ADMINISTRATIVE PROCEEDING
FILE NO. 3-4375

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	:
ROBERT W. HERKO	:
(FERRUGGIA, LIPPMAN & COYLE, INC.)	:
	:

INITIAL DECISION

Washington, D.C.
February 7, 1975

Max O. Regensteiner
Administrative Law Judge

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APPEARANCES: William Nortman, Jeffrey H. Tucker and Barry J. Mandel, of the Commission's New York Regional Office, for the Division of Enforcement.

Joseph P. McGinnis, of Lichtenberg, Herman and McGinnis, P.C., for Robert W. Herko.

BEFORE: Max O. Regensteiner, Administrative Law Judge

In these public proceedings pursuant to Sections 15(b) and 15A of the Securities Exchange Act of 1934, the order for proceedings presents the issue, among others, whether, as alleged by the Division of Enforcement, Robert W. Herko, while associated with Ferruggia, Lippman & Coyle, Inc. ("registrant"), then a registered broker-dealer, wilfully violated the antifraud provisions of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. The specific misconduct alleged is that, in connection with transactions in the common stock of International Hydrolines, Inc. ("IHI") during the period from about November 1971 to April 1972, Herko (1) charged prices not reasonably related to prevailing market prices; (2) recommended the purchase of IHI stock to customers without first having made a reasonable and diligent inquiry as to the company's financial condition and business operations; and (3) failed to disclose such practices to his customers. As amended in minor respects, the order also raises the issue whether Herko failed reasonably to supervise persons subject to his supervision who engaged in such conduct.[1/]

Following extended hearings, the parties filed proposed findings and conclusions. The Division also filed a memorandum of law in support of its proposed findings and conclusions and a reply to those submitted by Herko.

1/ In addition to Herko, the order named registrant, Gary T. Ferruggia, Mark L. Lippman and Leo Nardone as respondents. Those respondents submitted settlement offers which the Commission accepted by order dated December 9, 1974. Securities Exchange Act Release No. 11127, 5 SEC Docket 669. While the findings in this initial decision of necessity refer to certain of the former respondents, such findings are not binding on them.

The findings and conclusions herein are based on the preponderance of the evidence as determined from the record and upon observation of the witnesses.

The Respondent

Herko, after working for more than ten years as an accountant, entered the securities business on a full-time basis in 1969 or 1970. In August 1971, following brief stints with several other broker-dealer firms as trader and registered representative, he joined registrant (then known as Ferruggia & Lippman, Inc.) in those capacities. The firm's principal officers and stockholders at that time and throughout the period of Herko's association with it were Gary T. Ferruggia and Mark L. Lippman, who were respectively president and secretary-treasurer. In the course of his association with registrant, which terminated with his resignation in April 1972, Herko became a vice-president as well as a stockholder. There is considerable conflict in the record as to the extent of Herko's authority and the point in time when he assumed the status of a principal. Herko claims that he was neither formally nor de facto a principal until the National Association of Securities Dealers, Inc. approved his principal registration in March 1972, shortly before he left registrant. However, the record does not support that claim.

As further discussed below, the record demonstrates that during the entire period here under consideration, beginning in late October

1971, Herko, though clearly subordinate to Ferruggia and Lippman, was more than an ordinary employee, but was a participant with them in at least certain major business decisions. And from about November 26 on, he was in fact a principal of registrant.

On or about that date, Herko invested $15,000 in registrant. In the course of the Division's investigation leading to these proceedings, Herko testified that he became an officer at the time he made his investment.[2/] An amendment to registrant's Form BD dated December 15, 1971, filed with the Commission a few days later, reported that the name of the firm had been changed to Ferruggia, Lippman, Herko & Coyle, Inc. and that Herko was a vice-president, director and owner of up to 10% of the firm's common stock.[3/]

Herko is currently the president of another registered broker-dealer.

2/ As part of its case, the Division introduced into evidence as admissions portions of Herko's investigative testimony. Subsequently, the parties stipulated the balance of the transcript of that testimony into the record.

3/ The amendment did not pinpoint the precise date of the name change or of Herko's elevation to officer-director status. Schedule A of Form BD, on which information concerning officers, directors and shareholders must be reported, has a column for showing the beginning date of the relationship giving rise to the reporting requirement. In Herko's case, the date given on the December 15 amended Schedule A was August 1971. But that date obviously reflected the misapprehension of the person who prepared the schedule that what was called for was the date of first association with the registrant rather than the date on which the pertinent relationships began.

The Alleged Misconduct

Herko does not dispute -- and the record shows -- that the specified antifraud provisions were violated in connection with registrant's sales of IHI stock. His argument is essentially that any sales by him personally were not improper, and that he cannot be held responsible on any theory of responsibility applicable to a principal or supervisor since he did not occupy such a position during the relevant period.

Sales at Excessive Prices

Registrant's dealings in IHI stock commenced with its purchase of 10,000 shares from another dealer on October 29, 1971 at a price of 1 1/4. It appears that one Norman Brodsky, a friend of Lippman's, first stimulated registrant's interest in retailing the stock and directed it to the dealer from whom the purchase was made. Of the 10,000 shares, 6,000 were bought by registrant as agent for three of Herko's customers; the other 4,000 were taken into registrant's trading account. On November 8, registrant bought a second block of 10,000 shares from another dealer, this time at 1 1/2, and took the entire block into its trading account. In between the two purchases, registrant began to enter quotations for IHI in the "sheets" published by the National Quotation Bureau. Its quotations appeared on almost every trading day thereafter during the period under consideration.

The record shows that the dealers from whom registrant purchased were both acting as agents for Brodsky. Herko, who apparently effected the purchases for registrant, testified to the effect that directly or indirectly he was directed to the two dealers by Brodsky but was not aware at that time that Brodsky was the actual seller.

Shortly after its second purchase, registrant commenced the retail sale of IHI stock from its trading account. During the period from November 10 through December 2, 1971, while making no further purchases, it sold a total of 9,700 shares. Of those, 2,000 were sold to one customer at 1 1/4 on November 11 [4/] and 300 were sold to 2 customers on November 26 at 1 1/2. The remaining retail sales of 7,400 shares to 25 customers were all effected at $1.60 a share, for the most part on November 10. It is clear on the record that the sales at 1 1/2 and $1.60 were not reasonably related to the prevailing market price -- i.e., the interdealer price -- on the days when those sales were effected.

The Commission has repeatedly held that, absent countervailing evidence, a dealer's contemporaneous or substantially contemporaneous cost is the best evidence of market price for the purpose of computing mark-ups. [5/]

4/ Herko testified that this was a customer of his, whom he had intended to include among the agency purchasers on October 29, but had been unable to reach on that day.

5/ See, e.g., Mark E. O'Leary, 43 S.E.C. 842, 849-50 (1968), aff'd 424 F.2d 908 (C.A.D.C., 1970); Shearson, Hammill & Co., 42 S.E.C. 811, 837, n. 57 (1965); J.A. Winston & Co., Inc., 42 S.E.C. 62, 68 (1964); Naftalin & Co., Inc., 41 S.E.C. 823 (1964).

If the above sales prices are related to registrant's second 10,000-share purchase at 1 1/2, the price of $1.60, and a fortiori the price of 1 1/2, would not have been excessive. But the record here -- i.e., countervailing evidence -- shows that the price paid by registrant in that purchase was not representative of the prevailing market price, and that at the time of the sales in question market prices much lower than 1 1/2 prevailed.

In cases involving allegations of unfair pricing, it is almost invariably true that contemporaneous costs are lower than other asserted indicia of current market prices to which the respondents point. It is self-evident that a dealer does not normally purchase securities for its own account at any price other than the lowest which it can obtain. But here that does not appear to have been the case.

The record, which includes a schedule showing all or substantially all transactions by the broker-dealers appearing in the sheets during the period under consideration, shows that there were no other interdealer transactions on November 8, when registrant bought the second 10,000 shares.[6/] But on November 5, the preceding trading date, there were several interdealer transactions at prices ranging from 3/4 to 1 1/8.

6/ The Commission has held or indicated on a number of occasions that prices in contemporaneous sales by the respondent broker-dealer to other dealers or other interdealer sales are even better evidence of market price than contemporaneous cost. See, e.g., Langley-Howard, Inc., 43 S.E.C. 155, 161 (1966); Gateway Stock and Bond, Inc., 43 S.E.C. 191, 194 (1966); Mark E. O'Leary, supra, at 848. Here registrant made no sales to other dealers until December 10, 1971.

And on November 9 the only interdealer transaction was effected at 1. Moreover, on November 8, the asked quotations of the eight broker-dealers in the sheets [7] ranged from 1 to 1 1/4. [8] The record indicates that the November 8 purchase, as well as the purchase of the first block, were designed to get Brodsky out of a substantial position at a good price, and that the prices paid reflected amounts fixed by registrant without regard for the prevailing market. It may well be that the market price would have been pushed up had registrant sought to accumulate an equally large position through a series of smaller purchases. But that did not justify it in passing on to its customers the unreasonably high cost of the purchases it made.

On November 10, 1971, when registrant sold 5,800 shares to 21 customers at $1.60 per share, the highest price at which inter-dealer sales were effected was 1 1/8. Taking that figure as representative of the prevailing market price, registrant's mark-up was 42.2%. Registrant effected sales at $1.60 or $1.50 on four other days. On one of these days (December 2), there were no interdealer transactions, and on the other three days the interdealer transactions appear to reflect the bid rather than the asked side of the market. On the basis of representative asked quotations in the sheets on the four days other than those of registrant itself, [9] the mark-ups were in every instance at least 20% and ranged up to 42.2%. Such mark-ups were excessive and

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7/ Registrant was in the sheets, but without quotations.

8/ In appropriate circumstances, asked quotations in the sheets may be considered as evidence of prevailing market prices in the absence of actual transaction prices. See, e.g., Costello, Russotto & Co., 42 S.E.C. 798, 800 (1965); Midland Securities, Inc., 40 S.E.C. 333, 337 (1960).

9/ Registrant's asked quotations were the highest in the sheets on November 16 and 22. As the Commission pointed out in Langley-Howard, Inc., supra, at 160, where a dealer, although regularly in the sheets, sells primarily to retail customers, its own asked quotation can be a self-serving figure, and to allow its use as a base for computing mark-ups on retail sales would be to countenance a bootstrap operation.

constituted a fraud on registrant's customers.[10/]

Having so found, I must now determine whether responsibility for the excessive prices charged by registrant is at least in part attributable to Herko. The record as a whole and in particular Herko's own testimony -- both that which he gave at the hearings as a rebuttal witness called by the Division and especially that given during the investigation[11/] -- leads me to conclude that he was a knowing participant in the pricing violations and as such a willful violator of the designated antifraud provisions.

The record is long on evidence pertaining to the roles generally played in registrant's affairs by Ferruggia and Herko and to some extent Lippman, but relatively short on reliable evidence pertaining to the nature of their respective participations in the IHI transactions. Ferruggia, a Division witness, who along with Herko himself was in the best position of all the witnesses to know of Herko's role in those transactions,[12/] had little recall concerning such transactions,

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10/ See, e.g., J.A. Winston & Co., Inc., 42 S.E.C. 62, 68-9 (1964).

11/ Herko's investigative testimony, which was much closer in time to the events in question than his hearing testimony, reflects in my judgment a clearer recollection of those events than the latter testimony. I do not accept Herko's testimony at the hearing that principally because of certain personal problems under which he was laboring at the time of the investigation, his recollection was "probably better" at the later time.

12/ Lippman and Brodsky did not testify at the hearings. Anthony J. Howard, Jr., a salesman with registrant during the period under consideration who was also called as a witness by the Division, testified that the $1.60 retail price for IHI stock was determined by the trading room and that Herko was in charge of the trading room. But Howard was not in a position to know whether, as Herko claimed in his testimony, Ferruggia and/or Lippman directed Herko to set that price.

although his testimony concerning Herko's position and normal responsibilities -- to wit, that Herko was in charge of the trading room and that it was the responsibility of the trading room to check interdealer quotations and to set prices, reasonably related to prevailing market prices, at which retail sales from the trading account were to be effected -- would put the primary blame for the excessive prices squarely on Herko's shoulders. Herko, on the other hand, testified in much greater detail about the IHI transactions. His own testimony, which, as indicated, also inculpates him in the violations, though to a lesser degree, represents in my view the most reliable version of his participation in those transactions.[13/]

Herko's involvement in the misconduct arises in my opinion both from his participation in the decision to acquire the 10,000-share blocks of IHI stock for retailing and his participation in the retail sales that followed. In his investigative testimony, Herko stated that at the time IHI first came to his attention in October 1971,

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13/ The proposed findings submitted by Herko's counsel (which are for the most part in the form of a digest of the testimony) fail to come to grips with the import of that testimony. No reference whatever is made to Herko's investigative testimony and little to his hearing testimony. Rather, the emphasis, as was true of the defense presented at the hearings, is placed on an attempt to discredit and refute Ferruggia's testimony and to demonstrate that his role with registrant was more pervasive -- and Herko's authority correlatively lesser -- than reflected in that testimony. Herko suggests, among other things, that Ferruggia had a motive to testify adversely to Herko, because at the time he testified his settlement offer was still pending before the Division. It should also be noted that Ferruggia acknowledged -- as did Herko, for that matter -- that, at least as of the time Herko left registrant, a strong personal antagonism existed between the two. On the other hand, the objectivity of the principal defense witness, registrant's former cashier, who contradicted certain of Ferruggia's testimony, is also subject to question since at the time of her testimony she was engaged to be married to Herko. Because the material findings herein pertaining to the issue of Herko's culpability are based wholly or principally on his own testimony, there is no need to determine to what extent, if any, the testimony of Ferruggia and the cashier should be discredited.

Ferruggia, Lippman, Coyle and he "went through everything together," even though he and Coyle were not yet "officially partners," and that the decision to take a position in IHI and to make a market in the stock was made by all four, although the existing "partners" had the final "say-so". That testimony further shows that Herko, on behalf of registrant, executed or at least participated in executing the purchases of the two 10-000 share blocks. By the time the second block was purchased on November 8, registrant had already entered quotations in the sheets, and Herko must have been aware that the price of 1 1/2 which registrant paid was well in excess of the prevailing market price.[14/] Herko's testimony further indicates that while his "partners" were reluctant to acquire the blocks for resale to retail customers, he strongly advocated such action, undertook to "do the first piece" (i.e., to retail the first block), and said "we have to make money." In order to make money, the stock would of course have to be resold at a price above registrant's cost. And, absent a prompt and substantial rise in the prevailing market price, the excessive price paid by registrant would inevitably lead to an excessive sales price. It must be added, however, that it is less than clear whether Herko's advocacy related only to the first block or to both.

The record does not show that Herko personally sold any stock to customers at excessive prices.[15/] And he claimed that it was Ferruggia

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14/ Registrant first appeared in the sheets on November 2 and 3, but without quotations. Its first quotations were 3/4 bid and 1 1/4 asked, entered on November 4 and 5. On the following three trading days, November 8, 9, and 10, registrant's name again appeared without any indication of price.

15/ As noted, three of his customers bought IHI stock on an agency basis on October 29, and a fourth customer paid 1 1/4 in a principal transaction on November 11.

and/or Lippman who determined the retail price of $1.60, and that he had no part in establishing that price and in fact attempted to have them set a lower price. The record, including the circumstances described above surrounding the purchases, casts some doubt on Herko's disclaimer. However, even accepting his testimony that the decision was that of his superiors, the record shows that he participated in the execution of transactions with knowledge of the disparity between the retail price being charged and the prevailing market price.

Herko acknowledged that he made out the sell tickets from the trading account with respect to a "good portion" of the sales effected during November and December 1971, and in particular those effected on November 10, the day of the major retail effort.[16/] Herko sought to portray himself as a mere order clerk in these transactions. That characterization does not seem apt. As one who was at least a quasi-principal of the firm, he had an obligation not to participate as he did in the effectuation of a fraud on the firm's customers.

Accordingly, I find that Herko willfully violated the designated antifraud provisions.[17/]

16/ Herko made a number of statements in his testimony concerning this matter. Most were consistent with the finding above. At one point Herko did testify that "I don't think that I, physically, wrote them when I knew they were wrong. I told them 'Do it yourself.'" (Tr. 955). In light of Herko's other testimony, I do not credit this denial.

17/ The Division asks me to find that Herko further violated those provisions by giving favored treatment to certain of his customers in that, in two or three transactions in which they sold stock to registrant, they were paid prices well above prevailing market prices. I do not find it necessary to reach the question whether such conduct in and of itself is violative of the antifraud provisions, because it does not seem to me to be encompassed within the scope of the allegation pertaining to the charging of unreasonable prices.

Recommendation of IHI Stock Without Adequate Inquiry

Herko testified that he recommended the purchase of IHI stock to four of his customers who bought it in October and November 1971, and that he probably made such recommendation to other customers. The Division did not call any of Herko's customers as witnesses. Herko himself testified that he could not recall what he told them about IHI.

At the hearings, the Division offered in evidence a file containing material on IHI which Ferruggia testified appeared to be a "due diligence" file kept by registrant. The file was admitted into evidence without objection (Div. Ex. 3). The only one of the items in the file which could have been there during the period of the IHI retail sales is a brochure which touts the potentials of hydrofoil transport systems -- IHI's business -- but contains no financial information concerning the company and only minimal and generalized information about its business operations. While Herko testified that "he was shown some financial statements," he could not recall what they reflected, or whether they showed IHI's financial condition to be good or poor. And he did not state the date of those financials or at what point in time he saw them.[18/] The only thing he could recall about the company was that it operated a hydrofoil service in the Bahamas.[19/]

18/ The file includes unaudited financial statements of an IHI subsidiary dated December 31, 1971.

19/ The brochure stated that IHI was operating a 125-passenger hydrofoil in the Virgin Islands.

In Hanly v. S.E.C., [20/] the Court of Appeals for the Second Circuit enunciated certain selling practice standards applicable to securities salesmen. A salesman, it said,

> "cannot recommend a security unless there is an adequate and reasonable basis for such recommendation. He must disclose facts which he knows and those which are reasonably ascertainable. By his recommendation he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation. Where the salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information." [21/]

Here, the available information concerning IHI did not reflect that a reasonable investigation had been made. And no evidence was presented by Herko and he does not claim that disclosure of the nature referred to by the Court was made to the persons to whom he recommended the stock. I therefore find that in this respect as well Herko willfully violated the designated antifraud provisions.

Other Alleged Misconduct

As noted, Herko is also charged with further violations of the antifraud provisions resulting from his alleged failure to disclose the improper sales practices discussed above. However, there is in my opinion no warrant for finding additional violations here based on nondisclosure of conduct which itself has been found fraudulent.[22/]

20/ 415 F.2d 589 (C.A. 2, 1969).

21/ Id. at 597. In a note to the quoted statement, the Court cited Securities Exchange Act Release No. 6721 (February 2, 1962), in which the Commission, referring to several of its decisions, had enunciated essentially the same standards.

22/ Moreover, the finding that Herko made inadequately based recommendations itself involves an element of nondisclosure.

Finally, it is alleged, and the Division contends, that Herko failed to exercise reasonable supervision over persons subject to his supervision with a view to preventing the pricing and improper recommendation violations. The Division asserts, in this connection, that Herko was in charge of registrant's trading activities and that the violations took place in that area. However, as the Commission held in a recent case,[23/] where findings of substantive violations are made against an individual who is an active participant in the misconduct involved, "it is unnecessary to find him responsible for a failure of supervision with respect to the same misconduct." That concept covers and disposes of the allegation of supervisory failure at least to the extent it relates to the pricing violations.

It would not seem to preclude a finding -- if supported by the record -- that Herko, in addition to making inadequately based recommendations of IHI stock to his own customers, failed adequately to supervise others -- i.e., other principals of the firm and salesmen -- who made such recommendations to their customers. The Division's memorandum contains at least the suggestion of such an argument. But that argument founders on the record which in my opinion does not establish that it was Herko's responsibility to obtain for the firm -- as distinguished from himself -- adequate

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23/ Charles E. Marland & Co., Inc., Securities Exchange Act Release No. 11065 (October 21, 1974), 5 SEC Docket 313, 315.

information concerning IHI.[24/] Further, there is no basis in the record for finding that either the other principals or the salesmen were "subject to his supervision."[25/]

Public Interest

The final matter for determination is the remedial action which is appropriate in the public interest. The violations in which Herko participated were of a serious nature and his participation therein reflects conduct at variance with the obligation of persons engaged in the securities business to deal fairly with customers. The public interest requires, in my opinion, the imposition of a substantial sanction in order to impress upon Herko the need for scrupulous propriety in all aspects of his securities activities.

On the other hand, as reflected in my findings, the thrust of the Division's case which sought to place the principal locus of the violations in the trading room, Herko's area of operation, is not borne out by the record. Herko's role in the pricing violations has not been proven to be more than that of a relatively subsidiary participant. That does not, of course, excuse his conduct, but it is a pertinent element in the determination of the appropriate sanction. With respect to Herko's recommendations of IHI stock to his customers,

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24/ While Ferruggia testified that due diligence was Herko's responsibility as to stocks which the latter traded, IHI was a retail rather than a trading vehicle for registrant. The record further indicates that registrant's principal source of information concerning IHI was Brodsky, whose contacts were principally with Lippman, and more with Ferruggia than with Herko.

25/ This is an essential element of a finding of failure to supervise under Section 15(b)(5)(E) of the Exchange Act.

the evidence, while sufficient to warrant a finding of willful violations, is of a "bare-bones" character. Of some relevance in considering the gravity of those violations is the fact that those of Herko's customers who bought IHI stock on his recommendation are for the most part the same persons who, as the Division notes,[26/] were accorded favored treatment by him in other transactions.

Everything considered, it is my conclusion that a three-month suspension of Herko from association with a broker or dealer is appropriate in the public interest.[27/]

Accordingly, IT IS ORDERED that Robert W. Herko is hereby suspended from association with a broker or dealer for a period of three months.

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

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

Max O. Regensteiner
Administrative Law Judge

Washington, D.C.
February 7, 1975

26/ See note 17, supra.

27/ All proposed findings and conclusions submitted by the parties have been considered, as have their contentions. To the extent such proposals and contentions are consistent with this initial decision they are accepted.