4), 15 U.S.C. § 78c(a)(4)), aff'd, 545 F.2d 754 (1st Cir. 1976). The Commission's staff has stated that such participation includes assisting an issuer to structure a prospective securities transaction and to identify potential purchasers of securities, soliciting securities transactions, and participating in the order-taking or order-routing process. MuniAuction, Inc., 2000 SEC No-Act LEXIS 659 (Mar. 13, 2000). See also Financial Surveys, Inc., 1973 SEC No-Act LEXIS 210 (July 30, 1973) (stating that the term "effect," as used in Exchange Act Section 3(a)(4),"should be construed broadly to encompass not only persons who are engaged directly in the offer or sale of securities, but also those persons who perform other than purely ministerial or clerical functions with respect to securities transactions.").

Additionally, Webster's Third New International Dictionary (1971) defines the term "effect" to mean "to cause to come into being" or "to bring about." Id. at p. 724. It defines the term "induce" similarly to mean "to bring on or about," "to effect or to cause," and "to influence or to persuade." Id. at p. 1154.

[50] E.g. Russell Ponce, Exchange Act Rel. No. 43245 (Aug. 31, 2000), 73 SEC Docket 442, 466-67 & n.55 (evidence of conduct outside the limitations period is admissible to show motive, intent, or course of conduct), appeal pending, No. 00-71398 (9th Cir. Nov. 1, 2000).

[51] First Union and Cawley cite United States v. Rudi, 927 F. Supp. 686 (S.D.N.Y. 1996), for the proposition that the MSRB rule violation must have a sufficient nexus to the sale of municipal securities to establish an Exchange Act Section 15B(c)(1) violation. In Rudi, the district judge concluded that the conduct underlying the MSRB rule violation was "too remote and peripheral," "no more than an afterthought," and "only accidentally a part" of the sale of municipal securities. Id. at 688. The district judge accordingly dismissed the Section 15B(c)(1) charge against the defendant. By contrast, First Union's and Cawley's non-disclosure of material information cannot be characterized as an "afterthought" or an "accidental" part of their deceptive course of dealing. Rather, these actions were an integral part of, and in furtherance of, their initial deception in concealing from the County the payments made to Book.

[52] See, e.g., William H. Gerhauser, 53 S.E.C. 933, 945 (1998).

[53] Rule of Practice 320, 17 C.F.R. § 201.320.

[54] See Charles D. Tom, 50 S.E.C. 1142, 1145 (1992) (factors to consider in evaluating probative and reliability of hearsay include the possible bias of the declarant, the type of hearsay at issue, whether the statements are written, signed, and sworn, whether the statements are contradicted by direct testimony, whether the declarant is available to testify, and whether the hearsay is corroborated).

[55] Even if the Federal Rules of Evidence applied, the law judge properly admitted the evidence as non-hearsay. See Fed. R. Evid. 801(d)(2)(B) (a statement in which the party manifests an adoption or belief in its truth is an admission by a party-opponent); Fed. R. Evid. 801(d)(2)(A) (a party's own statement in either an individual or representative capacity is an admission by a party-opponent); Fed. R. Evid. 801(d)(2)(D) (a statement by a party's agent concerning a matter within the scope of his agency made during the existence of the relationship is an admission by a party opponent).

[56] For this same reason, we find no abuse of discretion in the exclusion of a letter written by the Division and sent to opposing counsel stating that two County officials had confirmed they had not been contacted by any First Union representative.

[57] See Fairbank v. Hardin, 429 F.2d 264, 267 (9th Cir. 1970) (law judge has wide latitude as to all phases of the conduct of the hearing); see also Rule of Practice 111(d), 17 C.F.R. § 201.111(d) (stating, among other things, that the law judge has the authority to "regulat[e] the course of a proceeding and the conduct of the parties and their counsel").

First Union's reliance on Perry v. Leeke, 488 U.S. 272 (1989), is misplaced. There, the Supreme Court held that it was not a Sixth Amendment violation to deny a criminal defendant the right to confer with counsel while he is testifying. In so holding, the Supreme Court affirmed that the district court, in its discretion in regulating the conduct of the trial, may impose restrictions on an attorney's contact with witnessesduring trial. See id. at 281-84.

[58] See 5 U.S.C. § 557(d)(1)(B) ("[N]o member of the body comprising the agency, administrative law judge, or other employee who is or may reasonably be expected to be involved in the decisional process of the proceeding, shall make or knowingly cause to be made to an interested person outside the agency an ex parte communication relevant to the merits of the proceeding.").

[59] See, e.g., Pioneer Hotel, Inc. v. NLRB, 182 F.3d 939, 944 (D.C. Cir. 1999) ("[T]he only prohibited communications [under 5 U.S.C. § 557(d)] are those with interested person[s] outside the agency") (internal quotations omitted).

[60] See 17 C.F.R. § 200.111(a)(2) ("No member of the Commission or decisional employee shall make or knowingly cause to be made to any interested person outside the agency an ex parte communication relevant to merits of the proceeding.").

[61] See Jay Frederick Keeton, 50 S.E.C. 1128, 1136 & n.28 (1992) (noting that the Commission's de novo review of the record "further dissipates the possibility of abuse") (citing cases).

[62] See Rule of Practice 360 (an initial decision does not become final when a petition for review is filed), 17 C.F.R. § 201.360; W. David East, Jr., Exchange Act Rel. No. 43569 (Nov. 16, 2000), 73 SEC Docket 2538 (order dismissing proceeding).

[63] Section 2462 provides that, "[e]xcept as otherwise provided by Act of Congress, an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise, shall not be entertained unless commenced within five years from the date when the claim first accrued." See Johnson v. SEC, 87 F.3d 484, 492 (D.C. Cir. 1996) (holding that Section 2462's limitations period applied to certain Commission administrative proceedings).

[64] See, e.g., SEC v. First City Fin. Corp., 890 F.2d 1215, 1230 (D.C. Cir. 1989); SEC v. Hughes Capital Corp., 124 F.3d 449, 455 (3d Cir. 1997).

[65] See, e.g., SEC v. Bilzerian, 29 F.3d 689, 697 (D.C. Cir. 1994) ("Whether or not [defendant's] securities violations injured others is irrelevant to the question whether disgorgement is appropriate. The primary purpose of disgorgement is not to refund others for losses suffered but rather `to deprive the wrongdoer of his ill-gotten gain.'").

As discussed previously, the law judge found that there were no violations with respect to the second refunding. The Division has not appealed that finding. We decline to consider whether the false warranty outside the limitations period would support First Union's disgorgement of the fees that it received for the second refunding, in addition to those received in connection with the first and third refundings.

[66] 15 U.S.C. §§ 78o(b)(6) and 78o-4(c)(4).

[67] See Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979), aff'd, 450 U.S. 91 (1981).

[68] The Division did not appeal the length of Cawley's suspension.

[69] 15 U.S.C. § 78u-3.

[70] KPMG Peat Marwick LLP, Exchange Act Rel. No. 43862 (Jan. 19, 2001), 74 SEC Docket 384, 436, reh'g denied, Exchange Act Rel. No. 44050 (Mar. 8, 2001), 74 SEC Docket 1351, petition denied, 289 F.3d 109 (D.C. Cir. 2002). These factors are considered by the Commission in determining the appropriate-ness of any sanctions to be imposed in the public interest.

[71] KPMG Peat Marwick LLP, 74 SEC Docket at 1360-61.

[72] Id. at 1360.

[73] Exchange Act Section 21C authorizes the Commission to impose cease-and-desist orders for violations of the Exchange Act or "any rule or regulation thereunder." 15 U.S.C. § 78u-3. Because we find that the imposition of cease-and-desist orders against First Union and Cawley is justified based on the Exchange Act Section 15B(c)(1) violations, we do not address First Union's argument that an MSRB rule violation cannot be the basis for a cease-and-desist order under Exchange Act Section 21C.

[74] See KPMG Peat Marwick LLP, 74 SEC Docket at 429.

[75] See id. at 429-30 & n.120.

[76] We were given cease-and-desist authority in the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 10-429, 104 Stat. 931 (1990).

[77] See S. Rep. No. 101-337, at 19 (1990); H.R. Rep. No. 101-616, at 23 (1990), reprinted in 1990 U.S.C.C.A.N. 1379, 1391-92.

[78] KPMG Peat Marwick LLP, 74 SEC Docket at 433 & 435.

[79] Id. at 434.

[80] 15 U.S.C. § 78u-2. Section 21B specifies a three-tier system for assessing the amount of the penalty. The first tier provides for a maximum of $5,000 for an individual and $50,000 for a firm. Id. The second tier provides for a maximum of $50,000 for an individual and $250,000 for a firm if the misconduct involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement. Id. The third tier provides for a maximum of $100,000 for an individual and $500,000 for a firm if the misconduct involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement, and resulted in, or created asignificant risk of, substantial loss to others or resulted in substantial pecuniary gain to the violator. Id.

The Commission increased the amounts for violations occurring after December 9, 1996, and again, for violations occurring after February 2, 2001. See 17 C.F.R. §§ 201.1001 (1996 adjustment) and 201.1002 (2001 adjustment).

[81] Although we have found that Respondents' conduct justifies second-tier penalties, the penalty assessed against First Union is below the limit for a first-tier penalty which may be assessed for any violative act or omission. See 15 U.S.C. § 78u-2.

[82] 15 U.S.C. § 78u-3(e) (authorizing disgorgement in cease-and-desist proceedings); see also Exchange Act Section 21B(e)

(authorizing disgorgement in monetary penalty proceedings), 15 U.S.C. § 78u-2(e).

[83] First City Fin. Corp., 890 F.2d at 1231; SEC v. Patel, 61 F.3d 137, 139 (2d Cir. 1995); First Jersey Sec., 101 F.3d 1450, 1475 (2d Cir. 1996). Even if the County were ineligible to receive disgorgement, we could still require disgorgement of First Union's ill-gotten gains. See, e.g., First City Fin. Corp., 890 F.2d at 1231.

[84] First City Fin. Corp., 890 F.2d at 1232.

[85] Id.

[86] Contrary to First Union's suggestion, the fees paid to Book in breach of the warranty provision are not the proper measure of its disgorgement liability. These fees do not reflect the financial gain obtained by First Union as a result of its wrongful activities.

[87] We note that the Division and Cawley evaded Rule 450's page limit requirements when they submitted briefs incorporating by reference certain pleadings filed before the law judge. This resulted in their submission of composite briefs that greatly exceeded the page limits set forth in Rule 450(c). The practice of incorporating pleadings submitted before the law judge (or self-regulatory organization) contravenes Rule 450(c). It also "unnecessarily confuses and diffuses the issues presented" on appeal. Fleming v. County of Kane, 855 F.2d 496, 498 (7th Cir. 1988) (per curiam) (parties should not adopt briefs previously

filed in support of motions at the district court level); see also Varda, Inc. v. Ins. Co. of North America, 45 F.3d 634, 640-41 (2d Cir. 1995). Henceforth, we will not consider any briefs that exceed the page limitations in the absence of a duly filed motion.

88 We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

http://www.sec.gov/litigation/opinions/34-48378.htm

Commission Orders – Settled Administrative Proceedings

In the Matter of John S. Reger II, and Business & Financial Advisors, Inc., Securities Act Release No. 7973, A.P. File No. 3-10221 (April 23, 2001).

I.

In these proceedings instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Sections 15(b)(6), 15B(c)(4), 19(h) and 21C of the Securities Exchange Act of 1934 (the "Exchange Act"), respondents John S. Reger II and Business & Financial Advisors, Inc. (collectively, "Respondents"), pursuant to Rule 240(a) of the Securities and Exchange Commission's (the "Commission") Rules of Practice, 17 C.F.R. § 201.240(a), have submitted an Offer of Settlement ("Offer") which the Securities and Exchange Commission has determined to accept.[1] Solely for the purpose of this proceeding and any other proceeding brought by or on behalf of the Commission or in which the Commission is a party, and without admitting or denying the findings contained herein, except for jurisdiction over them and the subject matter of this proceeding, which is admitted, Respondents, by their Offer, consent to the entry of the findings and the imposition of sanctions contained in this Order Making Findings and Imposing Cease-and-Desist Order and Other Relief ("Order").

II.

On the basis of this Order and the Offer submitted by Respondents, the Commission makes the following findings:

1. Respondents

John S. Reger II ("Reger") was at all relevant times the president, sole employee, and sole shareholder of Business & Financial Advisors, Inc.

Business & Financial Advisors, Inc. was at all relevant times a financial consulting firm founded by Reger in 1990 and incorporated in the State of West Virginia.

2. Summary

This case concerns Reger's failure to adequately disclose to an issuer of municipal securities located in the State of West Virginia (the "Board") a payment arrangement relating to the sale of government securities to the Board. Under that payment arrangement, Reger received $104,000 through BFA in return for Reger's selection of a particular broker-dealer (the "Escrow Provider") to serve as the provider of U.S. Treasury securities in a Board advance refunding transaction. Reger breached his fiduciary duty to the Board by not adequately disclosing to the Board the payment arrangement and associated conflicts of interest. Reger also did not disclose to potential purchasers of the Board's advance refunding bonds the payment arrangement or the risk that the payment arrangement might jeopardize the tax-exempt status of the Board's advance refunding bonds.

3. Facts

In 1993, Reger began acting as the Board's financial adviser in connection with a proposal to issue bonds to finance various capital improvements (the "Capital Improvement Bonds"). The Capital Improvement Bonds were ultimately approved by the voters at a bond referendum held in March 1995 and issued by the Board in June 1995.

In January 1995, Reger proposed to the Board that it refinance certain prior indebtedness through the issuance of new "advance refunding" bonds (the "1995 Advance Refunding Bonds").[2] The Board accepted Reger's proposal, and the 1995 Advance Refunding Bonds were issued in March 1995. Reger participated in the drafting, editing and review of the disclosure document (known as an Official Statement) prepared in connection with the public offering of the Board's 1995 Advance Refunding Bonds. Reger also obtained permission from the Board to take various actions in connection with the 1995 Advance Refunding without further authority, particularly the investment of bond proceeds and the delivery of the defeasance securities.

Reger selected the Escrow Provider to act as the escrow securities provider in the 1995 Advance Refunding. Escrow securities providers generally select and sell to an issuer the relevant portfolio of government securities for placement in the defeasance escrow established as part of an advance refunding transaction. Reger did not solicit proposals from any other entities that might be interested in acting as escrow provider for the transaction. Reger had a pre-existing arrangement with the Escrow Provider under which Reger would receive forty percent of the Escrow Provider's profits from the sale of government securities for defeasance escrows. Reger received such payments in three prior advance refunding transactions occurring in 1993. Reger had not disclosed this arrangement to the issuers in those prior advance refunding transactions.

In the 1995 Advance Refunding Reger did not adequately disclose the nature or consequences of the payment arrangement. Reger did not disclose to the Board the existence of the payment arrangement, the size of the payment Reger expected to receive from the Escrow Provider, the basis for calculating that payment, the various potential conflicts of interest resulting from the payment arrangement, or the risk that the payment from the Escrow Provider might jeopardize the tax-exempt status of the Board's 1995 Advance Refunding Bonds.

At the closing for the Board's 1995 Advance Refunding Bonds, a representative of the Escrow Provider executed a fraudulent certificate to the effect that the escrow securities had been sold to the Board at fair market value. The Board's Official Statement did not disclose the payment arrangement or the various implications of that payment arrangement, including, among other matters, the risk that the payment arrangement might jeopardize the tax-exempt status of the Board's 1995 Advance Refunding Bonds.

Consistent with his payment arrangement with the Escrow Provider, in April 1995 Reger received a check from the Escrow Provider made out to BFA in the amount of $168,000, of which BFA retained $104,000. In 1997, the IRS made a preliminary determination that the Board's 1995 Advance Refunding Bonds were taxable. In 1998, the Escrow Provider entered into a settlement agreement with, among others, the IRS that in effect preserved the tax-exempt status of the 1995 Advance Refunding Bonds. Absent this settlement, interest on the bonds might have been declared taxable to bondholders.

Legal Discussion and Findings

Sections 17(a)(2) and (3) of the Securities Act prohibit misrepresentations or omissions of material facts in the offer or sale of any security. Scienter is not required to prove violations of Sections 17(a)(2) or (3). Aaron v. SEC, 446 U.S. 680, 697 (1980). Instead, violations of these sections may be established by showing negligent conduct. SEC v. Hughes Capital Corp., 124 F.3d 449, 453-54 (3d Cir. 1997). For purposes of the Securities Act, a duty to disclose material information may be premised upon a fiduciary relationship, or the existence of a similar relationship of trust and confidence, which results in the party charged with the disclosure obligation being aware that the other party is relying on the relationship in making his or her investment decisions. See Chiarella v. United States, 445 U.S. 222, 228 (1980); United States v. Chestman, 947 F.2d 551, 568 (2d Cir. 1991), cert. denied, 112 S. Ct. 1759 (1992); Zweig v. Hearst Corp., 594 F.2d 1261, 1268 (9th Cir. 1979). A fiduciary relationship can exist between financial adviser and client when the relationship is marked by dependency and influence. Chestman, 947 F.2d at 568-69.

Reger and BFA knew, or should have known, that the tax-exempt status of the Board's 1995 Advance Refunding Bonds was in part dependent upon the purchase of the escrow securities being at "fair market value" as defined in the relevant Treasury regulations. Notwithstanding the Escrow Provider's fraudulent certificate to the contrary, Reger and BFA knew, or should have known, that the $168,000 payment by the Escrow Provider to Reger and BFA from the profits resulting from the sale of the escrow securities indicated that the escrow securities were not purchased in an arm's length transaction nor at fair market value.

Further, Reger and BFA had actual knowledge of the payment arrangement with the Escrow Provider. Notwithstanding Reger's participation in the drafting of the Official Statement, he did not disclose the payment arrangement or the various implications of that payment arrangement, and therefore assisted in preparing a disclosure document that Reger and BFA knew, or should have known, was misleading because it omitted material facts.

Reger and BFA owed a fiduciary duty to the Board, both as a financial adviser on the Capital Improvement Bonds and as agent of the Board in the investment of the 1995 Advance Refunding Bond proceeds in the escrow securities. As a result, Respondents were obligated to disclose all material facts concerning the selection of the Escrow Provider as escrow securities provider and the purchase of the escrow securities. See Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949) (petitioner acted in dual capacity of investment adviser and broker, owed a fiduciary duty to her clients, and violated Section 17(a) by failing to make full disclosure concerning certain securities transactions). Reger's and BFA's failure to make full disclosure of those facts violated Sections 17(a)(2) and (3) of the Securities Act.

Section 8A of the Securities Act authorizes the Commission to enter a cease-and-desist order against an individual who has violated any provision of the Securities Act.

Based on the foregoing, the Commission finds that Reger and BFA committed violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act.

III.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions specified in the Offer submitted by Respondents.

Accordingly, **IT IS HEREBY ORDERED** that Reger and BFA cease and desist from committing or causing any violation and any future violation of Sections 17(a)(2) and 17(a)(3) of the Securities Act.

IT IS FURTHER ORDERED that Respondents shall pay disgorgement and prejudgment interest totaling $128,817.00 to the United States Treasury. Such payment shall be: (1) paid within twenty-one days after service of this Order; (2) made by United States postal money order, certified check, bank cashier's check or bank money order; (3) made payable to the Securities and Exchange Commission; (4) hand-delivered or mailed to the Comptroller, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Alexandria, Stop 0-3, VA 22312; and (5) submitted under cover letter that identifies John S. Reger II and Business & Financial Advisors, Inc. as Respondents in these proceedings and the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Ronald C. Long, District Administrator, Philadelphia District Office, Securities and Exchange Commission, 601 Walnut Street, Suite 1120 E., Philadelphia, PA 19106.

By the Commission.
Jonathan G. Katz
Secretary

Footnotes

[1] An Order Instituting Public Proceedings against Respondents was issued by the Commission on June 9, 2000.

[2] In a typical advance refunding, a public entity issues new "refunding" bonds and immediately invests the proceeds in a portfolio of U.S. Treasury or agency securities structured to pay the principal of and interest on old bonds up to and including the date on which the old bonds can be retired, either at maturity or at an earlier call date. The portfolio of government securities is normally placed in a segregated account known as a defeasance escrow to guarantee repayment of the old bonds. Defeasance escrow portfolios are subject to Internal Revenue Code provisions and Treasury regulations that prohibit the issuer of tax-exempt refunding bonds from earning tax arbitrage (that is, a profit from the rate differential between the taxable and tax-exempt markets). In addition, to prevent an issuer from diverting tax arbitrage to the seller of the escrow securities by paying artificially high prices, the relevant regulations provide, in effect, that the price paid by refunding bond issuers for escrow securities purchased in the secondary market cannot exceed the fair market value of the securities as defined in those regulations. The relevant regulations generally define "fair market value" as the price at which a willing buyer would purchase the investment from a willing seller in a bona fide, arm's length transaction. A failure to comply with the applicable regulations could threaten the tax-exempt status of the refunding bonds. A determination that purportedly tax-exempt refunding bonds were in fact taxable would significantly reduce the market value of those bonds.

http://www.sec.gov/litigation/admin/33-7973.htm

In the Matter of RBC Dain Rauscher Incorporated, as successor to Rauscher Pierce Refsnes, Inc., Securities Act Release No. 8121, Exchange Act Release No. 46346, A.P. File No. 3-10863 (August 13, 2002).
See "UNDERWRITERS" section.

In the Matter of Kenneth D. Ough, Securities Act Release No. 8141, Exchange Act Release No 46736, A.P. File No. 10922 (October 29, 2002).
See "UNDERWRITERS" section.

ATTORNEYS

Injunctive Proceedings

SEC v. Terry Richard Martin, Silver Legacy Corporation, Silver Sound LLC, Jonas David Smith, Michael W. McCall, Charles J. Tull, Ibis Securities LLC, Kenneth R. Martin, George Tamura, Goldman Sig, Inc., Edward L. Tezak, Signal Mortgage Inc., and John H. White, Civ. Action No. C 03-2646 C (W.D. Wash.), Litigation Release No. 18315 (August 28, 2003) (complaint).
See "OBLIGATED PERSONS" section.

ACCOUNTANTS/AUDITORS

Injunctive Proceedings

<u>SEC v. William F. Buettner, Mark D. Kirstein and Amy S. Frazier</u>, Civ. Action No. 01-CV-3898 (E.D. Penn.), Litigation Release No. 17083 (August 1, 2001) (complaint).

The Securities and Exchange Commission announced today that it filed a complaint in the United States District Court for the Eastern District of Pennsylvania charging three senior Coopers & Lybrand, LLP ("Coopers," now PricewaterhouseCoopers, LLP) certified public accountants with securities fraud in connection with their audit of the consolidated financial statements of Allegheny Health, Education and Research Foundation ("AHERF") for the year ending June 30, 1997. Named as defendants are William F. Buettner, the engagement partner on the audit; Mark D. Kirstein, the senior manager on the audit; and Amy S. Frazier, the manager on the audit in charge of, among other things, auditing accounts receivable and bad debt reserves.

The Commission's complaint alleges that defendants Buettner, Kirstein and Frazier actively participated in a fraudulent scheme by AHERF, at its height the largest nonprofit healthcare organization in Pennsylvania, to mask its deteriorating financial condition. In so doing, the defendants participated in the creation and issuance of, and failed to correct unqualified audit opinions on AHERF's 1997 consolidated financial statements and AHERF's 1997 supplementary consolidating and combining financial information. For its fiscal year 1997, AHERF reported net income when, in reality, it was operating with a substantial net loss.

The scheme involved the fraudulent transfer of $99.6 million of reserves from the books of a recently-acquired entity to the books of a group of AHERF-related entities collectively known as the Delaware Valley Obligated Group ("Delaware Valley"). The transferred reserves were used by Delaware Valley to either increase its own reserves or to reduce expenses related to the write-off of uncollectible accounts receivable. The defendants played an active role in the fraud by, among other things, helping AHERF plan fraudulent transfers of reserves and then conducting the 1997 audit in a manner intended to hide both the fraud and their involvement in it.

Furthermore, they failed to expand their audit to address the improper transfers, or to investigate evidence of other non-GAAP transfers, as required by GAAS.

Ultimately, the defendants knowingly or recklessly caused Coopers to issue false and misleading unqualified audit opinions and related documents for 1997 that enhanced the credibility of AHERF's reported financial statements. The audited financial statements with attached consolidating schedules were made available to, among others, investors in AHERF-related bonds. The audit opinions falsely state, among other things, that the audit was conducted in accordance with Generally Accepted Auditing Standards ("GAAS") and that the financial statements were in accordance with Generally Accepted Accounting Principles ("GAAP") and fairly presented AHERF's financial condition. The financial statements, issued by AHERF in February 1997, materially misrepresented that AHERF and Delaware Valley had net income of $21.9 million and $23.7 million, respectively, for fiscal year 1997. Absent the fraud, AHERF and Delaware Valley would have posted substantial net losses of approximately $37.7 million and $35.9 million respectively.

On July 21, 1998, AHERF filed for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code on behalf of itself and four of its subsidiaries in the U.S. District Court for the Western District of Pennsylvania. By the time of the bankruptcy filing, one or more of the obligated groups were responsible for repaying a total of more than $900 million of outstanding AHERF Bonds. Subsequently, on September 2, 1998, AHERF issued a press release in which it acknowledged that its audits consolidated financial statement for 1997 were inaccurate. In the release, AHERF stated that "[n]o further reliance should be placed on the financial statements or the [Coopers] report thereon."

The complaint charges defendant Buettner with violating, and defendants Kirstein and Frazier with violating or aiding and abetting Buettner's violations of, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. The complaint seeks permanent injunctive relief and an order requiring the defendants to pay civil penalties.

See SEC v. David W. McConnell and Charles P. Morrison, SEC Litigation Rel. No. 16534, Accounting and Auditing Enforcement Rel No. 1254 (May 2, 2000) and SEC Lit. Rel. No. 16885, Accounting and Auditing Enforcement Rel. No. 1365 (Jan. 1, 2001); In the Matter of Albert Adamczak, CPA, Exchange Act Rel. No. 42743 (May 2, 2000); In the Matter of Stephen H. Spargo, CPA, Exchange Act Rel. No. 42742 (May 2, 2000); In the Matter of Allegheny Health, Education and Research Foundation, Exchange Act Rel. No. 42992 (June 30, 2000); In the Matter of Charles P. Morrison, CPA, SEC Litigation Rel. No. 16885, Accounting and Auditing Enforcement Rel. No. 1365 (Jan. 1, 2001).

http://www.sec.gov/litigation/litreleases/lr17083.htm

Commission Orders – Settled Administrative Proceedings

In the Matter of Charles P. Morrison, CPA, Exchange Act Release No. 43910, A.P. File No. 3-10415 (January 31, 2001).

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted against Charles P. Morrison ("Morrison") pursuant to Rule 102(e) of the Commission's Rules of Practice.[1]

In anticipation of the institution of these proceedings, Morrison has submitted an Offer of Settlement ("Offer") which the Commission has determined to accept. Solely for the purpose of this proceeding and any other proceedings brought by or on behalf of the Commission or in which the Commission is a party, and without admitting or denying the findings contained herein, except for those set forth below in Section II, paragraph C., which are admitted, Morrison, by his Offer, consents to the entry of the findings and imposition of sanctions contained in this Order Instituting Public Proceedings, Making Findings and Imposing Sanctions ("Order").

Accordingly, **IT IS ORDERED** that proceedings against Morrison be, and hereby are, instituted.

II.

On the basis of this Order and the Offer submitted by Morrison, the Commission finds that:

A. **Allegheny Health, Education and Research Foundation** ("AHERF") is a Pennsylvania nonprofit healthcare organization formed in 1983. Until 1998, it was the parent holding company and sole member or owner of numerous subsidiaries. On July 21, 1998, AHERF instituted bankruptcy proceedings under Chapter 11 of the United States Bankruptcy Code on behalf of itself and four of these subsidiaries in the U.S. District Court for the Western District of Pennsylvania.

B. **Charles P. Morrison**, age 41, resides in Venetia, Pennsylvania. He has been licensed in the state of Pennsylvania as a certified public accountant since 1983. From at least 1994 through August 1998, Morrison was the chief financial officer of a group of AHERF subsidiaries collectively known as the Delaware Valley Obligated Group ("Delaware Valley"). Morrison also was an AHERF Senior Vice President of Finance and Treasurer for related entities of AHERF based in the Delaware Valley. Prior to joining AHERF, Morrison worked as an accountant for a large accounting firm for eight years. In that position Morrison participated in one or more audits of the financial statements of public companies, which were included in filings with the Commission.

C. On January 31, 2001, a Final Judgment and Order was entered against Morrison by the United States District Court for the Eastern District of Pennsylvania, in Securities and Exchange Commission v. David W. McConnell, et al., Civil Action No.

00-2261, pursuant to his consent. The Final Judgment and Order permanently enjoined Morrison from future violations of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder; and ordered him to pay a civil penalty in the amount of $25,000.

D. The Commission's Complaint alleged that, as an umbrella holding company, AHERF managed and provided centralized corporate support services for the acquired entities, but did not assume liability for their pre-existing debt. The obligation to repay debt within AHERF was placed on collections of one or more of its non-profit subsidiaries known as "obligated groups."

E. The Commission's Complaint alleged that, pursuant to contractual obligations, the obligated groups, through AHERF as their agent, provided to nationally recognized repositories annual Secondary Market Disclosure Reports ("Disclosure Reports") containing audited financial statements prepared in accordance with Generally Accepted Accounting Principles ("GAAP"), debt coverage ratios and other information. These Disclosure Reports were made available to the public through these repositories and were the most easily accessible source of information for investors and potential investors in AHERF bonds.

F. The Commission's Complaint further alleged that AHERF made material misstatements in documents issued to the public in December 1996 and February 1998. Among other things, in published financial statements, AHERF overstated: (a) the 1996 income of Delaware Valley by approximately $40 million; (b) the 1997 income of AHERF by approximately $59.6 million; and (c) the 1997 income of Delaware Valley by approximately $59.6 million.

G. The Commission's Complaint alleged that, from at least December 1996 through July 1998, Morrison violated Section 10(b) of the Exchange Act and Rule 10b-5 by, among other things, creating, reviewing and approving false financial statements and Disclosure Reports of AHERF and Delaware Valley, thereby masking AHERF's severely deteriorating financial condition. The Complaint further alleged that, in accordance with Delaware Valley obligations under certain debt agreements, Morrison falsely certified to the Delaware Valley bond trustee and others that the 1997 audited financial statements fairly presented the consolidated financial position and the results of operations for AHERF, including Delaware Valley, as of and for the fiscal year ended June 30, 1997, and that they were prepared in accordance with GAAP.

III.

On the basis of the foregoing, the Commission deems it appropriate and in the public interest to accept the Offer submitted by Morrison and to impose the sanctions specified therein.

Accordingly, **IT IS HEREBY ORDERED**, effective immediately, that:

A. Morrison is suspended from appearing or practicing before the Commission as an accountant.

B. After three years from the date of this Order, Morrison may request that the Commission consider his reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:

1. a preparer or reviewer, or a person responsible for the preparation or review, of any public company's financial statements that are filed with the Commission. Such an application must satisfy the Commission that Morrison's work in his practice before the Commission will be reviewed either by the independent audit committee of the public company for which he works or in some other acceptable manner, as long as he practices before the Commission in this capacity; and/or

2. an independent accountant. Such an application must satisfy the Commission that: (a) Morrison or the firm with which he is associated is a member of the SEC Practice Section of the American Institute of Certified Public Accountants Division for CPA Firms ("SEC Practice Section"); (b) Morrison or the firm has received an unqualified report relating to his or the firm's most recent peer review conducted in accordance with the guidelines adopted by the SEC Practice Section; and (c) as long as Morrison appears or practices before the Commission as an independent accountant, he will remain either a member of the SEC Practice Section or associated with a member firm of the SEC Practice Section, and will comply with all applicable SEC Practice Section requirements, including all requirements for periodic peer reviews, concurring partner reviews, and continuing professional education.

C. The Commission's review of an application by Morrison to resume appearing or practicing before the Commission may include consideration of, in addition to the matters referenced above, any other matters relating to Morrison's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.
Jonathan G. Katz
Secretary

Footnotes

[1] Rule 102(e)(3)(i), in relevant part, provides that the Commission may suspend from appearing or practicing before it any accountant who by name has been permanently enjoined, by a court of competent jurisdiction in an action brought by the Commission, from violating any provision of the federal securities laws or the rules and regulations thereunder. 17 C.F.R. 201.102(e)(3)(i)(A).

http://www.sec.gov/litigation/admin/34-43910.htm

CONSULTANTS

Injunctive Proceedings

SEC v. Manoucher Sarbaz, Pacific Golf Community Development LLC and Lee Andrew Hill, Civ. Action No. CV 03 1310 JSL (CTX) (C.D. Cal.), Litigation Release No. 18001 (February 26, 2003) (complaint).
See "OBLIGATED PERSONS" section.
SEC v. Terry Richard Martin, Silver Legacy Corporation, Silver Sound LLC, Jonas David Smith, Michael W. McCall, Charles J. Tull, Ibis Securities LLC, Kenneth R. Martin, George Tamura, Goldman Sig, Inc., Edward L. Tezak, Signal Mortgage Inc., and John H. White, Civ. Action No. C 03-2646 C (W.D. Wash.), Litigation Release No. 18315 (August 28, 2003) (complaint).
See "OBLIGATED PERSONS" section.

SALES PRACTICES

Administrative Proceedings – Commission Decisions

In the Matter of Mark David Anderson, A.P. File No. 3-9499, Initial Decision Release No. 203 (April 30, 2002) (initial decision of administrative law judge).

Appearances: Aimee Dominguez Silvers and Michael R. Wilner
for the Division of Enforcement,
Securities and Exchange Commission

Elizabeth Lowery for Respondent Mark David Anderson

Before: Lillian A. McEwen, Administrative Law Judge

Summary

This Decision concludes that Respondent Anderson did not violate the federal securities laws as alleged in the instant case and dismisses the proceeding against him.

Procedural History

On December 4, 1997, the Securities and Exchange Commission (Commission) issued an Order Instituting Proceedings (OIP) pursuant to Section 8A of the Securities Act of 1933 (Securities Act) and Sections 15(b), 15B, 19(h), and 21C of the Securities Exchange Act of 1934 (Exchange Act). On July 7 through 9, 1998, a public hearing was held in Los Angeles, California.

The Division of Enforcement (Division) called four witnesses, including Respondent Mark David Anderson (Anderson). Anderson testified on his own behalf and called one additional witness. I admitted twenty-four joint exhibits, four exhibits for the Division, and ten exhibits for Anderson.[1]

Pursuant to the Administrative Procedure Act, 5 U.S.C. § 557(c), and the Commission's Rules of Practice, 17 C.F.R. § 201.340, the following posthearing pleadings were considered: (1) the Division's Post-Hearing Brief, dated September 10, 1998; (2) Anderson's Post-Hearing Brief, dated October 9, 1998; and (3) the Division's Post-Hearing Reply Brief, dated November 18, 1998.

Issues Presented

The OIP alleges that Anderson charged undisclosed, excessive markups and markdowns that violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. It also alleges that Anderson's undisclosed, excessive markups and markdowns aided and abetted and caused Armscott Securities Ltd. (Armscott) to violate Sections 15(c)(1) and 15B(c)(1) of the Exchange Act and Rule 15c1-2 thereunder, and Rules G-17 and G-30 of the Municipal Securities Rulemaking Board (MSRB). If I conclude that the allegations in the OIP are true, I must then determine what, if any, remedial sanctions are appropriate pursuant to the federal securities laws. The Division requests a cease-and-desist order, a third-tier civil penalty in the amount of $188,050, and disgorgement of $182,195 with prejudgment interest of $20,854. It also seeks a bar from owning or being associated with a broker, dealer, or municipal securities dealer, with the right to reapply after no less than three years.

Findings of Fact

The findings and conclusions in this Decision are based on the record and the demeanor of the witnesses who testified at the hearing. Preponderance of the evidence was applied as the standard of proof. See Steadman v. SEC, 450 U.S. 91

(1981). All arguments and proposed findings and conclusions that were inconsistent with this Decision were rejected. I find the following facts to be true.

Respondent Mark David Anderson

Anderson earned a bachelor's degree in business and marketing from Indiana University. From 1981 until 1984 he was an investment manager for a small conservative pension fund. In 1983, he acquired his general securities representative license, or Series 7. (Tr. 410.) Anderson worked at various brokerage firms from 1984 through 1988, performing back office functions such as processing and settling trades, opening accounts, coordinating activities with the clearing firm, and wiring money. (Tr. 412-13.) He also learned how to research bonds and participate in the bond market. (Tr. 414.) During the mid-1980s, Anderson obtained the following securities licenses: Series 24, the general securities principal license that allows you to supervise people who have a Series 7 and manage the securities business of a brokerage firm; Series 27, the financial and operations principal license that allows you to be a financial principal of a broker-dealer, and gives you responsibility for the firm's books and records; Series 53, the municipal securities principal license that allows you to supervise registered representatives or brokers who trade municipal securities, and requires you to be familiar with the rules in the area of municipal securities; Series 63, a general state license; and Series 4, the options principal license. (Tr. 388-92, 414.) Anderson was a registered representative for a brokerage firm based out of Santa Barbara, California for about a year and then in 1989, he went to Annandale Securities, Inc. (Annandale), another brokerage firm. (Tr. 417.)

Initially, Anderson served as a registered principal at Annandale. (Tr. 395.) Anderson later bought the firm from the original owner and became its president from the early 1990s until December 1994, when the firm withdrew its registration. (Tr. 394-95, 417.) For about 90% of the time, the only employees of Annandale were Anderson, an assistant, and a part-time receptionist. (Tr. 419.) At Annandale, Anderson dealt directly with the customers and was responsible for executing the trades. (Tr. 396.) Bonds were purchased for customers only if there was already a customer order in hand. (Tr. 398.) Anderson purchased the bonds from other dealers, temporarily placed the bonds into Annandale's trading account, and shortly thereafter sold the bonds to customers. (Tr. 397.) Customers were charged a higher price than what Anderson paid the other dealers to get the bond. The difference between the price Anderson paid for a security and the price it was sold to the customer is the markup. The process was reversed when a client wanted to sell bonds. Anderson bought the bond from a customer, placed it in Annandale's trading account, and then sold it to another dealer at a higher price. The difference between the price paid to the customer for the bond and the price Anderson sold it to another dealer is the markdown. (Tr. 396-99, 586.) Anderson determined the size of the markup or markdown charged. (Tr. 396.) He received 100% of the markup or markdown charged to Annandale customers. (Tr. 420.) Annandale was not a market maker for any of the bond trades that occurred in 1992 through 1994. By taking securities into inventory for a very short period of time, Annandale acted in a riskless principal capacity. (Tr. 397-99.)

From 1990 through March 1997, Anderson was the president and registered principal of Armscott, a registered broker-dealer. Armscott "sub-cleared" through Annandale; Armscott used Annandale's relationship with a clearing firm to process its trades until December 1994. (Tr. 396, 418, 422, 425; Jt. Ex. 24 at 2.) Armscott was owned by A.

Morgan Maree (AMM), a registered investment adviser. (Tr. 423, 425.) Anderson was responsible for executing trades at Armscott, and determining the size of the markup or markdown charged; however, he did not deal directly with Armscott's customers. (Tr. 396, 426, 430.) All of Armscott's customers were clients of AMM, the investment adviser. AMM would request that Anderson find bonds. He would then report to the investment adviser, who would decide whether or not to buy the bonds for its clients. (Tr. 426; Jt. Ex. 24 at 2.) Anderson received 20% of the markups or markdowns charged to Armscott's customers. (Tr. 426; Resp. Ex. 2.) Armscott also acted as a riskless principal and was not a market maker. (Tr. 397, 400.) In March 1997, Anderson went to Euro Pacific Capital, Inc. (Tr. 418.)

Anderson's Practice

From 1992 to 1997, Anderson had only 15 clients, out of a total of 300 to 400 clients, who traded bonds. His clients were knowledgeable investors with safety of principal being the most important factor for investment. (Tr. 453-57, 457-59, 535.) Anderson acquired a niche by prospecting registered investment advisers and financial planners for Fortune 500 company executives, who were looking for tax-free bonds for wealthy clients. (Tr. 484-85.) He showed them offerings in unique areas, at more of a discount. Eventually, the executives retired or left the planning service, and Anderson acquired them as clients by referral. (Tr. 484-85.) The bonds that Anderson traded were unique because they were either smaller issues or had features that were confusing and required experience. As a result, the bonds were usually underpriced or undervalued in the marketplace. Anderson believed that additional yield could be obtained by buying something that most brokers had not taken the time to evaluate. (Tr. 488-89.)

The primary factor that Anderson used to calculate the markup or markdown was the yield to the client. (Tr. 473-74.) He defined yield as "what the client receives on his investment dollars," with the price paid for the bond being "a component of the yield." Every markup differed in percentage because Anderson intentionally "factored yield into it." (Tr. 474.) Anderson believed he charged "a fair price" because he picked a point "somewhere in the middle of the yield charts, between non-rated and AAA, and what [he] thought was competitive to the client." He then "saw what was left over," after he "stayed under the NASD guidelines." (Tr. 474-75.) Thus, if Anderson and the client agreed on the yield, Anderson considered them to have "agreed on the price." Anderson acquired this method of pricing the markup or markdown from two brokers who taught him how to run a small firm. He was not aware of any other way to calculate a markup on a municipal bond transaction, and always assumed that if "the yield was not competitive, the client would not buy it." (Tr. 588.) The same method to calculate markdowns for municipal bond trades was used when a client wished to sell a security. (Tr. 589.)

Anderson did not subscribe to Bloomberg, Thompson, or Munifax data information services because the Bloomberg service alone would cost him $5,000 a month. He also did not subscribe to the Blue Sheet, Bond Buyer, or other publications of bond offerings, and lacked a functioning bond-yield calculator. (Tr. 582-85.) However, Anderson read five to twelve financial publications a month. (Tr. 540.) He also had a computer with quotations and clearing firm information accessible on it, and he calculated his markups and markdowns by locating a bond, describing it to his client, offering a yield to the client and then buying the security from another dealer and selling it to the client. (Tr. 584-85.) For municipal bonds, Anderson had other dealers use their bond yield calculators to quote for him "different yields at different prices," and from them he selected a yield to present to the client. In this manner, Anderson determined the price to the client and his own compensation, which might be as low as 1% or any figure up to 5% for municipal bonds. (Tr. 586-87.) Anderson believed he communicated his markups and markdowns by letting his clients know what their yield would be on the bonds if they bought or sold them. (Tr. 457-60.) Anderson did not keep his working notes, faxes from other dealers, or rate yield tables because he never thought he would need them to explain his trades. (Tr. 459.)

Anderson knew that the dealers quoted him accurate yields in these conversations because the next day Anderson's clearing firm routinely calculated the yield-to-call and the yield-to-maturity on the sale, as well as the price to the client. (Tr. 480-81.) He never asked another dealer what a competitive markup or markdown would be for a bond, because "you know what's competitive by the yield. . . . [T]he yield is a function of price, so the yield is what it is and the price is what it is. So, it doesn't matter if they're saying I'm charging [1%] or I'm charging [5%], if the yield's no good, it doesn't matter." (Tr. 482.) Whether a bond was rated AAA or non-rated was therefore not a factor in the amount of the markup or markdown. For Anderson, every trade was unique, although he could not recall their circumstances. (Tr. 483.)

Anderson also knew that he was selling bonds to his clients at competitive rates because he compared yields by searching the daily financial services for Treasury and tax-free bond trades. (Tr. 475-76.) There is no quoted market for municipal bonds, so institutional rate charts, which give a compilation of where all the tax-free instruments are trading for different maturities and qualities on that day, were used. Because Anderson did not have a bond-yield calculator, and "could never figure" the yield out with a regular calculator, other dealers helped him calculate markups. They might tell him that a certain markup would be too high because "it's going to kill the yield." Anderson thought that the "input" that he obtained from various dealers and the range of points he discussed with them to arrive at his markup and markdown figures for his clients were consistent with industry standards. (Tr. 476-79.)

The Thompson yield chart for September 24, 1993, is a typical source that Anderson used for a compilation of bond prices that generated a matrix yield curve for the industry. (Tr. 494-95; Resp. Ex. 4.) Anderson used a chart like it to begin his search for bonds in 1993 so that he would know what the institutional market was before markup or markdown. (Tr. 496-98.) He knew that the markup or markdown always reduced the principal amount that the holder could earn interest on and that it thus reduced the benefit of compounding; the total yield therefore changes, up to the maturity date, although the stated coupon bond rate never changes. (Tr. 498-500.) He also knew that the higher the markup the lower the yield. Anderson thought that he generally charged a smaller commission on a shorter-yield-time bond. (Tr. 501.) The Thompson yield chart for December 23, 1993, on the buy side is an example of sources Anderson used in making trades. (Tr. 521-22; Resp. Ex. 5.) Anderson believed that the clearing-statement yield after Anderson's markup was consistent with the yield for the industry. (Tr. 524-28; Jt. Ex. 6 at 4.) Anderson believed that he used common sense, the "interest rates of the day," and the yield calculations of the dealers from whom he bought bonds to determine what fair compensation should be. (Tr. 533-534.)

Anderson priced his markups and markdowns on municipal business, government obligations, agency business, "Ginnie Maes, and CMOs and the Freddie Macs" in the same way, calculating the paydown history for mortgage tranches and evaluating interest rates. He based all of his markup and markdown percentages on yield calculations, just as he understood other brokers did. (Tr. 616-17.) Anderson was the only registered representative at the firms who traded the bonds at issue, and no compliance officer or other executive reviewed Anderson's trades at Annandale or Armscott. (Tr. 625-26.)

The following table summarizes the number of the ninety-six trades at issue in the instant case at each percentage of markup or markdowns ranked from highest to lowest. (Jt. Ex. 24 at 7-12.)

The Trades

U.S. Treasury Securities		Government Agency Securities	
Markups		Markups	
No. @	%	No. @	%
1	4.01	1	4.07
2	4.00	1	4.04
1	2.99	1	4.01
		3	4.00
Markdowns		4	3.50
No. @	%		
		1	3.36
1	3.87	3	2.99
1	3.78	1	2.93
2	2.99	1	2.50
1	2.94	1	2.29
1	2.91	1	2.04
1	2.88	1	1.91
1	2.86	1	1.42
1	2.82		
1	2.79		
1	2.76		
1	2.75		

Municipal Securities

Markups

No. @	%
2	5.00
1	4.88
1	4.81
1	4.78
1	4.66
1	4.59
1	4.49
1	4.48
1	4.38
1	4.31
3	4.30
2	4.29
1	4.26
1	4.24
1	4.21
1	4.12
1	4.09
1	4.05
1	4.04
3	4.00
2	3.99
2	3.96
1	3.93
1	3.92
1	3.85
1	3.79

Markups (cont'd)

No. @	%
1	3.76
2	3.75
1	3.73
1	3.66
1	3.60
1	3.52
3	3.50
1	3.46
1	3.40
1	3.39
1	3.25
1	2.98
1	1.87

Markdowns

No. @	%
1	5.64
1	5.16
1	4.99
1	4.83
1	4.71
1	4.52
1	4.32
1	3.97
1	3.29
1	3.02

Anderson was aware of his responsibility to price securities "to the worst possible circumstances," but he believed that he could price a bond as if it would be a twenty-year bond in spite of a possible one-year call feature. This belief was based on his knowledge of the practice of other smaller regional firms. (Tr. 594.) Anderson also believed that his obligation to set a fair and reasonable price for a security allowed him to inform his client of his opinion that the first call date was irrelevant and then to ignore that call feature and price the bond as a twenty or thirty-five-year bond instead of a four-year bond. Although the "price to the first call was a factor," Anderson priced bonds for his clients based on his estimate of the "ultimate maturity" of the bond. (Tr. 595.) Anderson would still inform the client of the yield in "the worst case possible thing that could happen" however. (Tr. 592-94.) The customer confirmation slip states the yield to call, or the "worst-possible return" to the investor. (Tr. 636.)

Factors such as nature and availability of the bonds in the market and the size of the trades were all computed in the yield for the markup. (Tr. 635-36.) Bonds are more likely to be called when interest rates move down, because debt may be refinanced at a lower rate. For the last three years, interest rates have moved drastically downward. (Tr. 637-38.) If Anderson's clients had bought bonds through a mutual fund, they would have paid higher fixed fees and costs and higher management and sales fees than Anderson charged for his commissions. (Tr. 640-41.) Anderson earned $55,000 in 1993 and 1994; he earned $70,000 in 1995; and in 1996 and 1997, he earned in the mid-sixties. (Tr. 648-49.)

The NASD Reviews

In a November 29, 1993, NASD exit interview Anderson had markups of 4.3% to 5.6% brought to his attention in nine municipal trades at Annandale. (Tr. 546-47; Resp. Ex. 6 at 2.) He was also notified of "40 of 140 riskless principal trades reviewed" where markups and markdowns were between 5% and 5.3%. (Resp. Ex. 6 at 1.) Anderson made some refunds to clients. (Resp. Ex. 6 at 2-9.) On January 19, 1995, a consent order was entered by the NASD against Anderson and Annandale; they neither admitted nor denied making eleven sales with markups of 15% to 87.5% where all occurred over four days and all involved a single security. Anderson and Annandale were fined jointly and severally in the amount of $5,000, ordered to reimburse the firm's share of 20% of the total markups charged, and censured. (Jt. Ex. 23 at 4-5.) An NASD letter to Anderson, dated June 8, 1995, showed gross profit of $8,511 from a sample of markups and markdowns of 4.32% to 5.64%, and was the basis for Anderson's refund of charges over 5% to clients. (Resp. Ex. 7 at 6.) Most markups and markdowns were between 3.5% and 5.0%. (Tr. 555-559; Resp. Ex. 7.) On February 1, 1996, Anderson received a letter of caution from NASD associate director Daniel Stefak requesting a written response from Anderson recounting steps "to ensure future compliance" in reference to twelve municipal transactions with "excessive" markups and markdowns from 4.32% to 5.64%. It included a schedule of the municipal trades with a column titled "DBCC Guideline Markup," which listed 3% to 3.5% as the acceptable markup range. Anderson interpreted this subsequent letter to mean that a markdown or markup of 3% to 3.5% "is where they've moved it to now, and this is what I should use." (Tr. 563, 566-67, 572-73; Resp. Ex. 8.)

Anderson began to use the new, lower figure for his bond markups and markdowns. (Tr. 563.) However, he never reviewed his earlier bond trades to ensure that those markups and markdowns were rebated to clients pursuant to the schedule generated by NASD reviewers because he believed that the new standard applied to future bond trades, not past ones. (Tr. 565-67.) Anderson did give "a real good break" to three or four clients on future trades to make up for the old markups and markdowns that the NASD found excessive. (Tr. 568.) Thus Anderson refunded markups and markdowns over 5% back to 1993 because that was what he interpreted the NASD instruction to be. (Tr. 568-69.) Anderson thought that he was asked to rebate past markups and markdowns over 5% and that he was to use 3% to 3.5% as a guideline for future bond markups and markdowns, pursuant to the NASD exit interview and the subsequent letter. (Tr. 564.) On November 26, 1996, an exit interview also transpired between Armscott and an NASD reviewer. It refers to two municipal trades at 3.4% and 5.5% that exceed the NBCC guideline but not the DBCC guideline. (Resp. Ex. 9.)

In June 1998, Anderson contacted the Commission and requested its policy on markups and markdowns on municipal bonds and government obligations. The Commission responded with fee guidelines that Anderson did not find helpful. He believes that his fees from 1992 through 1997 were fair and reasonable (Tr. 573-77; Resp. Ex. 10.)

From December 15, 1992, through March 5, 1997, Anderson's bond trades included markups and markdowns ranging from 1.42% to 5.64%. (Jt. Exs. 1-22, Jt. Ex. 24 at 7-12.) Anderson received only 20% of commissions from many sales because of his fee-splitting arrangement with the investment adviser. (Tr. 426; Resp. Ex. 2.) The OIP was issued on December 4, 1997.

Industry Practice

The following witnesses were qualified as experts and testified as to industry practice: Fred Schwarz was qualified as an expert on sales practices regulated by the NASD; Robert MacLaverty was qualified as an expert on how the industry determines markups and markdowns for Treasury notes, Treasury strips, specified pools, and CMOs; Peter McCabe Jr. was qualified as an expert in the area of trading municipal securities, including markups and markdowns and sales practices; and Allissa Johnson qualified as an expert in the area of sales practices in the securities industry and NASD procedures. (Tr. 47, 100, 195, 359.) I have adopted the opinions of the experts only to the degree that they are described here.

One of the responsibilities of the NASD is to keep member firms informed of the guidelines and rules that apply to the securities industry through monthly notices and a manual that is periodically updated. (Tr. 50.) The NASD has a 5% markup and markdown guideline for equities, but deviations below 5% do not automatically mean the transaction was priced correctly, and deviations above 5% do not necessarily mean the price was wrong. (Tr. 52-53.) There is no similar guideline for municipal securities. (Tr. 54.)

In August 1994, an internal NASD staff memorandum sent to district directors from the staff committee on municipal markups discussed the range of threshold markup and markdown percentages, from 2.5% to 5%, for municipal securities among the eleven NASD district offices. (Tr. 56-57; Resp. Ex. 1.) The memorandum was part of an NASD plan to establish a national, consistent standard for municipal securities markup so that NASD examiners could have a baseline for a determination of reasonableness. (Tr. 79-82.) Once a baseline is determined, all NASD examiners would be operating within the same parameters and could then consider the reasonableness of anything outside of those parameters. For example, the effort involved in locating the specific number of certain bonds would be a consideration that may justify a higher markup. Large firms that can afford to subscribe to information services, or that have bond desks would put forth less effort to locate specific bonds and as a result, charge a lower markup. (Tr. 80-83.) Smaller denominations of bonds would be marked up higher than a large block of bonds. (Tr.

84-85.) It is also not unusual for small, retail investors to be charged larger markups than large institutional investors. (Tr. 85.)

Between December 1992 and March 1997, thirty-six out of a total of 111 of Anderson's bond transactions failed to conform to markup custom and practice in the securities industry. (Tr. 106-07.) Some markdown amounts also deviated from industry practice. When customers came to Anderson to sell Treasury notes, he quoted a bid that was lower than the price he in turn sold them for, to another dealer; the bid and ask prices are the prices at which dealers trade, not the public. (Tr. 106-07, 168, 204-11.) The markups for CMOs were also deviations from industry custom and practice for markups. (Tr. 109.) The bid-ask spread for U.S. Treasury notes of 2/32 to 3/32 has not changed since 1992. U.S. Treasury notes, strips, and mortgage pools usually have a spread of 4/32 to 6/32. (Tr. 109-13.) CMOs have bid-ask spreads of 1/4 to 3/4. (Tr. 113-14.) Brokers know the bid-ask spread for a bond by attending seminars, talking to dealers, and learning about the bond from computer research techniques and market makers. (Tr. 113-16.)

A single percentage cutoff to determine the appropriateness of a markup or markdown is not a good idea in fixed-income securities because each sector of the market behaves very differently. (Tr. 118.) The transactions in the instant case were riskless principal transactions, for Anderson, and carried only execution risk, which is minimal; Anderson traded "with an order in hand and he leaned on that order when he bought them in from another dealer and just filled it." (Tr. 119.) For analysis of the retail market, one should double "what would have been fair in the institutional world" to arrive at the standard for a markup in the instant case. (Tr. 120.) The spread between the bid and ask prices "would give you a guideline as to what a markup, a reasonable markup, could and should be. . . . At that particular time, under those market circumstances." (Tr. 122.) One should use "various wire services" to determine "market environment at the time of these transactions" as part of the data. (Tr. 123.) Anderson should have understood the features of the securities he traded. He is entitled to a reasonable profit, and he should have executed buys from the clearing firm at prices "that were executed to the best of his ability." (Tr. 124.)

For the markdowns, Anderson sold the U.S. Treasury notes on the open market, but he had not "crossed trades in-house with another customer," to collect fees "on both sides of the transaction." (Tr. 125.) Anderson's disclosed commission, of $100 for a $50,000 Treasury bond, was his usual minimum ticket cost for his services. (Tr. 126-27, 140-43.) Anderson executed twelve trades where he charged a markdown to his clients upon the sale of their Treasury notes. (Tr. 129-30.) Because the market for U.S. Treasury notes is "so deep and liquid," custom and practice in the securities business do not justify "any additional cost" for trading. (Tr. 130-31.) For these trades, the markdown consistent with industry practice would be $13,087. Anderson charged his customers $80,062 for the trades, however. (Tr. 132-33.) As for U.S. Treasury strips, Anderson's trades, if performed consistently with industry practice, should have resulted in a maximum markup of $1,594. Anderson assessed a markup fee of $11,489, however. (Tr. 134.)

In some specific bond pools Anderson charged markups totaling $25,000 more than that charged consistently with industry practice. (Tr. 133-35.) Some CMOs are sequential bonds, which entitled Anderson to a larger percentage markup upon sale for this volatile security. A total markup of $9,443 would have been consistent with industry practices, whereas Anderson charged $26,604 in aggregate markups. (Tr. 136-38.) Mortgage-backed securities are more back-office intensive then Treasury bonds. The settlement process is more complex, due to problems that might arise with mortgage payments and guarantees that must be reduced to writing and other factors. (Tr. 155.) For twelve U.S. Treasury notes; four U.S. Treasury strips; twelve mortgage-related specified pools; and eight CMOs traded by Anderson, industry standards dictated that commissions should not have exceeded 1% of the purchase price in reference to these thirty-six trades at issue. (Div. Ex. 2 at 2.) Markups and markdowns exceeded industry standards by $67,000 for U.S. Treasury note trades alone, and by $10,000 for U.S. Treasury strip trades. (Div. Ex. 2 at 3-7.) For mortgage-related specified pools, markups exceeded industry standards by $25,000. (Div. Ex. 2 at 8.) Markups exceeded industry standards by $17,000 for CMO sector trades. (Div. Ex. 2 at 9.)

Anderson also purchased municipal bonds for his clients through riskless transactions. (Tr. 203-04.) When he had a purchase order he either had to do the legwork himself to find the appropriate bond or call an intermediary such as a broker's broker. (Tr. 298.) Anderson also liquidated his clients' municipal bonds by obtaining bids through another dealer or broker's broker, purchasing them from his own clients at one price, and then selling them "to dealers with his markdown at a higher price." (Tr. 203-04.) The intermediary broker's broker would charge $2 per $50,000 bond transaction, a charge that is usually passed on to the customer. (Tr. 204-06.) There is nothing inconsistent or inherently unusual in the practice of buying a bond, marking it up, and selling it to a customer, or on a markdown, paying a customer a lower price than the bond ultimately sells for. (Tr. 210-11.)

Anderson traded some AAA-rated municipal securities in the instant case. (Tr. 214-15.) Usually, dealers charge less for trading higher-rated securities than they do for non-rated securities, which are more difficult to get information about. However, Anderson's "markup seemed to be the same in a given time frame" for all municipal bonds regardless of their rating. (Tr. 214-16, 320.) About a third of the municipal bond transactions in the instant case were of AAA grade. Over half were of investment grade, of Baa or higher. (Tr. 227.) Usually, the larger the transaction, the lower the markup. A trade of $5,000 to $10,000 would be considered a small trade and entitled to a larger markup because of "transaction costs and the effort expended by the broker." (Tr. 227-28.) The usual practice is that the markup on a longer-term bond is greater than the markup on short-term bonds, because the markup does not affect the yield on the longer-term bond as it does the short-term bond. (Tr. 238.) Also, markups on callable and prefunded bonds are, by industry practice, lower. Anderson made no distinction in his markup assessments, however, between prefunded bonds, callable, and long-term municipal securities. (Tr. 240-42.) Industry practice dictates that the broker charge less on customer sells than on customer purchases, because no salesmanship is required to consummate the trade. The broker's sole obligation is therefore to obtain the best price for the client. (Tr. 243-44.) Extraordinary service in the way of research or analytical materials provided to the client is worth something. (Tr. 245-46, 334.)

An NASD examiner might use guidelines to identify markups for closer scrutiny. (Tr. 357-59, 362-64.) When a trade was identified that exceeded the threshold, a representative of the NASD might contact an industry person, a member of the DBCC, or a large broker-dealer in an effort to determine the market price for the bond in question to determine whether the markup was truly excessive. (Tr. 365-

66.) The guidelines are not for use by brokers, however. (Tr. 367.) Brokers never had a numerical guideline, but always had the "fair and reasonable" guideline. (Tr. 381-82.) The threshold guidelines for markups on municipal bonds were established by the NASD merely for consistency in conducting examinations throughout the country when reviewing markups. (Tr. 383.) NASD never changed its general standard that markups on municipal bonds must be related to the market price for the bonds and must be fair and reasonable. (Tr. 383-84.)

Conclusions of Law

The OIP alleges that Anderson willfully violated Section 17(a) of the Securities Act and Sections 10(b) of the Exchange Act and Rule 10b-5 thereunder. Section 17(a) of the Securities Act prohibits any person from committing fraud in the offer or sale of securities. Section 17(a)(1) makes it unlawful to directly or indirectly employ any device, scheme, or artifice to defraud; Section 17(a)(2) provides that no one shall obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary to make the statements made not misleading; Section 17(a)(3) proscribes any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon a purchaser of securities. Section 10(b) of the Exchange Act outlaws the direct or indirect employment of manipulative and deceptive devices in connection with the purchase or sale of securities. Rule 10b-5 of the Exchange Act makes it unlawful for any person, directly or indirectly, in connection with the purchase or sale of a security, to make an untrue statement of material fact; omit to state a material fact; use any device, scheme, or artifice to defraud; or engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person.

To prove a violation of Section 17(a)(1) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5, the Division must show (1) that a misrepresented or omitted statement of fact was made in an offer, attempt to induce a purchase or sale, or an actual purchase or sale of a security; (2) that the misrepresented or omitted fact was material; and (3) that the respondent acted with the requisite scienter. See Basic Inc. v. Levinson, 485 U.S. 224, 240 (1988); Aaron v. SEC, 446 U.S. 680, 701-02 (1980). Scienter is "a mental state embracing intent to deceive, manipulate, or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976). It is established by a showing that the respondent acted intentionally or with severe recklessness, defined as highly unreasonable conduct involving not merely simple or inexcusable negligence, but "an extreme departure from the standards of ordinary care." Meyer Blinder, 50 S.E.C. 1215, 1229-30 (1992) (quoting Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977)); see also Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-69 (9th Cir. 1990); SEC v. Carriba Air, Inc., 681 F.2d 1318, 1324 (11th Cir. 1982). Proof of recklessness may be inferred from circumstantial evidence. See Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 47 (2d Cir. 1978). A finding of negligence is adequate to establish a violation of Sections 17(a)(2) and 17(a)(3) of the Securities Act. See Jay Houston Meadows, 52 S.E.C. 778, 785 & n.16 (1996), aff'd, 119 F.3d 1219 (5th Cir. 1997); see also SEC v. Steadman, 967 F.2d 636, 643 & n.5 (D.C. Cir. 1992) (citing Aaron, 446 U.S. at 701-02); Newcome v. Esrey, 862 F.2d 1099, 1102 n.7 (4th Cir. 1988).

Section 17(a)(2) of the Securities Act and Rule 10b-5 of the Exchange Act provide that only material misstatements and omissions are actionable. The materiality element is satisfied where there is a substantial likelihood that under all circumstances, a reasonable investor would consider the omitted or misstated information significant in making an investment decision. See Basic Inc., 485 U.S. at 231-32 (citing TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)). A statement is misleading if the information disclosed does not accurately describe the facts, or if insufficient data is revealed. See Basic Inc., 485 U.S. at 232; United States v. Koenig, 388 F. Supp. 670, 700 (S.D.N.Y. 1974).

In SEC v. American Commodity Exchange, 546 F.2d 1361, 1365 (10th Cir. 1976), the court indicated that actual sales by the defendant were not necessary to establish a violation of the antifraud provisions of Section 17(a) of the Securities Act. To the same effect, see United States v. Dukow, 330 F. Supp. 360 (W.D. Pa. 1971), and Fund of Funds Ltd. v. Arthur Andersen & Co., 545 F. Supp. 1314 (S.D.N.Y. 1982). The Dukow court held that even though the defendant was not a party to sales made by brokerage personnel, he was part of the scheme and was not exonerated from charges of securities fraud. 330 F. Supp. at 364. "[T]he securities laws include as a seller entities which proximately cause the sale . . . or whose conduct is a substantial factor in causing a purchaser to buy a security.'" Fund of Funds Ltd., 545 F. Supp. at 1353 (quoting Lawler v. Gilliam, 569 F.2d 1283, 1287 (4th Cir. 1978)).

The Division contends that Anderson did not disclose the size of markups and markdowns in Treasury securities strips of 2.75% to 4.01%; CMO markups of 1.42% to 4.0%; and municipal bond markups or markdowns of 1.87% to 5.64%. It further contends that ninety-six total transactions by Respondent resulted in deviations from industry practice and were excessive, and that Anderson aided and abetted Armscott's violations in many of these transactions.

The OIP also alleges that Anderson willfully aided and abetted and caused Armscott's violations of Sections 15(c)(1) and 15B(c)(1) of the Exchange Act and Rule 15c1-2 therunder, as well as MSRB Rules G-17 and G-30. Section 15(c)(1) of the Exchange Act prohibits any broker, dealer, municipal securities dealer, or government securities broker or dealer, from effecting any transaction in any security, municipal security, or government security by means of any manipulative, deceptive, or other fraudulent device or contrivance, as defined by Rule 15c1-2. Rule 15c1-2 of the Exchange Act defines the term to include any act, practice, or course of business, which operates or would operate as a fraud or deceit upon any person. It also includes any untrue statement of a material fact and any omission to state a material fact necessary to make statements made, in light of the circumstances under which they were made, not misleading. The elements of a cause of action under Section 15(c)(1) of the Exchange Act are the same as for Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5, except that Rule 15c1-2 of the Exchange Act requires that a statement or omission be made only with knowledge or reasonable grounds to believe that it is untrue and misleading. See SEC v. Great Lakes Equities Co., [1990-91 Decisions] Fed. Sec. L. Rep. (CCH) 95,685, at 98,206 (E.D. Mich. 1990); SEC v. Wexler, [1993 Decisions] Fed. Sec. L. Rep. (CCH) 97,758, at 97,653 & nn.5-6 (S.D.N.Y. 1993).

Section 15B(c)(1) of the Exchange Act prohibits a broker-dealer from violating MSRB rules. MSRB Rule G-17 requires broker-dealers to deal fairly with others and not engage in deceptive, dishonest, or unfair practices. See MSRB Rule G-17, MSRB Manual (CCH) 3581. Section 15B(c)(1) of the Exchange Act and MSRB Rule G-17 requires a showing of at least negligence. See SEC v. Dain Rauscher, Inc., 254 F.3d

852, 856 (9th Cir. 2001) (citing Merrill Lynch, Pierce, Fenner & Smith Inc., 67 SEC Docket 1807 (Aug. 24, 1998)). A violation of MSRB Rule G-17 is not appreciably distinct from Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act, and will not be considered separately. See SEC v. Fitzgerald, 135 F. Supp. 2d 992, 1027 & nn.11-12 (N.D. Cal. 2001) (citations omitted). MSRB Rule G-30 requires broker-dealers to charge fair and reasonable prices for municipal securities. See MSRB Rule G-30, MSRB Manual (CCH) 3646.

For aiding and abetting liability under the federal securities laws, three elements must be established: (1) a primary or independent securities law violation committed by another party; (2) awareness or knowledge by the aider and abettor that his or her role was part of an overall activity that was improper; and (3) knowing and substantial assistance by the aider and abettor in the conduct that constitutes the violation. See Graham v. SEC, 222 F.3d 994, 1000 (D.C. Cir. 2000); Woods v. Barnett Bank, 765 F.2d 1004, 1009 (11th Cir. 1985); Investors Research Corp. v. SEC, 628 F.2d 168, 178 (D.C. Cir. 1980); IIT v. Cornfeld, 619 F.2d 909, 922 (2d Cir. 1980); Woodward v. Metro Bank, 522 F.2d 84, 94-97 (5th Cir. 1975); SEC v. Coffey, 493 F.2d 1304, 1316-17 (6th Cir. 1974); Russo Sec. Inc., 53 S.E.C. 271, 278 & n.16 (1997); Donald T. Sheldon, 51 S.E.C. 59, 66 (1992), aff'd, 45 F.3d 1515 (11th Cir. 1995); William R. Carter, 47 S.E.C. 471, 502-03 (1981). A person cannot escape aiding and abetting liability by claiming ignorance of the securities laws. See Sharon M. Graham, 53 S.E.C. 1072, 1084 n.33 (1998), aff'd, 222 F.3d 994 (D.C. Cir. 2000).

Excessive Markups

The essential objective of securities legislation is to protect those who do [not] know market conditions from the overreachings of those who do. Such protection will mean little if it stops short of the point of ultimate consequence, namely, the price charged for the securities. Indeed, it is the purpose of all legislation for the prevention of fraud in the sale of securities to preclude the sale of securities which are in fact worthless, or worth substantially less than the asking price.

Hughes v. SEC, 139 F.2d 434, 438 (2d Cir. 1943) (citations omitted).

Among the basic representations implied by a broker-dealer is that when it sells a security to a customer, the dealer will charge a price that is reasonably related to the current market price. The fiduciary duty that the broker-dealer owes to its customer demands this commitment to fair dealing. Charging customers prices that are not reasonably related to prevailing market prices, without disclosure, is a violation of the antifraud provisions. See Assoc. Sec. Corp., 40 S.E.C. 10, 14 (1960), aff'd, 293 F.2d 738 (10th Cir. 1961). "Prevailing market price" is the price at which dealers are willing to, and do, buy and sell securities with one another. See LSCO Sec., Inc., 49 S.E.C. 1126, 1127-28 (1989);Alstead, Dempsey & Co., 47 S.E.C. 1034, 1035 (1984). Absent countervailing evidence, the best evidence of the prevailing market price at which dealers trade with one another is the dealer's contemporaneous cost. See Barnett v. United States, 319 F.2d 340 (8th Cir. 1963); Nicholas Codispoti, 48 S.E.C. 842, 844 (1987); Alstead, Dempsey, 47 S.E.C. at 1035; Powell & Associates, Inc., 47 S.E.C. 746, 748 (1982). The Commission has specifically held that a dealer's contemporaneous cost of acquiring a security should be used as the basis for computing a dealer's markup for riskless principal transactions. See First Independence Group Inc. v. SEC, 51 S.E.C. 662, 664 nn.9 & 11 (1993) (citing Kevin B. Waide, 50 S.E.C. 932 (1992)), aff'd, 37 F.3d 30, 32 (2d Cir. 1994).

Since 1939, the Commission has found excessive markups violative of the antifraud provisions.

It is well recognized that undisclosed markups on sales to retail customers can violate the antifraud provisions of the securities laws if they are not reasonably related to the prevailing market price and if such markups are charged with scienter. It also has been recognized that, at the least, markups on equity securities of more than 10% generally are fraudulent.

D.E. Wine Invs., Inc., 74 SEC Docket 2573, 2577 (Feb. 6, 2001) (citations and footnotes omitted).

Since 1943, pursuant to NASD Conduct Rules 2110 and 2440 and IM-2440, the NASD 5% policy has been the guideline for determining whether NASD members have complied with NASD markup and pricing rules. See id. at 2580-81. That guideline grew out of a survey that found 71% of the transactions were not over 5%. However, the Commission rejected an administrative law judge's application of the 5% guideline in determining markups were fraudulent. It reasoned that the policy is not applicable in the context of an OIP "where we must determine not whether the Respondent's pricing conformed to NASD rules but rather whether it violated the antifraud provisions of the securities laws." Id. at 2580-81. The Commission refused therefore to determine the prevailing marketplace price "mechanically," and found that a sale of 250 shares at $1.375 per share involving a 12.7% markup did not constitute excessive or fraudulent pricing because the transaction size was small and total compensation was thus comparable to a reasonable ticket charge. See id. at 2579, 2580 n.22 (citing Century Capital Corp., 50 S.E.C. 1280, 1283 n.10 (1992), aff'd, 22 F.3d 1184 (D.C. Cir. 1994)). Finally, the Commission reversed the administrative law judge's initial decision and dismissed the case. See id. at 2582.

However, brokers have been sanctioned for fraudulently charging excessive markups and markdowns when they traded stocks in a variety of circumstances. See, e.g., David Disner, 52 S.E.C. 1217, 1219, 1221-23 (1997) (finding 16% to 188% markups and markdowns in 359 penny sock transactions excessive); First Independence Group, 37 F.3d at 31 (finding 11.11% to 186.46% markups in 373 riskless principal transactions in thinly-traded stocks excessive); Toney L. Reed, 51 S.E.C. 1009, 1012 (1994) (finding markups of 19.05% to 58.74% in penny stocks excessive); G.K. Scott & Co., 51 S.E.C. 961, 966 (1994) (finding 16% to 157% markups in common stock sales excessive), aff'd, 56 F.3d 1531 (D.C. Cir. 1995) (unpublished table decision); Amato v. SEC, 18 F.3d 1281, 1282 (5th Cir. 1994) (finding markups of 20%, or more, in 80% of transactions excessive); Jeffery D. Field, 51 S.E.C. 1074, 1075 (1994) (finding 5% to 50% markup in 274 transactions for market maker excessive); Great Lakes Equity Co., [1990-91 Decisions] Fed. Sec. L. Rep. (CCH) at 98,212 (finding a 200% markup in 300 penny stock transactions excessive); Handley Inv. Co., 354 F.2d 64, 66 (10th Cir. 1965) (finding 14% to 57.9% markup in fifty penny stock transactions excessive); Merritt, Vickers, Inc., 42 S.E.C. 274 (1964) (finding markups of 10.5% to 125% for 120 stock sales excessive), aff'd, 353 F.2d 293 (2d Cir. 1965); Charles Hughes & Co. v. SEC, 139 F.2d 434, 436 (2d Cir. 1943) (finding 25% markup on riskless stock trades excessive); Charles M. Weber, 35 S.E.C. 663 (1954) (finding 38.9% markup on penny stock excessive).

Of course, the instant case involves bonds, not equity securities. More specifically the transactions at issue are in U.S. Treasury notes, U.S. Treasury strips, mortgage-related specified pools, CMOs, and municipal bonds. Other sources may be helpful in a determination of excessive bond markups. The MSRB, the primary regulatory authority in the municipal securities market, is a self-regulating organization created by Congress in 1975, and supervised by the Commission. It is authorized to propose and adopt rules to effectuate the purposes of the Exchange Act with respect to transactions in municipal securities. See Section 15B(b); Grandon v. Merrill Lynch Co., 147 F.3d 184, 191 (2d Cir. 1998).

The MSRB has expressly refused to adopt a specific percentage guideline for reasonable markups because of the heterogeneous nature of municipal securities transactions and municipal securities dealers. Specifically, the MSRB cited the following as factors that make a specific benchmark unfeasible: many differences in municipal securities transactions; size of the transactions; quality and maturities of municipal securities; nature of the services which municipal securities dealers provide; and varying pricing practices of municipal securities dealers in different areas. See Interpretive Notice to Rule G-30, "Report on Pricing" (Sept. 26, 1980), MSRB Manual (CCH) 3646, at 5159-60 (Report on Pricing). MSRB Rule G-30 requires that prices charged by a municipal securities dealer be "fair and reasonable, taking into account all relevant factors." MSRB Rule G-30; see also Grandon, 147 F.3d at 191. The MSRB enumerated the following "relevant factors" in the rule: (1) the best judgment of the broker, dealer or municipal securities dealer as to the fair market value of the securities at the time of the transaction and any securities exchanged or traded in connection with the transaction; (2) the expense involved in effecting the transaction; (3) the fact that the broker, dealer, or municipal securities dealer is entitled to a profit; (4) the total dollar amount of the transaction; (5) the availability of the security in the market; (6) the price or yield of the security; and (7) the nature of the professional's business. See MSRB Rule G-30; Report on Pricing, MSRB Manual (CCH) at 5160; Grandon, 147 F.3d at 190; Press v. Chemical Servs. Corp., 166 F.3d 535, 529 (2d Cir. 1999).

The Commission has discussed disclosure requirements for corporate, municipal, and government debt securities. See Zero-Coupon Securities, 38 SEC Docket 234 (Apr. 21, 1987). The release states that markups of 10% on equity securities are fraudulent, and that 5.1% markups on debt securities may violate MSRB rules. See id. at 235. The Commission has stated that "common industry practice regarding markups is to charge a markup over the prevailing inter-dealer market price of between 1/32% and 3.5% (including minimum charges) for principal sales" on conventional treasuries, depending on maturity, order size, and availability. (Resp. Ex. 10 at 7-9.) See id. at 235. The Commission concluded that markups on debt securities are historically smaller than those on equity securities. However, a markup as low as 1% of the face amount of a zero-coupon bond, a debt security that does not pay interest to the holder periodically prior to maturity, trading at a deep discount may be excessive, because the bond may have a short maturity. See id. at 235. Although the release does not set a specific percent for bond markups, it makes clear that NASD and MSRB general rules and policies as to markups do apply to debt securities. (Resp. Ex. at 16.) See id. at 236.

The legal standard for determining when a markup is excessive has long been whether, based on all of the facts and circumstances in a given case, the price charged was reasonably related to the prevailing market price, which I conclude, here, was the price at which Anderson himself traded the bonds at issue. The reasonableness of the markup or markdown charged can be determined only on the basis of the individual facts of each case. In making this determination, the finder of fact must assess various factors, including, but not limited to, industry practice regarding the range of appropriate markups or markdowns on a particular security or similar type of security in comparable transactions. See Grandon, 147 F.3d at 190 (citing Banca Cremi, S.A. v. Alex. Brown & Sons, Inc., 132 F.3d 1017, 1033 (4th Cir. 1997)); SEC v. Feminella, 947 F. Supp. 722, 729 (S.D.N.Y. 1996) (citations omitted). Thus, where a defendant "exacts unreasonable profits resulting from a price which bears no reasonable relation to the prevailing price" of the security, the antifraud provisions are violated. See Grandon, 147 F.3d at 190 (citing Bank of Lexington & Trust Co. v. Vining-Sparks Sec. Inc., 959 F.2d 606, 613 (6th Cir. 1992)).

Anderson concedes that the Division's experts described industry practice for the markups and markdowns at issue here, and I have so found. However, deviation from industry practice constitutes only one factor that must be considered. Given the fact-specific nature of the inquiry, it is clear that there is no single, fixed percentage standard for what constitutes an excessive markup or markdown for all transactions. Rather, the fact finder must determine whether, under all the circumstances of the transaction, the price charged for the security was reasonably related to the prevailing market price.

With regard to scienter, in order to establish this element, the Commission must show that the respondent acted with actual intent to deceive, manipulate, or defraud, or severe recklessness, which is limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the respondent or is so obvious that the respondent must have been aware of it.

In addition, while there is no fixed standard representing an appropriate markup for the transactions, at issue, there is regulatory guidance as to what is acceptable, which bears repeating: the price charged must be reasonably related to the prevailing market price of the security. Whether [respondent's] profit was unreasonable and whether [respondent] intended to deceive his client or acted with severe recklessness are questions of fact . . . .

Feminella, 947 F. Supp. at 731.

Sellers of bonds have been sanctioned in a variety of cases for excessive markups or markdowns. In Thomas F. White & Co., the Commission reviewed and affirmed NASD sanctions. 51 S.E.C. 932 (1994), aff'd, 68 F.3d 482 (9th Cir. 1995) (unpublished table decision). The non-market maker firm had bought certain bonds and resold them to retail customers at "68.5", regardless of the price it had paid for them. The activity resulted in thirty-two retail sales with markups from 7.03% to 14.17%, which were "improper." Id. at 934. The NASD's order to return all commissions over 5% was affirmed with slight modification. See id. at 937. The Commission based its decision on the following NASD factors: characteristics of the debt securities sold; the fact that the firm was not a market maker; the rapid turnover to retail customers; and the nature of the market in the bonds. See id. at 936.

In Investment Planning Inc., the Commission also affirmed NASD fines and suspensions for excessive markups. 51 S.E.C. 592 (1993). The firm and its executives routinely traveled to the homes of retired, conservative investors in rural areas. They sold the customers high-quality, zero-coupon municipal securities and interest-bearing bonds. The sales resulted in 4% to 7.26% markups for sixty-five corporate bond transactions, and 4% to 5.99% for sixty-seven municipal bond transactions, which were characterized as "extraordinary charges for ordinary transactions." Inv. Planning Inc., 51 S.E.C. at 594. In Donald T. Sheldon, the Commission upheld an administrative law judge's sanction of a permanent bar for a variety of misconduct, including excessive markups. 51 S.E.C. at 59. The dealer's procedures manual described the markup policy in the municipal bond industry to be a quarter of 1% to 5% over the current market price for a bond. However, brokers engaged in 109 transactions in bonds where undisclosed markups of 6% to 15% were charged. See Donald T. Sheldon, 51 S.E.C. at 76-77. In F.B. Horner & Associates, Inc., the Commission affirmed NASD sanctions against the brokerage firm and its president. 50 S.E.C. 1063 (1992), aff'd, 994 F.2d 61 (2d Cir. 1993) (per curiam). It agreed with the NASD that any markup in excess of 5% was unwarranted. See F.B. Horner, 50 S.E.C. at 1067. The Commission also rejected the expert's opinion that, because the trades were riskless, the appropriate markup was 1.8% to 2.9%. See id. at 1066. Instead, the Commission and the NASD based their decision on the time and effort that Horner had devoted to the client's portfolio and his expertise in locating and acquiring the unique product for his customers in deciding on a 5% markup threshold. See id. at 1067. The Commission imposed sanctions for markups of 8.09% and 6.9% on two purchases of principal-only CMOs that the client needed to balance the interest-only bonds in its portfolio. See id. at 1064-65.

In First Honolulu Securities, Inc., the Commission reviewed an NASD matter and partially set aside findings of violation for markups. 51 S.E.C. 695 (1993). The Commission noted its opinions suggest that while markups of municipal bonds may reach 5%, that figure might be acceptable in only the most exceptional cases, and that it had long held that markups over 5% in municipal securities were excessive. See First Honolulu, 51 S.E.C. at 698-99, 701. Accordingly, the Commission sustained the findings of violation with respect to the markups at issue that exceeded 5%. The Commission also held that markups exceeding 4% on high-quality, zero-coupon municipal securities were excessive, but set aside the findings of violation for such markups between 4% and 5%, because "it may not have been clear to applicants in 1990 that markups on municipal securities of over four percent usually are unfair." See id. at 701. Finally, the Commission commented that while it believed the markups below 4% on the municipal debt securities at issue were excessive, the NASD had introduced no evidence that would establish the unfairness of markups at those levels, and set aside those findings of violations. See id. at 701.

In Banca Cremi, S.A. v. Alex Brown & Sons, Inc., a bank sued when it was left holding six CMOs after a market downturn in February 1994 and the price of the CMOs had dropped precipitously. 132 F.3d 1017, 1026 (4th Cir. 1997). The broker had charged: two markups of 5.25%; seven markups between 3.1% and 3.77%; seven markups of between 2.4% and 2.84%; and three markups of 2.06%, 1.78%, and 4.99% respectively, where it had sold over $100 million in CMOs to a bank and received over $2 million in commissions. See Banca Cremi, 132 F.3d at 1034. The court refused to shift the burden to the respondent to prove reasonableness after an expert opined that undisclosed markups over 1% on CMO sales were excessive. See Banca Cremi, 132 F.3d at 1034. Summary judgment for the broker was upheld because the court concluded from deposition testimony that the bank did not express any concern regarding the amount of any markups, and that the amount of the broker's markup was not a consideration in its decision to invest. See id. at 1036-37. The court also noted that the Commission does not generally require disclosure of sales fees as markups. "It is even more puzzling why the SEC, having once abandoned an effort to administratively require such disclosures, should now seek to judicially impose the identical requirements on dealers." Id. at 1035 (citations omitted). I conclude that the Division has not proved that Anderson charged excessive markups or markdowns, or that the prices he charged were not reasonably related to the prevailing market price. The Division's experts' opinions were not based on factors or data that could establish excessive markups and markdowns. They did not establish that the yield after Anderson's markups or markdowns was not "comparable to the yield on other securities of comparable quality, maturity, coupon rate, and block size then available in the market." Report on Pricing, MSRB Manual (CCH) at 5161. The MSRB singled out the resulting yield as the most important factor in determining the fairness and reasonableness of price in any given transaction. See id.

Robert M. MacLaverty expressed an expert opinion as to the pricing on the following transactions: twelve U.S. Treasury notes; four U.S. Treasury strips; twelve mortgage-related specified pools; and eight CMOs. MacLaverty concluded that the markups and markdowns on all of the above transactions should not have exceeded 1% of the purchase price, and the markups and markdowns charged on these transactions were inconsistent with industry standards and other relevant factors. (Div. Ex. 2 at 2.) MacLaverty determined the proper markup or markdown for each type of security by doubling the bid-ask spread at the time of the transaction: U.S. Treasury notes and strips had a bid-ask spread of 1/32; mortgaged-specified pools had a bid-ask spread of 1/8; and CMOs had a spread of 1/5. He asserted that this method took into account the necessary factors when charging a markup or markdown on a principal bond transaction, and concluded that Anderson, in charging different markups or markdowns, did not take into account such necessary factors. (Div. Ex. 2 at 4-8.) I do not agree that the bid-ask spread should be used as a basis for decision making here. Instead, prices paid pursuant to Anderson's trades, or contemporaneous cost, should be used. See First Independence Group, 51 S.E.C. at 664 nn.9 & 11. Peter C. McCabe also expressed an expert opinion on the markups and markdowns on certain municipal bond trades. (Div. Ex. 3 at 2.) McCabe alluded to several relevant factors in his opinion. However, in discussing the specific bonds at issue, he simply assigned a range of "appropriate" markups or markdowns. In most cases he did not compare the particular bond at issue with the price of other bonds with similar characteristics trading at the time as required by Grandon. McCabe went through all sixty municipal bond trades and prepared charts that showed various characteristics of the bonds. He also provided what he believed to be an "appropriate" markup and markdown range. However, McCabe did not indicate the source for his "appropriate" markup and markdown ranges. (Tr. 257-71; Div. Ex. 3 at 20-23.) McCabe did not analyze similar bonds, available on those dates. (Tr. 318-19.) For sixty bond trades, Anderson's markups and markdowns exceeded industry standards by $68,386. (Div. Ex. 3 at 2-6, Div. Ex. 4.) McCabe also assigned no value to any special services Anderson provided his clients. (Div. Ex. 3 at 3.)

Careful analysis of the ninety-six bond trades in the instant case reveals that Anderson acted fairly based on the type of security. Anderson traded four times in U.S. Treasury securities where the markups ranged from 2.99% to 4.01%. He traded twelve times in U.S. Treasury securities where the markdowns ranged from 2.75% to 3.87% (with only two trades over 2.99%). He traded twenty times in government agency securities where the markdowns ranged from 1.42% to 4.07% (with only six trades over 4%). He traded fifty times in municipal securities where the markups ranged from 1.87% to 5.00% (with only twenty-six trades over 4%). And he traded ten times in municipal securities where the markdowns ranged from 3.02% to 5.64% (with only two trades over 4.99%). (Jt. Ex. 24 at 8-12.) Thus, for the type of security involved, I conclude that the pattern of trades shows commissions that are consistent with the standards described for pricing of bonds in the NASD Manual, MSRB Rules, and the Commission's own decisions and releases.

As for availability of the securities, several dozen primary dealers in the United States are required to make markets in U.S. Treasury notes and in U.S. Treasury strips daily. (Div. Ex. 2 at 3-4.) The CMOs that Anderson traded are more "back office intensive" to settle with a counter party and are not as liquid or as widely sold as treasuries. (Div. Ex. 2 at 7-9.) Municipal bonds likewise are not as widely available as U.S. Treasury notes; bond traders make markets in bond issues from most states in the secondary market. These municipal bond issues may also be underwritten by broker-dealers; there is no evidence that the municipal bond issues in the instant case were actively promoted at the time of the trades. (Div. Ex. 3 at 2-3.) Anderson's testimony that his trades were driven by the yield, tax consequences, portfolio, and special needs of each client was not contradicted. Thus, Anderson's trades in specialized securities justify the commissions he charged, and none of his clients were misled. (Tr. 484-89.) I disagree with the expert's opinion that Anderson ignored the call dates, and I credit Anderson's testimony, which was not contradicted, that he routinely discussed the issue of stated call dates with his customers and provided them with accurate yield figures that he had obtained from other brokers, along with his own estimate of what the call date might be. Investment advisers at AMM also assisted clients. (Tr. 426, 474-500; 524-34; Div. Ex. 3 at 2-4, Jt. Ex. 24 at 2.) Like the salesman in F.B. Horner, Anderson also used his expertise to locate securities that met the unique needs of the clients. (Tr. 462-63, 465.) See 50 S.E.C. at 1067. Thus he was entitled to higher markups.

The price of the security and the dollar amount of the trades are significant because broker profits and transaction costs can be spread over a larger number of bonds, lowering the charge per bond. (Div. Ex. 3 at 2.) Thus generally, the lower the price of the security or of the dollar amount of the trade, the higher the percent of reasonable markup. I disagree with the expert's characterization of the vast majority of the trades here as "institutional" in size and thus subject to lower markups. (Div. Ex. 3 at 2.) I credit Anderson's testimony to the effect that he had a continuing relationship with his clients, most of whom were wealthy individuals. His testimony is corroborated by the fact that the largest trade at issue was only one for $375,000; the next was a single trade for $288,000, followed by six for $250,000. All the remaining trades were smaller. (Jt. Ex. 24.)

I conclude that the Division has failed to prove that the prices the clients paid were not reasonably related to the market price. Anderson's testimony that the clients were knowledgeable experienced investors who understood financial markets and interest rates is not contradicted by any evidence in the record. (Tr. 535, 540-51.) is testimony that he routinely informed his clients of the yield based on what he reasonably viewed as "the worst-case possible thing that could happen" was also not contradicted. (Tr. 592-94.) Most importantly, Anderson's description of the manner in which he used yield to calculate a reasonable commission as markup or markdown has not been characterized by the testifying experts or by the Division as highly unreasonable conduct involving not merely simple or inexcusable negligence or as an extreme departure from the standards of ordinary care. It has not even been described as inconsistent with industry practice or standards. Thus, higher markdowns were justified even though they may have resulted in figures that deviated from industry practice.

Industry practice as to markups on a particular security or similar type of security should be considered as a factor, of course. In the instant case, that practice would dictate that Anderson should have charged about half the amount he charged in markups and markdowns for municipal bond trades. (Div. Ex. 3 at 20-24.) It would also dictate the he should have charged less then one-third of the stated markups for U.S. Treasury notes and strips, specified pools, and CMOs. (Div. Ex. 2 at 18.) I have credited the testimony of the experts to that degree, although Anderson contends that other fixed fees usually charged by mutual funds should not be ignored. (Tr. 640-44.) I agree with that contention. I conclude that because industry practice is only one factor in the determination of whether the charges in the OIP have been established, it cannot be determinative here. Thus, I reject the conclusion of the Division experts that the departures from industry practice were extreme. Indeed, the Division's reliance on the figures that the experts suggest is not the approach taken by the courts or the Commission. See Grandon, 147 F.3d at 190; Banca Cremi, 132 F.3d at 1033; Feminella, 947 F. Supp. at 729; D.E. Wine, 74 SEC Docket at 2580-81; Staten Sec. Corp., 25 SEC Docket 2006, 2007-09 (Apr. 9, 1982).

Anderson's testimony that he operated a small business with very few employees and that he earned a personal income well below $75,000 for the several years at issue here was not contradicted. (Tr. 648-49.) He is entitled to a profit and I conclude that the Division has failed to prove the prices that he charged his clients were not reasonably related to the prevailing market prices of the securities. He also attempted to cooperate with the NASD inquiry. I cannot take the settlements of other parties into account. Thus the case must be dismissed as to him. I must also conclude that since the markups and markdowns were not excessive, Armscott was not a primary or independent securities law violator. Therefore, Anderson did not aid or abet any Armscott violations. That section of the OIP must also be dismissed.

Record Certification

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), I certify that the record includes the items described in the record index issued by the Secretary of the Commission on October 7, 1999.

Order

IT IS ORDERED that the proceeding against Respondent Mark David Anderson be, and it hereby is, dismissed.

This Order shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that rule, a petition for review of this Initial Decision may be filed within twenty-one days after service of the decision. It shall become the final decision of the Commission as to each party who has not filed a petition for review pursuant to Rule 360(d)(1) within twenty-one days after service of the Initial Decision upon such party, unless the Commission, pursuant to Rule 360(b)(1), determines on its own initiative to review this Initial Decision as to any party. If a party timely files a petition for review, or the Commission acts to review as to a party, the Initial Decision shall not become final as to that party.

Lillian A. McEwen
Administrative Law Judge

Footnotes

[1] Citations to the hearing transcript, and exhibits offered by the Division and Anderson will be noted as "Tr. __," "Div. Ex. __," and "Resp. Ex. __," respectively. Exhibits offered jointly by the parties will be noted as "Jt. Ex. __."

http://www.sec.gov/litigation/aljdec/id203lam.htm

In the Matter of Mark David Anderson, Securities Act Release No. 8265, Exchange Act Release No. 48352, A.P. File No. 3-9499 (August 15, 2003).

APPEARANCES:	Michael R. Wilner and Thomas A. Zaccaro, for the Division of Enforcement.
	H. Thomas Fehn, Gregory J. Sherwin, and Elizabeth Lowery, of Fields, Fehn & Sherwin, for Mark David Anderson.

Appeal filed: May 20, 2002

Last brief filed: September 12, 2002

I.

The Division of Enforcement appeals from the decision of an administrative law judge dismissing proceedings against Mark David Anderson. From December 1992 through December 1994, Anderson was president and owner of Annandale Securities, Inc., a former registered broker-dealer.[1] From at least 1995 through 1997, Anderson was president of Armscott Securities, Ltd., a registered broker-dealer. [2]

The Division alleged that Anderson willfully violated Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Exchange Act Rule 10b-5 [3] by charging undisclosed and excessive markups and markdowns in trades with retail customers. The Division further alleged that Anderson aided and abetted and caused Armscott's violations of Exchange Act Sections 15(c)(1) and 15B(c)(1), Exchange Act Rule 15c1-2, [4] and Rules G-17 and G-30 of the Municipal Securities Rulemaking Board (the "MSRB"). [5] We base our findings on anindependent review of the record, except with respect to those findings not challenged on appeal.

II.

A. Anderson's Practices. The relevant facts of this case, including the amount of the markups and markdowns charged (on a percentage and dollar basis), are undisputed. [6] From December 1992 through March 1997, while associated with Annandale and/or Armscott, Anderson engaged in the 96 securities trades at issue here in which he charged retail customers either an undisclosed markup, if the customer was purchasing securities, or an undisclosed markdown, if the customer was selling securities. [7]

Neither firm acted as a market maker in any of the securities at issue. Anderson admits that he executed these trades "on a 'riskless principal' basis." In the case of a customer purchase, he bought "securities only to fill an order already in hand from a customer, and then [sold] the securities to the customer."

Anderson testified that, at some point in time, he owned a bond yield calculator, but it broke and he never replaced it. Anderson also did not subscribe to the leading sources of financial data regarding the bond market including Bloomberg LP, Thompson Financial, Muni Fax, The Bond Buyer, or the Blue Sheets.

Anderson was unable to recall "[s]pecific" details regarding particular transactions. He retained no notes regarding his trades. [8] He explained that he "never thought [he would] need them and it's a very . . . paper intensive business and . . . [his] files [were] stuffed already."

Anderson, however, testified concerning his general method of pricing bonds. He would identify a bond that might be of interest to one or more of his customers. He would then discuss with the selling trader what the resulting yield on the bond would be based on different markups. After assuring himself that the bond was available at a certain wholesale price, Anderson would negotiate with his customer regarding the yield. Anderson would then add a markup that would give the customer the agreed-upon yield.

Anderson further testified that he used a yield matrix published by Thompson that showed the average yields for municipal bonds based on the subject bond's rating and maturity, e.g., all bonds rated Baa maturing in 2003. He then added markups that reduced the yields of the bonds he was selling to levels consistent with the average yields for that grade and maturity of bonds shown on the Thompson matrix.

Certain of the municipal bonds at issue were "callable," i.e., they could be redeemed at the issuer's option before the final maturity date. If the issuer calls a bond before its final maturity date, its yield can be adversely affected. Anderson conceded that "[y]ou are supposed to price [callable bonds] to the worst possible circumstance." However, he also asserted that a call feature can be "ignore[d] if "you don't think it's going to happen." Thus, Anderson "would price the bond to what [hethought] the ultimate maturity of that bond [was] going to be." [9]

Anderson's testimony focused on municipal bonds. When he was asked about his methodology for setting markups and markdowns on instruments other than municipal bonds, he stated that he "did the same thing with them." [10]

Anderson executed many of these trades, acting as both registered representative and trader, for his own customers. Anderson also executed other trades as a trader on behalf of clients of A. Morgan Maree ("AMM"), a registered investment adviser. [11] Anderson testified that, when he executed on behalf of AMM, he shared 80% of the markups and markdowns with AMM, and retained the remaining 20%.

B. Anderson's Trades in Municipal Securities. Anderson charged markups ranging from 1.42% to 5% in 50 sales of municipalbonds to retail customers in 1993 through early 1996. He also charged markdowns ranging from 3.02% to 5.64% in purchasing municipal bonds from retail customers in 10 transactions during 1993 through 1995. In total, Anderson charged $128,268 in markups and $25,956 in markdowns in the 60 trades at issue.

The Division called Peter C. McCabe as an expert to review Anderson's municipal bond trades. [12] McCabe analyzed each of these trades by consulting widely-used financial data produced by Bloomberg Financial detailing the security's investment characteristics and history. He also discussed the trades with "peers in the securities business." McCabe considered various factors, including the nature of the market for the security (whether it was actively traded), its rating, its maturity date, whether it was subject to an early call date, and the resulting yield to the customer. [13]

McCabe expressed the opinion that these markups and markdowns substantially exceeded accepted industry practice. For example, in September 1993, Anderson purchased from a retail customer a $25,000 block of Anaheim, California municipal bonds at 101.89, which he contemporaneously resold for 106.29, a 4.32% markdown or $44 per bond. [14] The issuer had prerefunded this bond, which meant that it would be paid off early on a specified date, in this case less than a year later on August 1, 1994. [15] McCabe calculated that Anderson's markdown reduced the customer's yield "by 517 basis points or slightly over 5 percent."

According to McCabe, $5 to $15 per $1,000 bond, roughly equivalent to .5% to 1.5%, was the appropriate markdown for this bond. [16] Using a "generous" standard, McCabe determined that the maximum markdown Anderson could have charged was $375, rather than the $1,100 markdown charged by Anderson. He concluded that, since the bond had less than a year to maturity, the markdown "was way, way, in excess of industry standards at the time of this trade in 1993." McCabe explained that typically markdowns on municipal securities are less than markups. In a sale to a customer, a dealer frequently will be required to research the bond and locate a dealer willing to sell it. Where, as here, a dealer purchases a security from a customer and immediately resells it, little or no research is required.

McCabe also testified about Anderson's March 1994 purchase from a retail customer at 100.775 of a $150,000 block of "California State G/O Var Purp" bonds, which he immediately resold for 104.78. [17] These were general obligation bonds, rated A-1, i.e., high quality, by Moody's. Anderson's charge of $6,000 represented a 3.97% markdown. According to McCabe, the markdown had the effect of reducing the customer's yield to maturity by 55 basis points or roughly .5% on an annual basis. McCabe found this markdown to be much higher than industry practice, explaining that it was "a relatively short term bond, less than 10 years" and very marketable. McCabe stated that the highest markdown Anderson properly could have charged for this trade would have been $2,250.

McCabe also opined that Anderson charged markups that exceeded industry practice. In February 1994, for example, Anderson sold a $75,000 block of a San Dimas, California bond for 119.44. He had purchased the block contemporaneously for 113.75. [18] The bond was rated AAA. Although this bond had a maturity date of September 2016, it was callable on September 1, 2001. Anderson charged a markup on this trade of 5%, or $4,268, which McCabe calculated reduced the yield to call by

81 basis points, or roughly 3/4 of one percent per year. McCabe concluded that the maximum Anderson should have charged was $2,250.

In September 1995, Anderson sold a retail customer for 110.745 a $25,000 block of a Los Angeles California Regional Airport bond which he had purchased for 107. [19] Anderson charged $936 for the trade or 3.5%. According to McCabe, however, because the bond had a call date of November 1, 1995, the resulting yield to the customer was -42.95%. McCabe considered this trade to be highly unusual because "nobody buys bonds with a negative return to maturity, at least not on purpose." [20]

McCabe concluded that, over these 60 trades, Anderson overcharged his municipal bond clients by a total of $68,386. [21]

C. Anderson's Trades in Government and Mortgage-Related Securities.

Robert M. MacLaverty testified as an expert regarding trades involving government and mortgage-related securities. [22] MacLaverty testified that markups and markdownsin Treasury securities are "driven by th[e] bid-ask spread," that is "the difference between the price at which a dealer can be expected to buy such security from a competitive seller (the 'bid' price level), and the price at which it can be expected to sell that same security to a competitive buyer (the 'ask' price level)." MacLaverty opined that the spread incorporates the market's assessment of "[v]olatility, the interest rate environment, supply of the security, face value of the security, credit quality of the security, structure of the security, whether it has imbedded options." [23]

i. Treasury Notes. Anderson charged markdowns ranging from 2.75% to 3.87% on the sale of twelve United States Treasury Notes by a single customer on December 15, 1992. [24] The dollar amount of the markdowns ranged from $3,000 to $11,250 and totaled for all twelve trades $80,062.

The Treasury Note market is extremely liquid and such securities carry an implied rating of AAA, the highest rating available. MacLaverty testified that, during the period at issue, the bid/ask spread for Treasury Notes ranged between 1/32 and 2/32 of a point (which equals a dollar value of $312 to $624 for each $1 million face amount of notes priced at par),depending on various factors, including market volatility and the type of issue involved. MacLaverty testified that, while the spread is generally used to establish the markups and markdowns on institutional trades and many retail trades, in evaluating the trades at issue here, he "doubled what was custom and the practice in the industry."

MacLaverty concluded that, on December 15, 1992, when Anderson purchased the twelve Treasury Notes from the retail customer, the prevailing spread justified markdowns of between .25% and .5%. Using the high end of that range (.5%), Anderson overcharged his customer by $66,975. MacLaverty considered Anderson's markdowns an "extreme deviation from industry practice." MacLaverty concluded that, in setting these markdowns, Anderson failed to consider: (i) the nature and wide availability of Treasury Notes in the market; (ii) the negligible execution risk involved; (iii) the size of the orders; and (iv) the adverse effect of the markdowns on the customer's yield.

MacLaverty compared Anderson's markdowns to the commissions charged by Anderson on a similar Treasury Note trade executed on an agency basis. Where Anderson charged a commission, which was fully disclosed to the customer, the charge ($100 per $50,000 in bonds) was substantially less than the markdowns on the purchase of the twelve Treasury Notes. MacLaverty added that Anderson's commission corresponded to what is charged in the industry.

MacLaverty also considered whether any special circumstances in the market for Treasury securities justified Anderson's higher charges. He researched market activity for each of the days on which Anderson's trades occurred and checked with different "market scenarios" to see if any there were any justification for Anderson's charges. He did not find any special market condition that justified this level of markdowns.

In response, Anderson testified that he made what he described as "herculean efforts" to execute these trades. According to Anderson, these notes had to be liquidated immediately because of significant tax considerations arising from the customer's failing health. Anderson further asserted that executing these trades was complicated because of unusual weather conditions affecting traders on the East Coast of the United States. Anderson admitted, however, that, despite theasserted challenges, the twelve trades were executed by him within a single hour. [25]

ii. Treasury Strips. [26] Anderson charged markups ranging from 2.99% to 4.01% on four sales of Treasury strips during 1994. The dollar amount of the markups ranged from $1,946 to $3,756, for total markups of $11,489.

According to MacLaverty, strips, like Treasury Notes, trade in "comparable 1/32 bid-ask spread increments." MacLaverty established a markup/markdown standard for strips by doubling the amount of the spread, which permitted Anderson in MacLaverty's view "a rather generous profit." Using this standard, Anderson overcharged his customers by $9,895. MacLaverty could find no extraordinary circumstances that might have justified Anderson's markups.

iii. Agency Specified Pool Securities. Anderson charged markups ranging from 2.29% to 4.07% on twelve sales of agency specified pool securities during 1994 and 1995. [27] The dollar amount of these markups ranged from $1,026 to $6,528 and totaled $35,485.

According to MacLaverty, these securities are highly rated with a spread "usually no wider than 4/32 or 6/32." [28] MacLaverty noted that these securities also are "more 'back office intensive' to settle with a counterparty. That is, for the same amount of bonds, mortgage[] [backed securities] are a higher dealer cost security than treasuries . . . ." Accordingly, MacLaverty opined that a 1% markup standard should be used to evaluate Anderson's pricing. Using this standard, Anderson overcharged his customers by $25,633. MacLaverty could find no basis for Anderson's markups.

iv. Collateralized Mortgage Obligations. Anderson charged markups ranging from 1.42% to 4.04% on eight sales of collateralized mortgage obligations" or "CMOs" during 1994, 1995, and 1997. [29] The dollar amount of the markups ranged from $1,354 to $9,634 and totaled $26,604.

The CMOs at issue here generally traded in bid-ask spreads of "less than one-half of one point, or less than $5,000 per million dollars face amount." [30] In setting a markup standard, MacLaverty doubled the spread. Using this standard, Anderson overcharged his customers by $17,161. As with the other securities trades he considered, MacLaverty opined that there were no extraordinary circumstances present to justify Anderson's deviation from industry standards.

MacLaverty found that, in a total of 36 trades in government, agency-specified securities and CMOs, Anderson charged markups and markdowns that "did not conform" to the criteria that are "widely known and practiced in the industry," and that Anderson's excessive charges totaled $119,664. Except for the December 1992 Treasury Note trades, Anderson did not specifically address any of these trades during his testimony or in his briefs.

III.

Courts have recognized that "sales of securities by broker-dealers carry an implied representation that the prices charged are reasonably related to the prices charged in an open and competitive market." [31] We have long held that "a dealer violates antifraud provisions when he charges retail customers prices that are not reasonably related to the prevailing market price at the time the customers make their purchases." [32] The prevailing market price is "the price at which dealers trade with one another." Where, as here, the dealer is not a market maker in the security and there is no countervailing evidence, the best evidence of the current market is the dealer's own contemporaneous cost to acquire the security at issue. [33] Moreover, trades executed on a riskless principal basis "should be treated similarly to an agency transaction, in which a firm may retain no more than a commission computed on the basis of its cost." [34]

We find that Anderson's markups and markdowns were not reasonably related to the prevailing market prices for these securities. We have observed "that a significantly lower markup is customarily charged in the sale of debt securities than in transactions of the same size involving common stock." [35] It iswell-settled, for example, that markups and markdowns on municipal securities may be excessive although they are substantially below 5%. [36] Indeed, we previously have observed that "markups on municipal securities are often as low as one ortwo percent in frequently traded issues . . . ." [37] In 1988, we noted that the then "common industry practice" was "to charge a mark-up over the prevailing inter-dealer market price of between 1/32% and 3 1/2% (including minimum charges) for principal sales to customers of conventional or 'straight' Treasuries." [38]

Markdowns generally are lower than markups. [39]

The price Anderson's customers paid or received, Anderson's cost to acquire the security or the price he received in reselling it, and the resulting markup or markdown are undisputed. The Division introduced expert testimony which supported its contention that Anderson's pricing was "well above what professionals in the business would generally charge for the transactions in question" [40] and not warranted by any extraordinary circumstances.

Based on the Division's evidence, a prima facie case that Anderson's prices were not reasonably related to the prevailingmarket price has been established. [41] At that point, the burden of going forward shifted to Anderson "to explain why, notwithstanding the evidence to the contrary, [this] pricing was fair." [42]

Anderson does not dispute the trading data regarding the amount of his markups and markdowns. Nor does he challenge the opinions of the Division's two experts that his pricing did not conform to industry standards. [43] The law judge found, based onthat expert testimony, that Anderson's markups were at least two to three times greater than prevailing industry practice. Anderson asserts, however, that industry practice is merely one of many factors to be considered and that, based on all the relevant factors, his pricing was appropriate.

MSRB Rule G-30 identifies the following factors as relevant to determining a "fair and reasonable" price for a municipal security: "the best judgment of the broker, dealer or municipal securities dealer as to the fair market value of the securities at the time of the transaction . . . , the expense involved in effecting the transaction, the fact that the broker . . . is entitled to a profit, and the total dollar amount of the transaction." [44] Anderson relies on an MSRB Interpretative Notice which states that, "[o]f the many possible relevant factors . . . the resulting yield to a customer is the most important . . . ." [45] According to the MSRB Notice, "[s]uchyield should be comparable to the yield on other securities of comparable quality, maturity, coupon rate, and block size then available in the market."

Anderson asserts that he based all of his markup and markdown percentages on yield calculations, a practice which he believed was consistent with what others in the industry did. As noted, Anderson could not recall "[s]pecific" details regarding particular transactions. Anderson claimed that he "backed into" a markup after determining the yield, i.e., he took "what was left over" after providing "whatever [he] thought was competitive and would sort of excite the client to say yeah, I want to buy it, because it's a good yield . . . ." [46]

Anderson asserts that "he knew he was selling bonds to his clients at competitive rates because he compared his customers' yields to publicly available reporting services." Anderson claims that he determined these competitive rates by using an industry matrix which provided the average yield for a particular grade of security with a specified maturity. Anderson would then locate a municipal bond which would generate that yield after he factored in his markup.

Anderson used a small number of his trades to illustrate his methodology. [47] For example, Anderson noted that his customers received a 5.96% yield on Santa Margarita, California bonds that they purchased from him on December 27, 1993. He asserts that this yield compared favorably with the 4.85% to 5.00% average yields listed, as of December 23, 1993, [48] for bonds of the same grade and maturity on the industry matrix he used. However, Anderson paid 104.55 for the bonds and sold them in riskless principal transactions at 109.55, generating a markup of 4.78%. We note that McCabe found that the markup converted to a charge of 91 basis points to the first call date. As a result of Anderson's markups, the yield on the bonds fell from 6.87% to 5.96%.

Accepting Anderson's testimony regarding his approach to setting the markups and markdowns at issue, we find his conduct to be, at a minimum, highly unreasonable. Anderson's reliance on such an industry matrix did not by itself fulfill his responsibilities as set forth by the MSRB. Although the matrix provided general information about average yields for bonds of the same grade with similar maturities, it provided insufficient data to permit a meaningful evaluation of the appropriate yields for the municipal bonds Anderson sold. [49]

In setting his markups, Anderson failed to consider various factors identified by the MSRB other than yield, including the fair market value, the bonds' coupon rates, and the block size involved. Anderson also admittedly ignored call dates in calculating the resulting yields when he believed that the instrument was unlikely to be called on such dates. Although his markdowns on municipal securities ranged as high as 5.64%, Anderson provided no justification for them at all.

The MSRB guidelines do not apply to the Treasury and government agency securities. Anderson offered no particularized justification for the markups or markdowns he charged in trades involving Treasury strips, CMOs, or agency-specified pool securities. While Anderson claimed that there were special circumstances surrounding his purchase of Treasury securities in December 1992 described above, the expert testimony regarding the liquidity of those securities and the fact that he was able to make all twelve trades for the customer within one hour indicates that the effort he made was in no way extraordinary.

Anderson asserts that, for at least a portion of the period at issue, he attempted to comply with what he believed to be NASD pricing guidelines. Anderson introduced a copy of an NASD exit interview report completed by an NASD staff member following an examination of Annandale in 1993. The examiner identified municipal bond trades with markups and markdowns between 5% and 5.3%. Anderson testified that, at that time, he explained to the examiner that he understood that 5% was the then-current NASDguideline and that Anderson exceeded this guideline by mistake. Anderson testified that he provided rebates to customers who had been charged markups or markdowns exceeding 5%, and provided proof of such rebates to the NASD. [50]

In 1995, following a subsequent examination, the NASD informed Anderson that his markups and markdowns on municipal bond trades ranging from 4.32% to 5.64 "appear[ed] to be excessive and an apparent violation" of the NASD's Rules of Fair Practice. After discussions with the NASD, Anderson and the NASD agreed that Anderson would rebate markups and markdowns of 5% and above. The record established that, at this time, Anderson was informed that the NASD's "internal guidelines" provided that markups and markdowns of 3.0% to 3.5% could be excessive, depending on circumstances. [51] Although we do not necessarily agree with the NASD guidelines to which Anderson refers, [52] his apparent reliance on them mitigates against a finding that he acted with scienter. [53]

Nonetheless, the evidence clearly establishes that Anderson's markups and markdowns deviated significantly from industry norms. Based on his own testimony, Anderson approached pricing in a way that was not consistent with the pricing principles we have long enunciated. We believe that Anderson'sconduct in pricing these transactions demonstrates at least negligence.

Securities Act Section 17(a)(2) makes it unlawful for any person, in the offer or sale of any security, to make an untrue statement of material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. Section 17(a)(3) prohibits any person, in connection with the offer or sale of any security, from engaging in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser. These two sections may be violated without evidence of scienter. [54] Under the circumstances, we find that Anderson willfully violated Securities Act Sections 17(a)(2) and 17(a)(3) as a result of his charging the undisclosed markups and markdowns at issue here. We further find that, as a result of his actions, Anderson caused Armscott's violations of Exchange Act Sections 15(c)(1) and 15B(c)(1), Exchange Act Rule 15c1-2, and MSRB Rules G-17 and G-30. [55] Although we have declined to find that Anderson acted with scienter because of possible uncertainty regarding the applicable standards during the period at issue, we nevertheless expect that, to the extent those standards were ambiguous, they have now been clarified. [56]

IV.

The Commission has broad discretion to set sanctions in administrative proceedings. [57] In determining the need to impose sanctions, we are guided by the following factors:

[T]he egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations. [58]

Anderson charged excessive markups and markdowns in 96 transactions over several years, generating close to $200,000 in illegal profits. Moreover, Anderson, who remains employed in the industry, appears not to appreciate his obligation to give his customers prices that are reasonably related to the prevailing market price. We also note that, in 1991, Anderson and Annandale settled earlier NASD allegations of unfair pricing by each agreeing to be censured, to pay a joint and several fine of $5,000 and to reimburse customers for excessive markups. [59]

Under the circumstances, we believe that Anderson's conduct warrants a significant civil money penalty. Section 21B of the Exchange Act authorizes the imposition of civil money penaltieswhere it is in the public interest to do so. [60] That section authorizes a money penalty of up to $5,000 for each of Anderson's violative transactions. We believe that it is appropriate that Anderson pay a civil money penalty of $1,000 for each of the 96 trades at issue.

We also believe that it is appropriate that Anderson pay disgorgement. Exchange Act Section 21C(e) authorizes disgorgement in this proceeding. [61] Disgorgement requires a wrongdoer to relinquish proceeds "causally related" to his misconduct. [62] The Division has the initial burden of showing that its disgorgement figure reasonably approximates the amount of unjust enrichment. [63] Once the Division has made this showing, the burden shifts to the respondent to demonstrate that the requested disgorgement amount is not a reasonable approximation. [64]

The Division introduced evidence to establish that Anderson should disgorge $182,195 in illegal profits based on his excessive markups and markdowns. [65] Anderson introduced evidence that he paid $115,504 of those markups and markdowns to AMM, the adviser on the trades, pursuant to an agreement. The law judge made findings in support of Anderson's assertion, and those findings were not appealed. [66] Consequently, we will order Anderson to pay disgorgement of $66,691, plus interest.

With respect to the remedy of a cease and desist order, "evidence showing that a respondent violated the law once probably also shows a risk of repetition that merits our ordering him to cease and desist." [67] Here, Anderson's serious and repeated misconduct over an extended period, along with his disciplinary history, raise at least "some risk" of future violations. This risk is heightened by Anderson's unwillingness to accept the wrongfulness of his conduct.

An appropriate order will issue. [68]

By the Commission (Chairman DONALDSON and Commissioners GLASSMAN, GOLDSCHMID, and ATKINS); Commissioner CAMPOS not participating.

Jonathan G. Katz
Secretary

In the Matter of Mark David Anderson, Securities Act Release No. 8265, Exchange Act Release No. 48352, A.P. File No. 3-9499 (August 15, 2003).

ORDER IMPOSING REMEDIAL SANCTIONS

On the basis of the Commission's opinion issued this day, it is

ORDERED that Mark David Anderson cease and desist from committing or causing any violation or any future violation of Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933, and Sections 15(c)(1) and 15B(c)(1) of the Securities Exchange Act of 1934 (due to a violation of Rules G-17 or G-30 of the Municipal Securities Rulemaking Board), due to the charging of excessive and undisclosed markups or markdowns on securities trades involving retail customers; and it is further

ORDERED that Mark David Anderson disgorge $66,691, plus prejudgement interest determined in conformity with 26 U.S.C. § 6621(a)(2) from March 5, 1997, the date of the last transaction at issue in this matter, to the date of this order, and it is further

ORDERED that Mark David Anderson pay to the United States Treasury a civil money penalty of $96,000, pursuant to Section 21B of the Securities Exchange Act of 1934, within 21 days of the issuance of this Order. Such payment shall be: (i) made by United States postal money order, certified check, bank cashier'scheck, or bank money order; (ii) made payable to the Securities and Exchange Commission; (iii) delivered by hand or courier to the Comptroller, Securities and Exchange Commission, 450 5th Street, N.W., Washington, D.C. 20549; and (iv) submitted under cover letter which identifies the respondent in these proceedings, and the file number of these proceedings. A copy of this cover letter and check shall be sent to Thomas A. Zaccaro, counsel for the Division of Enforcement.

By the Commission.
Jonathan G. Katz
Secretary

APPENDIX

A. Treasury Notes

	SECURITY	SETTLE. DATE	PURCH. PRICE	SALE PRICE	VALUE OF SEC.	% MARK-DOWN	$ MARK-DOWN
1	US Treas Note 8/15/97	Dec 15 92	105.9062	109.906	$250,000	3.78%	$10,000
2	US Treas Note 4/15/95	Dec 15 92	103.3125	107.313	$250,000	3.87%	$10,000
3	US Treas Note 11/15/98	Dec 15 92	108.6562	111.656	$250,000	2.76%	$ 7,500
4	US Treas Note 2/15/99	Dec 15 92	108.9687	111.969	$250,000	2.75%	$ 7,500
5	US Treas Note 11/15/94	Dec 15 92	103.1875	106.188	$250,000	2.91%	$ 7,500
6	US Treas Note 9/30/93	Dec 15 92	100.3437	103.344	$250,000	2.99%	$ 7,500
7	US Treas Note 7/15/97	Dec 15 92	106.25	109.25	$125,000	2.82%	$ 3,750
8	US Treas Note 8/15/95	Dec 15 92	104.9062	107.906	$100,000	2.86%	$3,000
9	US Treas Note 11/15/00	Dec 15 92	107.5	110.5	$100,000	2.79%	$ 3,000
10	US Treas Note 12/31/94	Dec 15 92	102.125	105.125	$100,000	2.94%	$3,000
11	US Treas Note 5/15/02	Dec 15 92	101.4375	104.469	$200,000	2.99%	$6,062
12	US Treas Note 10/15/96	Dec 15 92	104.3125	107.313	$375,000	2.88%	$11,250

B. Treasury Strips

	Security	Settle. Date	Purch. Price	Sale Price	Par Value	% Markup	$ Markup
	Markups - U.S. Treasury Securities						
1	Strips TINT 11/15/04	Apr 25 94	47.25	49.14	$155,000	4.00%	$2,930
2	Strips TINT 11/15/09	Apr 25 94	31.71	32.98	$225,000	4.01%	$2,857

3	US Treas Sec Stripped Int 11/15/99	Apr 25 94	69.52	72.3	$ 70,000	4.00%	$1,946
4	Strips - TINT due 11/15/96*	Jun 27 94	86.53	89.12	$145,000	2.99%	$3,756
	*Trade executed for multiple clients						

C. Agency Specified Pool Securities

	SECURITY	SETTLE. DATE	PURCH. PRICE	SALE PRICE	PAR VALUE OF BONDS	% MARK-UPS	$ MARK-UPS
1	GNMA Pass Thru Pool 392228X	Jun 21 94	94.75	98.55	$ 50,000	4.01%	$1,900
2	GNMA Pass Thru Pool 392339X *	Jun 30 94	93.25	96.98	$175,000	4.00%	$6,528
3	GNMA Pass Thru Pool 380752X Western Mort Corp	Jul 21 94	96.75	100	$ 47,912	3.36%	$1,557
4	GNMA Pass Thru Pool 392343X Countrywide Funding Corp *	Jul 19 94	92.0625	95.81	$125,000	4.07%	$4,684
5	GNMA Pass Thru Pool 392344X *	Jul 19 94	95.125	98.93	$ 50,000	4.00%	$1,903
6	GNMA Pass Thru Pool 392392X *	Jul 19 94	96.125	99.97	$150,000	4.00%	$5,768
7	GNMA Pass Thru Pool 392344X	Jan 25 95	90.0625	92.125	$ 49,758	2.29%	$1,026
8	GNMA Pass Thru Pool 163866X Pioneer Mort Corp	Mar 23 95	100.25	103.25	$ 56,773	2.99%	$1,703
9	GNMA Pass Thru Pool 196002X Home Mort of El Paso	Mar 23 95	100.25	103.25	$ 49,504	2.99%	$1,485
10	GNMA Pass Thru Pool 352669X Temple-Inland Mort Corp	Sep 12 95	96.25	99.618	$ 38,083	3.50%	$1,283
11	GNMA Pass Thru Pool 377732X *	Sep 12 95	96.25	99.618	$155,798	3.50%	$5,247
12	Fed Nat Mort Assn Remic Pass Thru Ctf Tr 1993-32 C1 K *	Nov 17 95	95.5	98.36	$ 83,948	2.99%	$2,401
	* Trade executed for multiple clients						

D. Collateralized Mortgage Obligations

	SECURITY	SETTLE. DATE	PURCH. PRICE	SALE PRICE	PAR VALUE OF BONDS	% MARK-UPS	$ MARK-UPS
1	Fed Home Loan Mort Cor CMO/Series 1412*	Jun 21 94	91.3125	95	$ 58,000	4.04%	$2,139
2	Fannie Mae Remic Trust Series CMO/1992-162 *	Sep 11 95	95.625	98.97	$288,000	3.50%	$9,634
3	Fannie Mae Remic Trust CMO/Series 1993-G31 *	Sep 13 95	97.5	100.91	$ 86,953	3.50%	$2,965
4	Fannie Mae Remic Trust CMO/Series 1992-188 *	Nov 13 95	98.125	100	$100,000	1.91%	$1,875
5	Fannie Mae Remic Trust CMO/Series 1994-042 *	Nov 13 95	98	100	$ 96,144	2.04%	$1,923
6	Fed Home Loan Mort Corp MLTCL Mtg Partn Series G043 CL OB*	Nov 14 95	96.63	98	$98,808	1.42%	$1,354
7	Fed Home Loan Mort Corp MLTCL Mtg Part Ser 1804 C1 B	Dec 6 95	95.875	98.27	$100,000	2.50%	$2,395
8	Fed Home Loan Mort Corp MLTCL Mtg Part Ser 1461	Mar 5 97	99	101.9	$148,948	2.93%	$4,319
	* Trade executed for multiple clients						

E. Municipal Securities (Markups)

	ISSUER	SETTLE. DATE	PURCH. PRICE	SALE PRICE	PAR VALUE OF BONDS	% MARK-UP	$ MARK-UP
1	LA Reg Airpt Western Air	May 20 93	117.5	121.5	$ 50,000	3.40%	$2,000
2	Los Angeles Cty CA Met Trans Auth Sales Tax Rev Ref	May 25 93	91.25	95.25	$ 50,000	4.38%	$2,000
3	Sacramento CA Imp Bd Act Sunrise Corridor	Jul 7 93	100.25	104.25	$ 50,000	3.99%	$2,000
4	Orange Cty CA Comty Fac Dist 87-7 Ser A	Sep 29 93	109	114	$ 25,000	4.59%	$1,250
5	Pico Rivera CA Redev Agy Tax Alloc Proj 1	Sep 29 93	102.5	107.5	$ 25,000	4.88%	$1,250

6	LA Reg Airpt Western Air	Nov 30 93	118	122	$ 15,000	3.39%	$600
7	LA Reg Airpt Western Air	Dec 16 93	118	123	$ 40,000	4.24%	$2,000
8	Cal Health Fac Auth Presb Hosp	Dec 21 93	104	109	$ 50,000	4.81%	$2,500
9	LA Reg Airpt Western Air	Dec 21 93	118	123.5	$180,000	4.66%	$9,900
10	Bay Area Gov Assn CA Fremont Lid 23R-Ser F*	Dec 27 93	99.5	103	$125,000	3.52%	$4,375
11	Santa Margarita CA WD 7A Ser A*	Dec 27 93	104.55	109.55	$110,000	4.78%	$5,500
12	Wilkins Area PA Ind Dev Auth Oakmont Inc	Dec 28 93	100.5	105	$ 25,000	4.48%	$1,125
13	NYS Urban Dev Corp Correctional Cap Ser 4	Dec 30 93	95.7	100	$100,000	4.49%	$4,300
14	NYC G/O Ser A FSA TAGSS-ETM	Dec 30 93	106.68	110.68	$ 50,000	3.75%	$2,000
15	Cornwall Lebanon PA Sch Dist	Jan 11 94	106.6	110.6	$50,000	3.75%	$2,000
16	West Chester PA G/O	Jan 26 94	108.9	113	$ 50,000	3.76%	$2,050
17	Orange Cty CA IMOT Bd Assmt Dist 88-1 Ser A	Jan 20 94	101	105	$ 50,000	3.96%	$2,000
18	North Huntington Twp PA Swr Rev Ref	Jan 12 94	111	115	$ 50,000	3.60%	$2,000
19	San Bernardino CA Hosp Rev *	Jan 27 94	104	108	$ 25,000	3.85%	$1,000
20	Santa Margarita CA WD 7A Ser A	Jan 7 94	105.46	109.46	$ 25,000	3.79%	$1,000
21	Palo Alto Hlth Care Fac Lytton Gardens	Feb 4 94	107.73	112	$100,000	3.96%	$4,270
22	Cal St Pub Wks Bd Lease Rev Calif St Univ 1992 Pjs A	Feb 7 94	111	115.5	$ 50,000	4.05%	$2,250
23	Orange Cty Comm Fac Dist 88-2 Lomas Laguna	Feb 9 94	110	114.5	$ 50,000	4.09%	$2,250
24	San Dimas CA RDA Tax Alloc Ref Creative Grth Proj Ser A	Feb 15 94	113.75	119.44	$ 75,000	5.00%	$4,268
25	Santa Margarita CA WD 7A Ser A	Feb 15 94	107.5	112.88	$ 50,000	5.00%	$2,690
26	Santa Margarita CA WD 7A Ser A	Feb 24 94	107.33	111.33	$ 25,000	3.73%	$1,000
27	LA Reg Airpt Western Air	Mar 2	115.5	119.25	$ 50,000	3.25%	$1,875

		94					
28	NYS Loc Govt Asst Corp Ser A	Mar 18 94	112.125	116.525	$150,000	3.92%	$6,600
29	Port Auth NY/NJ Cons 67th Ser	Mar 18 94	109.5	113.8	$125,00	3.93%	$5,375
30	San Francisco CA Cty RDA South Beach Proj	Apr 5 94	95.628	99.125	$ 30,000	3.66%	$1,049
31	Puerto Rico Commw Hwy Transp Rev Ser W	Apr 6 94	93.25	97.25	$130,000	4.29%	$5,200
32	Garden Grove CA Part Bahia Vlg Emerald Isle FSA	Apr 8 94	95	99	$ 50,000	4.21%	$2,000
33	San Marcos CA Pub Fin Auth Ser A	Apr 28 94	99.5	103.48	$ 25,000	4.00%	$995
34	San Bernardino CA Hosp Rev *	May 11 94	101	105.3	$ 50,000	4.26%	$2,150
35	Santa Margarita CA WD 7A Ser A	May 11 94	103.25	107.5	$ 50,000	4.12%	$2,125
36	PA St Tpk Commn Oil Franchise Tax	May 12 94	99	103	$ 25,000	4.04%	$1,000
37	Cal Health Fac Ref Cath Hosp *	May 12 94	87	90.74	$100,000	4.30%	$3,740
38	Port Oakland CA Rev Ser A*	May 12 94	108.77	113.44	$100,000	4.29%	$4,670
39	Central CA Jt Power Hlth Fin Auth Cops Comm Hosp Proj *	May 17 94	86.57	90.29	$100,000	4.30%	$3,720
40	Cal St Pub Wks Bd Leas Rev Univ Calif Proj Ser B	May 19 94	90.5	94.4	$ 50,000	4.31%	$1,950
41	Los Angeles Airport Laxfuel Corp	May 19 94	100	104.3	$ 50,000	4.30%	$2,150
42	Sta Margarita Ca WD 7A Ser A	Jun 30 94	102.5	106.6	$ 50,000	4.00%	$2,050
43	San Diego CA RDA Orchard II Ser A	Jul 21 94	104.5	108.68	$ 55,000	4.00%	$2,299
44	Fontana Ca Pub Fin Auth North Fontana Redev Proj A	Jul 21 94	91.19	94.83	$ 45,000	3.99%	$1,638
45	LA Reg Airpt Western Air *	Mar 1 95	107	109	$200,000	1.87%	$4,000
46	Local Govt Fin Auto CA Hoover Rdv Pj-Sub Fin	Sep 13 95	103.5	107.125	$ 50,000	3.50%	$1,813
47	LA Reg Airpt Western Air	Sep 15 95	107	110.745	$ 25,000	3.50%	$936
48	LA Reg Airpt Western Air	Oct 20	105.35	109	$ 50,000	3.46%	$1,825

		95					
49	LA Reg Airpt Western Air	Nov 17 95	106	109.71	$ 20,000	3.50%	$742
50	LA Reg Airpt Western Air	Mar 12 96	105.75	108.9	$ 25,000	2.98%	$788
	* Trade executed for multiple clients						

F. Municipal Securities (Markdowns)

	ISSUER	**SETTLE. DATE**	**PURCH. PRICE**	**SALE PRICE**	**PAR VALUE OF BONDS**	**% MARK-DOWN**	**$ MARK-DOWN**
1	Anaheim CA RDA Tax Alloc Alpha Proj Ser D	Sep 24 93	101.89	106.29	$ 25,000	4.32%	$1,100
2	Anaheim CA COPS Area Land Acquis	Sep 24 93	100.25	105.25	$ 25,000	4.99%	1,250
3	Los Angeles Cty CA Met Trans Auth Sales Tax Rev Ref	Sep 24 93	88.655	93.655	$ 50,000	5.64%	$2,500
4	Industry CA Urban Dev Agy Pj 1	Sep 24 93	106.07	111.07	$ 50,000	4.71%	$2,500
5	Sacramento CA Imp Bd Act Sunrise Corridor	Sep 24 93	96.943	101.94	$ 50,000	5.16%	$2,500
6	Oakland CA Redev Agy Cent Dist Redev Proj	Sep 24 93	110.638	115.64	$ 25,000	4.52%	$1,250
7	Redlands CA CTES Partn Domestic Water	Sep 24 93	102.794	107.76	$ 25,000	4.83%	$1,243
8	Cal St G/O	Mar 21 94	100	103.02	$200,000	3.02%	$6,038
9	Cal St G/O Var Purp	Mar 21 94	100.775	104.78	$150,000	3.97%	$6,000
10	LA Reg Airpt Western Air	Sep 28 95	106.5	110	$45,000	3.29%	$1,575
	Note - Anderson executed trades before January 1995 through Annandale Securities. Anderson executed subsequent trades through Armscott Securities.						

Footnotes

[1] In January 1995, Annandale filed a Form BDW to withdraw from registration with the Commission.

[2] Armscott consented, without admitting or denying the findings, to the entry of a cease and desist order in which the Commission found that Armscott violated antifraud provisions of the securities laws by charging customers undisclosed, excessive markups and markdowns in the sale of government agency and municipal securities in 1995 through 1997. See Armscott Securities, Ltd., Exchange Act Rel. No. 7482 (Dec. 4, 1997), 65 SEC Docket 3022. Armscott also agreed to pay disgorgement and to withdraw its registration as a broker-dealer.

[3] 15 U.S.C. § 77q(a); 15 U.S.C. § 78j(b); 17 C.F.R.

§ 240.10b-5.

[4] 15 U.S.C. §§ 78o(c)(1) and 78o-4(c)(1); 17 C.F.R. § 240.15c1-2. Section 15(c)(1) and Rule 15c1-2 prohibit any broker-dealer and any municipal securities dealer from inducing the purchase or sale of securities or municipal securities by means of any manipulative, deceptive, or other fraudulent device or contrivance. Section 15B(c)(1) prohibits a broker-dealer from violating MSRB rules.

[5] MSRB Rule G-17 provides that, in conducting its municipalsecurities business, a dealer must "deal fairly with all persons" and "not engage in any deceptive, dishonest or unfair practice." Rule G-30 requires a dealer to sell municipal securities to a customer at an aggregate price that is "fair and reasonable taking into consideration all relevant factors . . . ."

Although the subject transactions occurred at both Annandale and Armscott, the Order Instituting Proceedings alleges only that Anderson's conduct aided, abetted, and was a cause of Armscott's violations.

[6] The parties executed a series of stipulations regarding the case prior to the hearing.

The individual trades, along with the data needed to calculate the resulting markup or markdown, are presented in an appendix to this opinion.

[7] According to Anderson, prior to 1995, Armscott "subcleared" through Annandale, which provided broker-dealer services to Armscott's customers. Armscott signed a clearing agreement with Bear Stearns, Annandale's clearing firm, when Annandale withdrew its registration, and, according to Anderson, he "just moved over to Armscott."

[8] Anderson testified that he disposed of his "working notes, my faxes from other dealers, my rate yield tables" when he was "through with the transaction."

[9] Compare text accompanying n.20 infra.

[10] According to Anderson, "[I]ts yield. Again, it's the same as in municipals. It's yield based."

Anderson added, with respect to government agency securities, that

You've got to buy the right tranche, you've got to buy the right payment history. You've got to look for the Ginnie Mae's that are either seasoned, unseasoned. You've got to figure what the paydown history of the mortgages may be, where interest rates you think are going. You get hypothetical values done and you do the same amount of work, it's just a different security.

[11] AMM and its owner consented, without admitting or denying findings, to the entry of a cease and desist order in which the Commission found that the respondents had violated various provisions of the Investment Advisers Act of 1940 in connection with 75 municipal and government agency bond trades executed by Annandale and Armscott in 1994 and 1995. See A. Morgan Maree & Associates, Inc., Advisers Act Rel. No. 1718 (Apr. 27, 1998), 67 SEC Docket 49. Prior to 1995, Anderson testified that "[a]ll of Armscott's clients were from [AMM], not from [Anderson] or not from Annandale."

[12] McCabe, at the time of his testimony, was a managing director of Securities Corporation of Iowa, which he described as a full service brokerage firm which underwrites between 100 and 200 separate municipal bond issues annually and engages in extensive municipal bond trading in the secondary market. With close to forty years of experience in the securities industry, McCabe was responsible, among other things, for supervising his firm's municipal bond traders.

[13] McCabe stated that he was asked to review over 100 trades for excessive charges, but characterized a charge as excessive only where it was "extremely higher than the industry norm." McCabe determined not to classify as excessive charges that were merely slightly above industry norms.

[14] Trade Number 1 in Chart F of the Appendix to this opinion.

[15] McCabe explained that, as a result of the proposed pre-refunding, the bonds were secured by U.S. Treasury securities.

[16] McCabe stated that the appropriate range for this trade should have been "between 57 basis points and 184 basis points."

McCabe testified that he sought to "quantify" what this markup "meant in terms of yield" to the customer. He explained that "[a]ll muni's are traded in terms of yields of maturity or yield to the call."

[17] Trade Number 9 of Chart F. The bond was non-callable.

[18] Trade Number 24 in Chart E of the Appendix.

[19] Trade Number 47 in Chart E.

[20] According to Anderson, he "made the calculated gamble" "after talking with the company" and to the paying agent that the bond would not be called because it was "a very high coupon, 11 3/4." While asserting that the bond made money for several of his customers, Anderson conceded that this customer lost money on the bond.

[21] McCabe stated that he had reviewed Anderson's extensive investigative testimony for any indication that Anderson did "something special" for these customers to "justify his markups." McCabe found no such justification.

[22] MacLaverty, a financial analyst and consultant, hadextensive experience trading and selling government securities.

[23] Whenever MacLaverty felt that the charge Anderson assessed could have been warranted by circumstances, he excluded it from the group he considered excessive. At the Division's request, MacLaverty evaluated over 100 trades in which Anderson bought from or sold to retail customers. With respect to roughly 75 trades out of the over 100 trades evaluated, MacLaverty concluded that there might "have been a way to justify the extent of the markup" as a result of "extenuating circumstances."

[24] Anderson charges that the Order Instituting Proceedings ("OIP"), which was dated December 4, 1997, "was issued five years after some of the trades at issue." Anderson does not specify the trades to which he is referring, but the earliest trades at issue are Anderson's purchase of these twelve Treasury Notes, which settled on December 15, 1992. Consequently, the general five year federal statute of limitations for penalty claims does not apply. See 28 U.S.C. § 2462.

[25] When Anderson was asked whether the trades took one hour, he testified: "I had one hour to do it, but I still had -- the trade still had to be settled, you still had to get the bonds from the other place . . . ." He added that, in addition to these Treasury notes, Anderson also had to liquidate "thirty or so common stocks for her."

[26] MacLaverty described a "U.S. Treasury strip" as a "U.S. Treasury note that's had a coupon stripped off of it and sold." Thus, a strip holder receives a principal payment only.

[27] MacLaverty described "agency specified pools" as "pools of single-family home owner mortgages that get bundled together into federal agency-backed pools." These agencies include the Government National Mortgage Association ("Ginnie Mae") and the Federal National Mortgage Association ("Fannie Mae").

[28] MacLaverty stated that, because these securities are subjectto prepayment risk, i.e., the risk that borrowers on the underlying mortgages will prepay principal, "there is also a commensurate adjustment in the willingness of dealers (fewer in number than for treasuries) to purchase and sell at prices too close to each other."

[29] MacLaverty described CMOs as "pools of specified pools, if you will, which then have their cash flows carved up into different bonds or tranches for different investor types."

[30] MacLaverty also testified that these particular CMOs "trade in bid-ask spreads of anywhere between 1/4 of a point and 3/4 of a point."

[31] Grandon v. Merrill Lynch & Co., Inc., 147 F.3d 184, 192 (2d Cir. 1998). See also Meyer Blinder, 50 S.E.C. 1215, 1228 (1992) ("Broker-dealers have a duty to deal fairly with the public, which includes the implied representation that the price a firm charges bears a reasonable relationship to the prevailing market price.").

[32] Alstead, Dempsey & Co., Inc., 47 S.E.C. 1034, 1035 (1984).

[33] Alstead, Dempsey, 47 S.E.C. at 1035. See also Edward J. Blumenfeld, 47 S.E.C. 189, 191-92 (1979) (holding that prices paid for a security by a dealer in actual transactions closely related in time to his retail sales are normally a highly reliable indication of prevailing market price).

[34] Kevin B. Waide, 50 S.E.C. 932, 935 (1992).

[35] Investment Planning, Inc., 51 S.E.C. 592, 595 (1993) (citing Exchange Act Rel. No. 24368 (Apr. 21, 1987), 38 SEC Docket 234, 236 (advising broker-dealers that "what might be anappropriate mark-up for the sale of an equity security may be an excessive mark-up for a debt security transaction of the same size")). See also First Honolulu Securities, Inc., 51 S.E.C. 695, 697 (1993) (significantly lower markup is customarily charged in the sale of debt securities than in transactions of the same size involving common stock) and 699 n.14 ("mark-ups on government securities, like mark-ups on corporate and municipal debt securities, usually are smaller than those on equity securities"); NASD Manual IM-2440(b)(1) (noting that "a higher mark-up customarily applies to a common stock transaction than to a bond transaction of the same size"); Zero-Coupon Securities, Exchange Act Rel. No. 24368 (Apr. 21, 1987), 38 SEC Docket 234, 235 n.15 ("it is the industry practice, in general, for broker-dealers in principal transactions to charge retail customers mark-ups on sales of debt securities that are measurably lower than those charged on sales of equity securities").

[36] See First Honolulu Securities, Inc., 51 S.E.C. at 698-99 ("[A]lthough some markups on municipal bonds may reach 5%, that figure might be acceptable in only the most exceptional cases.") (citing SEC v. Charles A. Morris & Assoc., Inc., 386 F.Supp. 1327, 1334 n.5 (W.D. Tenn. 1973) ("It is the practice in the municipal bond industry to charge retail customers a price which is no more than one quarter of one per cent to five per cent over a bond's current market price.")); Staten Securities Corp., 47 S.E.C. 766, 767 (1982) ("As a general rule, markups on municipal bonds are significantly lower than those for equity securities."). In First Honolulu, we noted that "markups on municipal debt securities . . . below four percent may well have been unfair" although, in that case, evidence did not "establish the unfairness of markups at th[o]se levels." Id. at 701. See also Investment Planning, Inc., 51 S.E.C. at 595-96 ("our opinions suggest that although some markups on municipal bonds may reach 5%, that figure might be acceptable in only the most exceptional cases," finding markups from 4% to 5.9% on municipal bonds improper).

[37] Staten Securities, 47 S.E.C. at 768 n.9.

[38] 38 SEC Docket at 235.

[39] See, e.g., Shamrock Partners, Ltd., 53 S.E.C. 1008, 1011 (1998) ("Markdowns are generally smaller than markups."). For example, in a landmark study of the Securities Markets, the National Association of Securities Dealers, Inc. (the "NASD") found that "in over 82% of dealer's riskless purchases from customers, markdowns did not exceed 2%; and that in over 17% of the purchases, no markdown was taken or the stocks were purchased at a loss." Hamilton Bohner, Inc., 50 S.E.C. 125, 128 (1989) (citing Thill Securities Corporation, 42 S.E.C. 89, 92-95 (1964)). See also The Report of the Special Study of Securities Markets, H.R. Doc. No. 95, Pt. 2, p. 626, Table VII-23 (1963).

[40] Investment Planning, Inc., 51 S.E.C. at 596. We have stated that "expert testimony is generally very helpful when the question to be resolved is the proper pricing of debt securities." F.B. Horner, 50 S.E.C. 1063, 1066 n.11 (1992), aff'd, 994 F.2d 61 (2d Cir. 1993) (per curiam). In Horner, we accepted expert testimony that, at that time, it was industry practice for a firm that was not at risk, to charge markups of 1.8% to 2.9% on certain principal only CMO securities. Id.

[41] Donald T. Sheldon, 51 S.E.C. 59, 77 (1992) (Under the Administrative Procedure Act, "[o]nce the Division presented evidence of the[] markups, the burden shifted to [the respondent] to refute that evidence."), aff'd, 45 F.3d 1515 (11th Cir. 1995). Anderson claims that there is no authority for shifting the burden in this way where the respondent is charged, as here, with "federal securities fraud." Sheldon, however, involved allegations of fraud in connection with the retail pricing of municipal and government securities.

Citing Banca Cremi, S.A. v. Alex Brown & Sons, Inc., 132 F.3d 1017, 1034 (4th Cir. 1997), Anderson also argues that the burden of proving excessive pricing remained with the Division even after it introduced expert testimony that the markups and markdowns were excessive because they exceeded specified percentages. Banca Cremi involved a private litigant and revolved around an element of a private securities fraud action, reliance, which is not at issue in a Commission enforcement proceeding.

Moreover, the court in Banca Cremi held that the ultimate burden of proving fraud could not be shifted to the defendant based solely upon testimony regarding the excessiveness of the markups. We do not mean to suggest that the burden of proof shifts but merely that the experts' testimony regarding industry practice had the effect of placing with Anderson the burden of producing evidence to support his claim that his pricing was not excessive. As we made clear in Sheldon, the ultimate burden of persuasion remains with the Division.

[42] Richard R. Perkins, 51 S.E.C. 380, 383 n.16 (1993).

[43] Anderson did not present evidence to challenge the Division's evidence regarding industry practice andexpressly concedes that the Division's experts established that "certain of Anderson's markups deviated from the normal range."

[44] The Second Circuit has held that, "[i]n assessing whether markups on municipal bonds are, in fact, excessive . . . courts should begin with the factors set forth under MSRB Rule G-30." Grandon, 147 F.3d at 193.

The MSRB, in its Report on Pricing, also identifies "a number of other factors which might be relevant in determining the fairness and reasonableness of prices in municipal securities transactions." These factors "include the availability of the security in the market, the price or yield of the security, the maturity of the security, and the nature of the professional's business."

[45] In 1980, the MSRB proposed establishing a pricing guideline for municipal securities of "1 point to 2 ½ point." After receiving comments on this proposal, the MSRB determined not to set any numerical guideline. In a 1980 Report on Pricing, the MSRB concluded that such a guideline "would not be feasible" because of "the heterogeneous nature of municipal securities transactions and municipal securities

dealers." We previously have expressed our agreement with the MSRB's approach "because to focus on particular percentages might encourage charging markups as high as thespecified figure." Investment Planning, Inc., 51 S.E.C. at 595 n.14.

[46] Because he lacked access to the requisite equipment, a bond yield calculator, Anderson relied on contra parties to calculate what markup would produce the desired yield.

[47] Anderson claims that he "randomly went through some" of the trades at issue and chose ones to analyze "because they were larger sizes."

[48] It is unclear why Anderson employed a yield chart for a date other than December 27.

[49] Noting that the guide reflected municipal bond trading across the country, Anderson acknowledged that "bonds in different states all trade differently."

[50] A former and a current NASD official testified as expert witnesses regarding general NASD markup and markdown policies. Their testimony supports Anderson's contention that the NASD pricing policy for municipal securities was not entirely clear during the period at issue. Neither witness was familiar with Anderson's conversations with the NASD at the time.

[51] Based on the evidence introduced by the Division, his subsequent markups and markdowns did not exceed 3.5%.

[52] We note that percentage pricing guidelines do not convey authority to charge the maximum amount. Charges significantly lower than the guidelines can be excessive under particular facts and circumstances

[53] Because we have declined to find scienter, we dismiss the the allegations that Anderson violated Securities Act Section 17(a)(1), Exchange Act Section 10(b) and Exchange Act Rule 10b-5, or that he aided and abetted violations of Exchange Act Sections 15(c)(1) and 15B(c)(1), Exchange Act Rule 15c1-2, or MSRB Rules G-17 and G-13.

[54] See Sheldon, 51 S.E.C. at 82 n.94 (finding violation of Sections 17(a)(2) and 17(a)(3) based on negligence and citing Aaron v. SEC, 446 U.S. 680, 695-700 (1980)).

[55] See, e.g., Sharon M. Graham, 53 S.E.C. 1072, 1085 n. 35 (1998) ("A respondent is a 'cause' of another's violation if the respondent 'knew or should have known' that his or her act or omission would contribute to such violation."), aff'd, 222 F.3d 994 (D.C. Cir. 2000).

[56] Anderson complains that, in light of the age of the alleged misconduct, "further prosecution of [the Division's] claim . . . constitutes an abuse of Anderson's due process rights . . . and violates fundamental principles of fairness." Consequently, he argues that the proceeding should be dismissed in its entirety. We disagree.

We instituted these proceedings in December 1997, less than a year after the alleged violative activity ended. Although Anderson complains that the trades are difficult to remember at this date, he gave investigative testimony regardingthese trades as early as 1995, within three years of the first trades at issue. Under the circumstances, we do not believe Anderson was prejudiced by the delay.

[57] See, e.g., Butz v. Glover Livestock Comm'n Co., 411 U.S. 182, 188-89 (1973) ("The fashioning of an appropriate and reasonable remedy is for the Secretary [of Agriculture], not the court. The court may decide only whether under the pertinent statute and relevant facts, the secretary made 'an allowable judgement in [his] choice of the remedy.'") (quoting Jacob Siegel Co. v. FTC, 327 U.S. 608, 612 (1946)).

[58] Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979), aff'd on other grounds, 450 U.S. 91 (1981).

[59] Anderson further testified that, as part of the settlement, he agreed to stop acting as a market maker in stocks.

[60] 15 U.S.C. § 78u-2(a).

[61] 15 U.S.C. § 78u-3(e). See SEC v. First City Fin. Corp., 890 F.2d 1215, 1230 (D.C. Cir. 1989) ("Disgorgement is . . . designed to deprive a wrongdoer of his unjust enrichment and to deter others from violations of the securities laws.").

[62] Id. at 1231.

[63] Id. at 1232.

[64] Id.

[65] According to the Division, its disgorgement request was reduced by $5,855 because Armscott had already disgorged that amount in a related administrative proceeding. See n.2, supra.

[66] Anderson concedes that he received approximately $52,000 in profits from these markups and markdowns.

[67] KPMG Peat Marwick LLP, Exchange Act Rel. No. 43862 (Jan. 19, 2001), 74 SEC Docket 384, 430, motion for reconsideration denied, Exchange Act Rel. No. 44050 (Mar. 9, 2001), 74 SEC Docket 1351, petition denied, 289 F.3d 109 (D.C. Cir. 2002).

[68] We have considered all of the arguments advanced by the parties. We reject or sustain them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

http://www.sec.gov/litigation/opinions/33-8265.htm

<u>In the Matter of William M. Ucherek</u>, Exchange Act Release No. 46408, A.P. File No. 3-10870 (August 23, 2002).

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that a public administrative proceeding be instituted against William M. Ucherek ("Ucherek" or "Respondent") pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act").

II.

In anticipation of the institution of these proceedings, Ucherek has submitted an Offer of Settlement (the "Offer"), which the Commission has determined to accept. Solely for the purpose of this proceeding and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and admitting the findings contained herein, including the jurisdiction of the Commission over him and over the subject matter of this proceeding and the entry of the permanent injunction set forth in paragraph III.C., below, Ucherek by the Offer consents to the entry of this Order Instituting Public Administrative Proceeding, Making Findings and Imposing Remedial Sanctions Against William M. Ucherek ("Order"), by the Commission.

Accordingly, **IT IS HEREBY ORDERED** that a proceeding pursuant to Section 15(b) of the Exchange Act be, and hereby is, instituted.

III.

On the basis of this Order and the Respondent's Offer, the Commission finds that:

A. Ucherek, age 57, was a resident of Danville, California, during the relevant period. From October 1995 until June 2001, Ucherek was a registered representative associated with Pacific Genesis Group, a now-defunct municipal securities dealer based in Alameda, California. From July through October 2001, Ucherek became associated with Brookstreet Securities, Inc., a registered broker-dealer and municipal securities dealer based in Irvine, California.

B. On April 24, 2002, the Commission filed a complaint in the United States District Court for the Northern District of California against Ucherek, captioned <u>SEC v. William M. Ucherek</u>, C-02-2003 (JCS). The Commission's complaint alleged, among other things, that Ucherek ran a Ponzi scheme by which he raised approximately $3 million from at least 20 elderly investors by telling them he was investing their money in funds supposedly sponsored by Charles Schwab & Co. The complaint alleged that, in reality, the funds Ucherek described did not exist. Instead, he simply deposited the money into his personal brokerage account from which he withdrew money to pay for his own personal expenses and gambling debts, as well as to repay prior investors.

C. On June 17, 2002, the United States District Court for the Northern District of California entered a Final Judgment of Permanent Injunction and Other Relief Against William M. Ucherek, enjoining Ucherek from violating Section 17(a) of the Securities Act of 1933and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Ucherek consented to the entry of the permanent injunction.

IV.

Based on the foregoing, the Commission deems it appropriate and in the public interest to accept the Offer submitted by Ucherek and impose the sanctions specified in the Respondent's Offer.

ACCORDINGLY, **IT IS ORDERED** that Ucherek be, and hereby is, barred from association with any broker or dealer.

For the Commission, by its Secretary, pursuant to delegated authority.
Jonathan G. Katz
Secretary

http://www.sec.gov/litigation/admin/34-46408.htm

REINVESTMENT OF PROCEEDS

Injunctive Proceedings

SEC v. Steven T. Snyder, Civ. Action No. 01-CV-1870 (E.D. Pa.), Litigation Release No. 16967 (April 17, 2001).

The Securities and Exchange Commission ("Commission") announced that, on April 17, 2001, it filed a complaint in federal district court in Philadelphia, Pennsylvania, charging that Steven T. Snyder, a former registered representative of Meridian Capital Markets, Inc. ("Meridian"), engaged in a fraudulent scheme to generate profits for Meridian by charging various school districts and other municipalities in Pennsylvania and West Virginia unfair prices for U.S. Treasury securities. The Commission's complaint charges that the securities were sold to the municipalities from March 1993 through December 1995, in connection with certain tax-exempt refinancings known as advance refundings. The Commission's complaint further alleges that, in connection with those transactions, Snyder engaged in a practice known as "yield burning" in which a broker or dealer purposely inflates the prices it charges customers on Treasury securities in order to reduce the yield on those securities and make it appear that the advance refunding transaction complies with federal tax laws. Furthermore, in order to secure Meridian's selection in certain advance refundings, Snyder arranged for Meridian to make payments to a financial consultant who provided services to certain municipal entities in West Virginia.

Without admitting or denying the Commission's allegations, Snyder consented to the entry of a judgment which permanently enjoins him from violating Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and

Rule 10b-5 thereunder. In addition, the judgment directs Snyder to pay to the U. S. Treasury: (1) an aggregate of $279,987 in resolution of the Commission's claims, as well as potential claims by the Internal Revenue Service and the Department of Justice, and (2) a civil penalty of $20,000.

In a related administrative proceeding Snyder consented to an order, based on the entry of the civil injunction, barring him from association with any broker, dealer or municipal securities dealer, with a right to reapply for association after three years.

http://www.sec.gov/litigation/litreleases/lr16967.htm

Commission Orders – Settled Administrative Proceedings

In the Matter of Steven T. Snyder, Securities Act Release No. 7970, Exchange Act Release No. 44190, A.P. File No. 3-9583 (April 17, 2001).

I.

In these proceedings instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Sections 15(b), 15B and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), respondent Steven T. Snyder ("Snyder") has submitted an Offer of Settlement ("Offer") which the Securities and Exchange Commission ("Commission") has determined to accept.[1] Solely for the purpose of this proceeding and any other proceeding brought by or on behalf of the Commission or in which the Commission is a party, and without admitting or denying the findings contained herein, except for jurisdiction and the findings set forth below in subparagraphs II.A., II.B. and II.C., which he admits, Snyder, by his Offer, consents to the findings and the imposition of the sanctions and other relief contained in this Order Making Findings and Imposing Remedial Sanctions ("Order").

II.

On the basis of this Order, and the Offer submitted by Snyder, the Commission finds that:

A. Meridian Capital Markets, Inc. ("Meridian Capital"), was a municipal securities dealer registered with the Commission pursuant to Section 15B(a)(2) of the Exchange Act from February 1987 through November 12, 1996, when the entity officially ceased operations.

B. Snyder was licensed as a registered representative with Meridian Capital and was a director of Meridian Capital's Public Finance Department from March 1993 until January 1996.

C. On April 17, 2001, a Final Judgment and Order ("Final Judgment") was entered against Snyder by the United States District Court for the Eastern District of Pennsylvania, in Securities and Exchange Commission v. Steven T. Snyder, Civil Action No. 01-CV-1870. The Final Judgment enjoined Snyder from future violations of Sections 17(a) of the Securities Act, and Section 10(b) of the Exchange Act and

Rule 10b-5 thereunder. In the civil action, the Commission alleged that Snyder had violated those provisions, as described in the Order Instituting Proceedings. Snyder consented to the Final Judgment without admitting or denying the allegations in the Commission's complaint.

III.

On the basis of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions and other relief specified in Snyder's Offer of Settlement.

Accordingly, **IT IS ORDERED** that Snyder is barred from association with any broker, dealer or municipal securities dealer, with the right to reapply for association after three years to the appropriate self-regulatory organization, or if there is none, to the Commission.

By the Commission.
Jonathan G. Katz
Secretary

Footnotes

1 An Order Instituting Proceedings ("Order Instituting Proceedings") against Snyder was issued by the Commission on April 23, 1998.

http://www.sec.gov/litigation/admin/33-7970.htm

In the Matter of Pryor, McClendon, Counts & Co., Inc., n/k/a Pryor, Counts & Co., Inc., Raymond J. McClendon, Allen W. Counts, and Theresa A. Stanford, Securities Act Release No. 8062, Exchange Act Release No. 45402, A.P. File No. 3-9884 (February 6, 2002).
See "UNDERWRITERS" section.