ADMINISTRATIVE PROCEEDING
FILE NO. 3-6091

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	:
THOMAS J. FURNARI	:
	:

INITIAL DECISION

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Washington, D.C.
March 23, 1983

Jerome K. Soffer
Administrative Law Judge

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APPEARANCES: Robert F. Moyer and Michael W. Schley of the Chicago Regional Office, for the Division of Enforcement of the Securities and Exchange Commission.

T. Edward Malpass and Dennis Waldon for respondent, Thomas J. Furnari.

BEFORE: Jerome K. Soffer, Administrative Law Judge.

On February 5, 1982, the Commission issued an Order for Public Proceedings (Order) pursuant to Sections 15(b) and 19(h) of the Securities Exchange Act of 1934 (Exchange Act), naming Thomas J. Furnari and Hillel Maeir as respondents. [1/]

The Order is based upon allegations of the Division of Enforcement (Division) that the respondents, directly and indirectly, willfully violated Sections 17(a)(1), (2) and (3) of the Securities Act of 1933 and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder in connection with the offer, purchase and/or sale of listed options and other securities.

The Order directed that a public hearing be held before an Administrative Law Judge to determine the truth of the allegations set forth and what, if any, remedial action is appropriate in the public interest for the protection of investors. Hearings were held on July 12, 13, 14, 15, 16, and 21, 1982, in Chicago, Illinois.

Following the close of the hearing, successive proposed findings of fact, conclusions of law and supporting briefs were filed by the Division and by respondent. A reply brief was filed by the Division.

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

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1/ As a result of an offer of settlement accepted by the Commission, the administrative proceeding has been terminated and remedial sanctions imposed upon respondent Maeir by an order dated July 1, 1982 (SEA Rel. No. 18862). While the decision herein may contain references to Maeir the findings are binding only upon Furnari, the remaining respondent.

the demeanor of the witnesses. The preponderance of evidence standard of proof has been applied. See Steadman v. S.E.C., 450 U.S. 91 (1981).

Background

During all times relevant hereto, Furnari and Maeir were employed at the Chicago-North offices of Blythe, Eastman, Dillon & Company, (BEDCO), a registered broker-dealer, and its successor, Paine, Webber, Jackson and Curtis, Inc. (Paine Webber), also a registered broker. (BEDCO was merged into Paine Webber on December 31, 1979). Maeir was employed as a retail registered sales representative at BEDCO since 1976, principally engaged in the sale at retail of municipal bonds to individual accounts. Furnari first went to work for BEDCO in January of 1979 to promote the development of institutional accounts in the managed options area. Specifically from October 1, 1979 until his services were terminated on August 22, 1980, he was employed as a retail registered sales representative. He is currently a vice-president of sales at the investment firm of Oppenheimer & Co., Inc.

Respondent began his activities in the securities field in 1973 in the employ of a registered broker-dealer including some work in the field of stock options. From January 1, 1976 to January 1, 1979 he had a seat on the Chicago Board Options Exchange (CBOE) as an independent licensed broker-dealer functioning as a market-maker trading for his own account on the floor

of the exchange. When he left to take the position with BEDCO, he leased his exchange seat to another, still retaining ownership for himself.

The Collateralized Options Writing Program

In his early months with BEDCO, respondent became acquainted with and developed an interest in a program of collateralized options writing. (Hereinafter referred to as the "C-O-W" program) The C-O-W program, as pertinent to this proceeding, is an option strategy involving the simultaneous writing (selling) of out-of-the money combinations, i.e., a put and call, having the same expiration date, using securities as collateral to cover naked positions and investing the premiums received from the sale of the options in short-term interest bearing securities issued by the United States Treasury. 2/

2/ A call option is a contract which gives the buyer upon the payment of a premium the right to buy 100 shares of the underlying stock at a specified price within a specified period of time. The seller (writer) of such an option, for having received a premium from the sale, is bound for the life of the contract to deliver the stock at the specified price if the option is assigned (called).

A put option is a contract which gives the buyer, in return for paying a premium, the right to sell 100 shares of the underlying stock at a specified price within a specified period of time. The writer of such an option, for having received a premium, is bound for the life of the contract to purchase the underlying stock at the specified price during the specified time if it is assigned or exercised.

Naked (uncovered) refers to a strategy in which a call writer does not own the underlying security for delivery in case of assignment.

(footnote continued on next page)

During his early months at BEDCO, respondent became acquainted with the C-O-W program through conversations with Dr. Henry M. Pounds (and his superior, Henry R. Ferguson) who was employed by BEDCO as head of an options account program which managed discretionary accounts having $100,000 minimum in each. In the spring of 1979 the firm set up a collateralized option writing program similar to the C-O-W program described above. However, the program was discontinued after about seven months because of problems which were found to exist in connection

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2/ (continued)
Assignment is the act of requiring the writer of an option to fulfill his contractual obligation to purchase or sell the underlying stock. Conversely, exercise is the action taken by the holder of an option to require the writer to fulfill his obligation.

Striking price (exercise price) is the agreed upon, fixed price at which the writer of the option agrees to purchase or sell the underlying stock.

The term "out-of-the-money", in the case of calls, refers to a situation where the striking price of the call exceeds the current market price of the underlying stock. This term, in the case of puts, refers to a situation where the striking price is lower than the current market price of the underlying stock.

The term in-the-money is the converse of out-of-the-money and refers, in the case of a call option, to a situation where the striking price of the call is lower than the current market price of the underlying stock, and in the case of a put, to a situation where the striking price of the put exceeds the current market price of the underlying stock. An option contract, put or call, can move in and out of the money throughout its life.

Combination refers to a strategy where a call and a put on the same underlying stock but with different striking prices are both written or purchased together.

with it.

Specifically, it was found that the program required a tremendous amount of time and effort to monitor the various positions which were taken. An important part of the program is the adjustment of positions as the market moved up or down, depending upon the volatility of the underlying security or of the market itself. Sometimes there would be the need to adjust positions daily. Thus, if the trader did not close out positions promptly when there was a strong movement against them, money could continue to be lost without maximum. In fact, while BEDCO was running the program there were problems with positions actually being out of control.

Other problems with the C-O-W program in BEDCO's experience was that the limited number of listed stocks in which one could deal in both puts and calls prevented proper diversification. Finally, it was found that the program was very commission-intensive since each transaction involved 2 or 4 trades, with each trade generating corresponding commissions; additional commission would result when adjustments of positions had to be made because of market movements.

Finally, in order for the program to be successful, clients had to be advised that they would have to be in the program for a minimum of two years.

According to Dr. Pounds, respondent was aware of the existence of the program, of the decision to stop taking on new customers and ending it, and the bad experience that BEDCO had

with it. Respondent, on the other hand, in relating that the results of his conversations with Dr. Pounds involving the BEDCO program, claims that he got the impression that the program was working quite well. Based upon the testimony of Dr. Pounds and Mr. Ferguson it is difficult to see where respondent got that impression.

The Maeir Clients

Having learned something about the C-O-W program from various sources including articles and literature on the subject, respondent joined together with Maeir to approach CEMP Investment of Montreal, a very large family trust, with the intention of having the trust embark upon the C-O-W program through the two of them as brokers. Because of the size of the trust and the amount of collateral it had available, the account would have generated commissions in the neighborhood of $5 million annually. The managers of the CEMP trust fund expressed an interest in the program but wanted some tangible proof that it would work and respondent suggested the development of a pilot program to demonstrate its viability. With this in mind he and Maeir proceeded to try to develop such a program with Maeir's municipal bond customers. At that time, the market values of municipal bonds had become depressed because of ever-increasing interest rates.

Respondent discussed the setting up of a C-O-W program with Dr. Pounds who advised him against it recounting the bad

experience that BEDCO had with its own efforts along those lines. Similar discussions were had between respondent and Henry R. Ferguson, the manager of the options department at BEDCO who expressed negative feelings to respondent based upon past experience and expressed his belief that a retail client should not be allowed to engage in that type of program.

Nevertheless, respondent and Maeir, ever aware of the CEMP trust account, agreed to go ahead with the program and to involve Maeir's customers who would be asked to use their deferred municipal bonds as collateral. It is noted that prior to his relationship with respondent, Maeir had never traded in options for himself and rarely for customers. The two brokers agreed to share the commissions earned in the options program and set up a separate account number with their employer.

The Brochure

In order to further the program, respondent and Maeir drafted a brochure entitled "A New Perspective on Options Management" (The Brochure) which described the C-O-W program pretty much along the lines of the program that BEDCO had outlined for its customers in 1979 under Dr. Pounds and Mr. Ferguson. As noted, respondent had discussed this program with them. He also examined the written materials describing the prior BEDCO program. Thus, he was primarily responsible for the contents of the Brochure, especially in view of Maeir's lack of experience in options. They approached H. Robert Holmes, the

manager of the Paine Webber Chicago office where they were employed, with the proposal to operate in partnership in the C-O-W program using municipal bonds as collateral. They also showed him a draft of the Brochure. Holmes advised them that this was a fairly sophisticated type of options trading and that their customers should also be sophisticated and understand what it is they were going to embark upon, including being made aware of the high degree of risk involved in options trading. He also advised them that it was the standard policy of the firm that no discretionary accounts would be allowed on the retail side. Holmes objected as unacceptable to a portion of the draft of the Brochure which quotes percentage returns that could be expected to be earned. The respondent prepared and distributed the Brochure containing the objectionable language to Maeir's customers by obtaining the approval of the sales manager who performed such approval functions when Holmes was absent.

The Four Accounts

During the month of December 1979 Maeir contacted his customers with a prospecting letter highly praiseworthy of respondent and his options abilities. Four of these customers expressed an interest in the program and were sent the Brochure for examination. Eventually, they opened accounts with Paine Webber for trading in options in accordance with the C-O-W Program, to be serviced jointly by Furnari and Maeir. These

accounts were: (1) Whitfield G. Hughes, Jr., (2) Raymond and Lilly Mesirow, (3) Erwin Weiner,[3] and (4) Bernard, Beverly and Merle Resnik.

Hughes owns and operates a corporation engaged in the distribution of commercial laundry and refrigeration equipment. He had been a customer of Maeir in municipal bonds for several years. He discussed the C-O-W program with a trader on the Mercantile Exchange and was advised that the program could make money.

Raymond Mesirow, age 68, is a retired part-owner of a pharmaceutical manufacturing company. He had been buying and selling stocks for over 30 years. For a period of some 3 years he had also engaged in trading in listed options.

Weiner, 70 years of age, has been Personnel Director of Cook County, Illinois for 13 years. He has a son who is a trader on the Chicago Board of Trade. In addition to having invested in municipal bonds with Maeir, he had, from time to time traded in commodities such as silver and lumber. For a period of time he had traded unsuccessfully in sugar futures, suffering losses of about $50,000 to $60,000.

Bernard Resnik, age 55, is a medical doctor. He has had varied investment experiences, including real estate limited partnerships, stock, utilities and money market funds. For a short period in 1978, he had invested profitably in call spreads

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3/ The record does not show that Weiner received a copy of the Brochure, but the terms of the Program were explained to him by Furnari and Maeir.

in "Ginny Mae" and treasury bills under the direction and following the suggestions of a broker who did the trading. He also joined with the same broker in owning a seat on the Chicago Board of Trade, resulting in a small loss to himself.

Prior to opening these accounts, the customers personally met with respondent and with Maeir. At these meetings, respondent explained the outlines of the C-O-W program as a conservative one in which options in combination would be sold using the customer's municipal bonds as collateral to cover naked call positions and the premiums generated from the sales invested in treasury bills. As a result of these oral presentations, primarily by Furnari, each of these customers opened options accounts. They all understood that trading was to be done on their behalf by Furnari on a completely discretionary basis and relied completely on his professed expertise. Option trading activity began in the Hughes account on January 7, 1980 and involved the deposit of municipal bonds in the face value of $290,000 to serve as collateral. The Mesirow account also began in January and a total of $100,000 in face value of municipal bonds was deposited. Weiner opened his account in February with $50,000 in bonds and Resnik in March with some $300,000 in bonds.

In August of 1980, respondent was fired from his position at Paine Webber and found employment with Bache, Stuart, Halsey, Shields, Inc. (Bache). By that time losses had

been suffered in each of the accounts computed by the Commission's options expert witness, Stanley Whitten, at a combined realized and unrealized total in excess of $227,000.[4/] Howard Sikorski, the securities expert testifying on behalf of respondent, calculated the losses both realized and unrealized in these four accounts in excess of $230,000 in August and over $259,000 in September of 1980.

The Charges of Fraud

In support of the charges that respondent had violated the anti-fraud provisions of the securities laws,[5/] the Order

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4/ Realized losses are those which were represented by option positions that had been closed. Unrealized losses are those that would have been sustained by positions still open had they been closed at the prevailing market price on a given day (sometimes referred to as "mark-to-market").

5/ Section 17(a) of the Securities Act makes it unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce, or by the use of the mails, directly or indirectly -- to do any of the following:

"(1) to employ any device, scheme or artifice to defraud, or

(2) 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 the light of the circumstances in which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

Section 10(b) of the Exchange Act makes it unlawful, in connection with the purchase or sale of any security to use or

(Continued on next page)

for Procedings contains six allegations specifying acts of commission and omission. The first four specifications may be lumped under a general heading of "misrepresentations claimed to have been made during solicitation"; the fifth and sixth specifications involve charges relating to conduct after trading began, specifically, of excessive trading (churning) and the making of false and misleading status reports.

During Solicitation - I

The first specification is that respondent allegedly told customers they could expect to earn rates of return ranging from 15 to 20 percent through the C-O-W program, when in fact the strategies and methods employed by respondent in managing their accounts could not be expected to yield such returns.[6/]

The Brochure prepared by the respondent and distributed to the customers describing the [C-O-W] program stated that

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5/ (continued)
employ, "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5 promulgated thereunder, extends, in effect and with a few language changes, the provisions of 17(a) relating to the sales of securities to both the purchase or sale thereof.

6/ The Division's brief also charges respondent with having told customers during solicitation that commissions would be low, when in fact the C-O-W program by its very nature generates high commissions. However, such a specification is not mentioned in the Order for Proceedings. In any event, commissions will be discussed in connection with the charge of excessive trading.

"O-T-M combinations will be selected so that the maximum return (not annualized) is at least 20%***" 7/

Hughes was told that the program would generate between 30% and 40% profit including the income from investments of premiums in treasury bills, and that he could withdraw up to $5,000 a month from the program out of the cash to be generated by profits. This return was to be over the course of a year (and not over the course of a market cycle as contended by respondent in his testimony). As Hughes understood, the return was to be 40% of the money that was to be generated from the premiums received from the sale of options, including the revenues to be earned from the treasury bills that were to be bought with the option premium. 8/

Mesirow was told by respondent that he could expect to make about a 25% return based on the value of bonds which he was putting up as collateral for the program. In the copy of the Brochure given to him, there was also included a sample portfolio showing how the combinations of puts and calls would work. This sample showed returns on each security listed ranging from a low of 16% to a high of 47% with the majority

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7/ As noted previously, this is the language that was objected to by the office manager, Mr. Holmes, but which was not taken out of the Brochure.

8/ The Division's proposed findings of fact characterized this testimony of Hughes as an error on his part due to alleged "confusion with terminology." There is nothing in the record to show that Hughes was any more confused on this point than on the rest of his testimony.

of the profits falling within the 30% to 40% range. On another occasion Furnari told him that he could expect to earn from 15% to 30% on the value of the bonds on an annual basis (and not on a market cycle basis).

Resnik was told that he could realize a return of 15% to 20% annually on the values of the collateral bonds in addition to the income to be derived from the investment in treasury bills of the premiums from the sale of puts and calls. [9/] Resnik eventually deposited about $300,000 market value of municipal bonds as collateral under the program.

Weiner offered no testimony concerning representations to him by respondent as to percentage rates of return prior to his opening an account for the options of trading. However, during the ensuing period respondent told him on several occasions that he would have a profit of $25,000 by Christmas of 1980. [10/]

When respondent first mentioned the C-O-W program to Maeir he indicated that both the risks and the profits would be in the 10 to 15% range, information which Maeir passed on to

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9/ At a later time, after trading had begun in his account, respondent gave Resnik a status report of his account in which he had handwritten that his goal for the account was a profit of $75,000 for 1980; this sum would have amounted to a return of 30%.

10/ The Division, in its proposed findings, projects this amount of profit over the time the account was active as amounting to 55% of the face value ($55,000) of the bonds deposited by Weiner. Since the alleged misrepresentation is as to rate of return, there is no basis for attributing the 55% figure to respondent.

the prospective clients. According to Pounds and Ferguson, their experience with the BEDCO accounts showed that the C-O-W proposal could normally be expected to yield an annualized return of 5 and 10% of total collateral value, provided the account were maintained for at least two years and that over a longer period of time it would be able to make as much as 15%. Pounds felt that a more aggressive program could yield as much as 20% although at a much higher risk to the underlying collateral. However, whether this information had been imparted to respondent during their discussions is not at all clear in the record. Since the Brochure that respondent had prepared was based upon the BEDCO program, and since he had discussions with Pounds and Ferguson about it, it is fair to assume that he had knowledge of the results of the BEDCO operation. On the other hand, he also read literature prepared by BEDCO. Thus, Dr. Pounds wrote, in describing a proposed program for one of his clients's (exhibit R) that "the maximum return (not annualized) is at least 25% and the percentage move (by the stock) to the breakeven points in each direction is at least 10%". This is very similar to the language utilized by respondent in the Brochure. Again, in an article written for "Options Digest," a BEDCO publication, on April 23, 1979, Dr. Pounds, in describing the C-O-W program on a simulated basis, projected a rate of return of more than 30% in the first seven months.

In the last analysis, the question of whether respondent misrepresented to his customers the rate of return that could be

expected under the program depends upon whether under all of the circumstances known to him he should have made any representation about it. His estimates varied from one prospect to another. It is quite clear that rather than doing an independent study or analysis of his own, he chose to rely upon some writing by Pounts in a purely theoretical and conjectural basis and to have ignored the actual experience of BEDCO under its C-O-W program. In effect, there was no basis for his statements concerning rate of return. While he may not have had a deliberate intent to defraud his customers, he made representations to them with reckless disregard as to their truth or falsity in order to induce them to open their options trading accounts with him.

Accordingly, it is concluded that respondent misrepresented the rate of return that could be expected under the C-O-W program, and that such conduct was "willful", as that term is understood in securities matters. 11/

II.

The second allegation of misrepresentations made during

11/ It is well established that a finding of willfulness does not require an intent to violate the law; it is sufficient that the one charged with the duty consciously performs the the acts constituting the violation. See Tager v. S.E.C., 344 F.2d 5, 8, (C.A. 2, 1965); and Arthur Lipper & Co. v. S.E.C., 547 F.2d 171, 180 (1976).

solicitation is that respondent had told prospective customers that he had been successful in trading for his own account at the CBOE when, in fact, he had lost nearly a quarter of a million dollars doing so.

Hughes was told that respondent was an accomplished and successful trader in options on his own account and had earned up to $250,000. Mesirow was told that respondent was a "genius" in options trading. Resnik was told that respondent had been a successful trader at the CBOE. Weiner was told that respondent owned a seat on one of the exchanges and had made a lot of money. These statements were made usually by Maeir but in the presence of respondent and with his apparent assent.

The evidence concerning the falsity of these representations is not at all clear in this record. For one thing, there is no proof that respondent had <u>lost</u> nearly $250,000 in trading for his own account at the CBOE, as alleged in the order. The proof that he was less than an outstanding success there is rather nebulous. While he admitted that at one time his losses on the CBOE amounted to $243,000, he also claims that at other times he had made that much, and that at the end of his trading he came out with about $60,000 more than he went in with. He also admitted that his testimony during the investigatory phase of this proceeding to customers that he "was very successful" were not correct only to the exent of the use by him of the word "very".

Since there is no proof in the record as to the specific or general monetary success or lack of success enjoyed by respondent as a market-maker on the CBOE other than his own testimony that he came out ahead, it is concluded that the Division has failed to sustain its burden of showing that respondent lost $250,000 or any other figure as a trader.

III.

The third allegation under the heading of misrepresentations made during solicitation of the customer accounts is that Furnari and Maeir

> told customers that Furnari had been successful in managing the accounts of other customers involved in collateralized option writing, when, in fact, some of such statements were made prior to the beginning of trading activity for any customers and other of such statements, made after trading had begun, were not accurate representations of the results of Furnari's trading for customers' accounts;. . . .

In this connection, it is noted that Hughes signed the "clients agreement" forms on or about December 15, 1979 and trading was begun on his account on January 7, 1980; Mesirow signed the account forms on January 20, 1980 and trading was begun on January 29; Weiner opened his accounts on February 7, 1980 and trading was commenced the next day; and Resnik signed his account opening forms on March 4, 1980 and trading commenced on March 20.

During a solicitation meeting with Mesirow on December 4, 1979, prior to the opening of any account, Furnari told him

that he was already running the program for others of Maeir's customers, showed him programs developed for these others with the name covered over, and stated that a customer was ahead $30,000 and another was ahead some $4,000 or $5,000.

During the solicitation of later accounts, respondent told Weiner that other customers in the C-O-W program were doing very well, although he did not state any amounts of profits; and told Resnik that other customers in the program were doing well, to the extent of 20% or better. He also represented to Hughes at various times during April, May and June that all customers in the program were "ahead".

As a matter of fact, the individual accounts showed profits in only a few months between January and September 1980.[12/] Weiner had profits in April and May and had losses in all other months; Resnik had profits in May only; Mesirow showed a profit only in May; and Hughes had profits in February, April and May. On a cumulative basis, Weiner's account was behind early but showed a small profit in May and June declining substantially thereafter; Resnik was ahead only as of April but his cumulative losses increased thereafter; Mesirow and Hughes showed losses from the very beginning and at no time thereafter were they ever ahead on a cumulative basis.

Finally, taking the total of all four accounts together,

12/ All statements herein as to account profit and loss status are based upon the computations of respondent's expert, Howard Sikorski, on a mark-to-market basis.

they showed profitability only during April and May, and, on a cumulative basis, were behind from the very beginning and stayed that way.

It would appear, therefore, that, except during April and May of 1980, statements that the accounts were "ahead" were patently untrue, especially during the early months of January, February and March when the accounts were being solicited.

If respondent actually knew of the profit and loss status of each of the accounts, since it is fair to conclude that he had such information available to him, his statements were willfully false and misleading. If, however, respondent's defense that the chaotic condition of the Paine Webber back office records (which is discussed hereinafter) prevented him from learning the status of these accounts, then he was grossly negligent in making the representations as to profitability, since he along with everyone else knew of these conditions. Hence, it is concluded that the record establishes this allegation of the Order.

IV.

The fourth alleged misrepresentation during solicitation, as set forth in the Order, charges that respondent "understated to customers the risk inherent in the trading strategy and methods which Furnari employed in managing their accounts."

The Brochure talks about the construction of a diversified portfolio of 15 combinations, and contains the further

advisory that if the market moved strongly in unison in one direction, the entire program could lose money. However, it states that as a further safeguard against risk the program will write options only on stocks that are rated B+ or better and which have a market risk ("Beta") of 1.5 or less. 13/ Further, it refers to the daily monitoring of positions by respondent and to the revising of positions in accordance with a pre-determined procedure when necessary. Thus, when the underlying stock made a sustantial advance or decline, the combination would be replaced with a new position to reflect this change.

When Mesirow expressed concern about the Brochure statement concerning a possible loss if the market moved in one direction, he was reassured by respondent that such losses could be minimized by his constant monitoring of positions. Although Mesirow knew that options trading was speculative, he was assured by respondent that the normal risks involved with options trading would be avoided by the selling of combinations, that the puts and calls would "protect each other." Mrs. Mesirow also questioned this statement in the Brochure, but was assured by respondent that C-O-W was a "no-risk" program and a very conservative one and that he

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13/ "Beta" is a measure of a stock's sensitivity to moves of the market as a whole and is also a measure of volatility. Beta is a mathematically computed figure.

would not allow an extreme loss to occur. When she asked why, if there were no risks, they had to put their municipal bonds as collateral, he replied that "the SEC demands it."

When Resnik, Weiner and Hughes each indicated that he was interested only in a conservative type of investment, he was also assured by respondent along the same lines as with the Mesirows, including the use of "stops."

As part of the opening of their accounts, each of the customers signed options account opening forms in which they acknowledged receipt of the Options Clearing Corporation prospectus, their awareness of the special risks attendant upon options trading, and that they were financially able to sustain losses. Moreover, after all of the accounts were open, each of them was asked to sign a prepared letter acknowledging their understanding that options trading has a number of inherent risks which they were prepared to assume and would stand financially, that options trading was not unsuitable for them, etc. When they asked respondent why this letter had to be signed, they were told that it was a mere formality and a matter of routine.[14/] As a matter of fact, respondent's branch manager insisted that he obtain such a "risk letter" from each of them, even though their accounts already were opened.

Despite the contents of the account opening forms and letter recognizing the risks involved in options transactions, each customer asserted that they did not pay much attention thereto, choosing instead to rely on the oral representations made

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14/ The customers treated the signing of the letter as perfunctory since their accounts were by that time opened.

by respondent and joined in by Maeir. They trusted Maeir having done business with him for several years and were impressed with respondent's assurances of his past CBOE experience, that the program would be carefully monitored and that the risks described were hypothetical and would be minimal.

However, it is clear that respondent did not inform the customers of all the serious risks inherent in the C-O-W program. Most significantly, he failed to advise that since the C-O-W program involved the writing of uncovered (naked) options, the account was subject to the entire risk of the market place in the case of an uncovered call with an infinite amount of money that theoretically could be lost. [15/] Secondly, he failed to advise that not only did the customers face losses if the entire market mad a dramatic move in one direction or another, but that even if one of the underlying securities made such a move, despite the direction of the market in general, the entire account could be wiped out. These failures also occur in the Brochure.

The Division's expert witness describes the C-O-W program not as a conservative one, but, in light of the actual risks, as a highly speculative one. This opinion is not contradicted by any other testimony. Henry R. Ferguson, who

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15/ As noted in Michael E. Tennenbaum, 24 SEC Docket 799, 803 (1982), complex spreading transactions and uncovered option writing are both highly speculative investment strategies, citing this Commission's "Report of the Special Study of The Options Markets", H.R. Com. Print IFC 3, 96th Cong., 1st Sess. 1 (1978).

was manager of the options department at BEDCO, also stated that the C-O-W program is not for a conservative investor because of the risks involved. And, as pointed out previously, both Ferguson and Pounds had conveyed to respondent their negative experience with the BEDCO program which caused the company to discontinue it.

Under all the circumstances, it is concluded that respondent, in his anxiety to get the program started and perhaps to make a track record to show CEMP, and despite the warnings from Ferguson and Pounds, felt that he had sufficient ability and skill to avoid the risks which exist in options trading, particularly in uncovered calls. He conveyed this optimism to his prospective customers and appealed to their desire for a conservative type of investment by so characterizing the C-O-W program, and in reckless disregard of very serious risks inherent in this type of trading. This misrepresentation as to the risks involved was willful. (See footnote 11, above).

Churning

The Order charges Furnari with having effected discretionary purchases and sales of listed options for customer's accounts, which transactions were excessive in size and frequency in view of the investment objectives of such customers. This is basically a charge of "churning." It further alleges that as a result of such activity the four customers involved herein, whose accounts he handled for an average of 7 months, incurred commission expenses aggregating approximately $91,000.

In order to establish churning, it must appear: (1) that the broker in question exercised control over the trading in the account; (2) that the trading in the customer's account was excessive in light of his investment objectives; and (3) that the broker acted with the intent to defraud, or with willful and reckless disregard for the interest of his client. Rolf v. Blyth, Eastman, Dillon & Co., Inc., 424 F. Supp. 1021, 1039-1040 (S.D.N.Y. 1977), aff'd 570 F.2d 38 (1978), cert. den. 439 U.S. 1039; and Mihara v. Dean Witter & Co., 619 F.2d 814, 821 (C.A. 9, 1980). Churning essentially involves improper purpose on the part of the broker to derive profits for himself with little regard for the interest of his customer. Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 845 (E.D. Va., 1968).

I.

As to the first element of churning, there is a sharp conflict in the testimony relating to whether respondent exercised control and had discretionary authority over the trades executed under the C-O-W program on behalf of the clients of Maeir.

On the one hand, respondent has testified that he usually consulted each of the customers in advance concerning particular transactions, and that each customer made his own decision as to what trades should be made, what positions should be established, and whether to accept or to reject respondent's recommendations. He also claims they frequently offered recommendations of their own. Specifically, he contends that Hughes had discussed the trades that respondent intended to make,

had received a set of recommendations based upon a consensus between the two of them, and knew of the trades and gave respondent permission to make them. Respondent asserts that Weiner primarily wanted to speculate, boasted that he was using his "play money", had previous options experience, and knew of and discussed all trades before they were made. Respondent testified that Mesirow made all selections of transactions and insisted upon their execution even where Furnari was in disagreement with some of them. Finally, respondent insists that Resnik was worth in the millions, had been a speculator in commodities and futures contracts, knew of and gave approval to every transaction on his behalf, and in some instances, made up his own strategies to be followed.

On the other hand, the testimony of these customers is in sharp disagreement with respondent. Each of them testified that they were primarily municipal bond investors interested in conservative investments; that they became aware of respondent and his program only through the solicitation or Maeir; that they had little or no experience in options and especially the type of program proposed; that they believed respondent had been a very successful trader on his own account on the CBOE; that the program would involve consistent and close monitoring of the positions by respondent; and that their entrance into the program was founded in their belief in the abilities and skill of respondent to make and execute the necessary transactions to carry it out.

Hughes testified that he was never asked by respondent for permission to enter into a trade nor was he asked his opinion of a trade in advance. Mesirow and his wife both expressed their understanding that respondent was a "genius" who would enter into the transactions for them, monitor them, and protect them from unusual situations which could result in losses. They clearly understood that only respondent would enter into transactions and would do so without any input by them. The same type of testimony was given by Mr. Weiner and Dr. Resnik. In sum, all of the customer witnesses expressed a lack of understanding about the the options strategies inherent in the C-O-W program, and only entered into it in reliance upon respondent's abilities, past experience, and his undertaking to watch the positions very closely.

Respondent's clients were in no way capable nor had any understanding of the types of sophisticated strategies inherent in the C-O-W program. It is also clear that from the very beginning they expected respondent to have complete discretion in managing these accounts. Even a reading of the Brochure demonstrates that only close management of respondent would make the program work. Thus, in the introduction it describes options as "new and complex investment instruments requiring considerable asset management expertise and know-how" and the need to have established professional assistance. It stated that the choice of actual positions will be based on a computer program (none of these customers had computers), and that they would be

monitored daily under the supervision of respondent and revised according to a predetermined procedure. It talks about revising positions, replacing them with new positions, all in recognition of changes in underlying stock prices.

Even Mr. Maeir, an experienced account representative having spent many years in the securities business both here and abroad expresses total ignorance of the strategies involved in the C-O-W program. 16/

The only conclusion that can be made on this record is that respondent was intended to have, and did exercise, complete discretion and control over each and every transaction performed on behalf of these four accounts. Whatever conclusions are to be drawn from the activities in the accounts, whatever losses or gains were incurred, and whatever consequences flowed therefrom, are all attributable to the trading decisions made by respondent and carried out by him alone.

16/ It is also clear that Maeir, although a partner in the brokerage account, had no input in the making of investment decisions or their execution. His background did not encompass options trading and he relied upon Furnari's explanation of the C-O-W program. On occasion, he wrote up an order ticket, but he only did so under the direction of Furnari. In fact, when at one point respondent threatened to break up the partnership because Maeir was not bringing in more customers, Maeir agreed to split all of his commissions, including those from his municipal bond accounts, in order to keep Furnari running the C-O-W program simply because Maeir was in no position to do so. Respondent's assertions that Maeir had executed options transactions for the joint customers cannot be considered accurate.

Respondent was exercising, in effect a pattern of _de facto_ control over these accounts. See _Mihara_ v. _Dean Witter_, _supra_. p. 821; and _Hecht_ v. _Harris Upham and Company_, 430 F.2d 283 F. Supp. 417 (N.D. Cal. 1968), aff'd 430 F.2d 1202 (C.A. 9, 1970). His testimony that the customers participated in the making of the decisions to any extent is totally at variance with the facts and, under the circumstances, borders on the incredible.

II.

Whether trading is "excessive" is a question which must be examined in light of the investment objectives of the customer.

The investment objectives of the four accounts involved herein were those spelled out in the C-O-W program under which respondent, the possessor of expertise in options trading, by careful monitoring and strict adherence to the program, was to enter into combination sales of puts and calls in such a way as to provide the minimum of risk in accordance with the conservative investment programs of these customers and to enable them to utilize their holdings in municipal bonds as collateral to cover the naked positions taken. Moreover, the premiums generated from the sale of puts and calls were to be invested in treasury bills and similar securities in order to produce income.

The first thing to be noted is that by its very nature, the C-O-W program would generate high commissions. This is so, because every position taken would involve at least four commission

transactions: two commissions for opening a position (one for the selling of the put and one for the simultaneous selling of the call), and two additional commissions when each of these positions was closed. Since options last for three-month periods, and assuming the need to diversify among 15 different underlying stocks, there would be generated over a 9-month period 180 different transactions, each one involving a commission. Furthermore, the volatility of a particular underlying security might require "rolling up" or "rolling out", or both, [17/] which would increase the number of transactions resulting from these changes of positions, thereby producing additional commissions.

Since the nature of the C-O-W program normally would generate numerous transactions, there is a question as to whether they would be an "excessive" (i.e., more than a normal) number under the circumstances. For one thing, there is no formula that has been discerned which would establish excessiveness in options trading as there exists in other types of securities accounts, in which the cases talk of a "turnover rate". [18/]

17/ "Roll up" refers to a trading strategy whereby an open short position is closed and a new position with a different striking price is established. "Roll out" is a change of position in order to open up a more distant expiration date.

18/ This turnover rate, as stated in Looper & Co., 38 SEC 291, 297 (1957) is computed by dividing the cost of the purchases by the average investment, the latter representing the cumulative total of the net investment in the account at the end of each month, exclusive of loans, divided by the number under consideration.

Thus, an annual turnover rate of 6 would reflect excessive trading (Mihara, supra, p. 821), but a rate of no more than 1.85 would not (Rolf, supra, p. 1039).

However, the C-O-W program does not involve investments in typical securities. Rather, it embraces the sale of puts and calls for premiums. When it is considered that options have a duration of 90 days, and that customers did not deposit monies in their accounts for the purpose of trading, but merely put up securities to serve as collateral to cover the sale of naked options, the Looper formula cannot be applied.

Still, there are other factors which should be examined in order to determine whether churning has occurred with respect to the type of account under consideration, such as the nature of the account, the number of trades and the frequency thereof, the "in-and-out" trading, the amount of commissions earned, the length of time the securities were held, and their percentage of the representative's income. See Stevens v. Abbott, Proctor and Paine, supra, at page 846.

It is clear that the high commissions aspect of the C-O-W program was never fully explained to or understood by the customers. Nor were they made aware that this was one of the factors found undesirable by BEDCO under its own C-O-W program. Respondent did tell Hughes that commissions would be approximately 25% of profits, Weiner that commissions would be approximately 30% of profits, and Resnik that commissions would be a small percentage both of the amount invested and of the expected profit.

In addition to the doubt that the customer ever undertsood that numerous commissions would be generated, there is the serious factor that respondent, as will be shown hereinafter, traded to a considerable extent outside of the program, and entered into a number of transactions which far exceeded those which might reasonably be expected.

During the period January through September 1980, there were some 1,400 options transactions executed on behalf of the four customers. This was almost double the number that the program could have been expected to generate at 180 transactions per account (for a total of 720) per nine-month period. Commissions on these 1,400 transactions totalled $75,448 (according to the Division's expert), or about 29% of the total losses of $259,000.[19/]

Respondent's share of all commissions earned was 15% or roughly $11,200. He had no other accounts during this period and hence no other commission income. In fact, he complained that he was not being given a "draw", although requested from his employer, beyond the Federal minimum wage.

The commissions earned also represented, on an annualized basis, 19% of the face value ($740,000) of the bonds deposited as collateral by the four customers. However, the market value

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19/ Respondent's expert computed the commissions at $70,500. However, the method used by the Commission's expert is more accurate. In any event, the difference is not so great as to affect the conclusions concerning the issues herein.

of the bonds at about the time of these transactions was roughly 75% of the face value and the collateral value was only 50% of the face value. Hence, the proportion of commissions to the value of collateral should be increased accordingly.[20/]

In recognition of the large commissions generated, respondent voluntarily offered a 50% discount on commissions to the four customers, as follows: to Hughes because he was a high volume customer; to Mesirow because the account was losing money; to Weiner on stock purchase but not on options; and to Resnik when the market started a precipitous move in an upward direction in June or July of 1980.

By far the most striking indication pointing to excessive trading is the large number of instances in which respondent departed from the objectives outlined in the C-O-W program in his trading. These variances embraced opening transactions that included sales of straddles or combinations that were "in-the-money", sales of straddles and combinations where the BETA of the security was greater than 1.5, the purchase of options (which created a debit in the account by paying out money rather than receiving premiums), and the sale of a call or a put without a corresponding transaction, thereby not involving

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20/ On an individual basis, the annualized ratios of commissions to face value varied on each account. In the Hughes and Mesirow accounts the commissions amounted to 22% of face value, in the Resnik account to 11%, and in the Weiner account to 35%. The Report of the Special Study (see footnote 15) cited as an example of excessive trading in an account in which the annual commission rate was 24% of average equity.

a combination as contemplated. The study further found instances of closing transactions that varied from the program by the closing of one side of a combination at a profit while leaving the losing position open. Other instances of variances that were found included "day trades" and next day trades, where the opening and closing options transactions occurred on the same trade date or the next day, time spreads and "butterfly" spreads, none of which were contemplated within the program as originally presented and agreed to by the customers. These variances resulted in numerous unnecessary losses (and occasional profits) in the different accounts. In some cases involving day trades or next-day trades, positions were found to have been opened and closed, or closed and then reopened, the only effect of which was the generation of commissions, especially since in many cases neither profits nor losses resulted. Finally, assignments or exercises were entered into which varied from the program.

For the most part, respondent does not dispute the making of these transactions which were clearly not in line with the program. He even concedes that the trading in the Weiner, Mesirow and Hughes accounts were outside of the program and that the only one he considers to have been within it was Dr. Resnik. His defense is that all of the transactions outside of the program were done at the instance of the individual clients due to their own desires and wishes. However, as was seen in connection with the discussion of discretion and control, such

testimony not only contradicts that of the four customers, but is totally inconsistent with any objective analysis. While it is true that the customers received confirmations of each transaction, and monthly account statements from Paine Webber which reported all of the transactions, it is also true that they were in no position to understand them and frequently turned to respondent for explanation. They had difficulty in matching opening and closing position confirmations, and in comprehending their monthly statements. They possessed neither the background, training nor experience to appreciate the sophisticated nature of the transactions entered into for them by respondent.

There can be no explanation for these frequent and unannounced departures by respondent from the program other than the desire on his part to generate commissions. Surely, such departures are not found in the writings and advice of Dr. Pounds and others. Departures from the program could not serve as a "show-case" of the C-O-W strategems for the benefit of the CEMP trustees. Add to this the fact that these commissions were respondent's only source of income, and the fact that actual commissions (even after the 50% discount) bore extremely high percentages to the values of the collateral securities deposited and to the losses sustained in each account.

Under all the circumstances found herein, it is concluded (along with the uncontradicted opinion of the Division's expert witness) that trading in the accounts involved herein was excessive especially in the light of the customer's trading objectives.

III.

The third element requisite in the establishment of churning is the existence of "scienter" -- or the intent to defraud. This requirement is also satisfied by a showing on the part of the broker of reckless conduct -- the willful and reckless disregard for the interests of his clients. _Mihara, supra_, at p. 821; _Rolf, supra_, at 1039.

The manner in which respondent handled the accounts of the four clients represents, at the very least, a reckless disregard for their interests. The frequency with which he departed from their stated objectives, as embodied in the C-O-W program in which they were induced to join, and about which only respondent could have been expected to be aware, is sufficient to establish that recklessness. Hence, a willful intent to defraud need not be found, although the overall manner in which respondent handled these accounts, i.e., the "totality of the circumstances" as described in _Stevens, supra_, at p. 847, might well spell out such an intent.

Under all the foregoing, it is concluded that the charge of excessive trading, or churning, has been adequately established.

Account Profitability

The final allegation, concerning fraudulent conduct after the customer accounts were open, is that in order to induce the customers to continue to engage in options trading, respondent represented to them that their accounts were profitable when in fact they were not. Specifically, the Division charges that

respondent made such representations to them: (1) in computerized portfolio summaries and appraisals, (2) by orally telling them that their accounts were more profitable than they were, and (3) by entering trades designed to insure that losses would be concealed.

Before examining the nature of respondent's representations as to profitability, cognizance should be taken of the records that were available to him from which he could base such representations. There were, of course, the back office records of Paine Webber, including the confirmations of transactions and the monthly statements to customers and other reports which issued therefrom. It is uniformly agreed by all those having awareness of the conditions prevalent in the back office (including respondent) that records were frequently inaccurate, that transactions were not accounted for, and that the work of the office generally was in a chaotic condition, particularly following the BEDCO merger. Salesmen and other personnel made complaints to management about the manner in which records were kept.[21/]

Another type of record-keeping available to respondent was the computer which respondent and Maeir rented in April 1980 for the sole purpose of recording and keeping track of the transactions in the four options accounts. From the beginning,

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21/ In fact, one of the principal reasons that the Chicago office resident manager, H. Robert Holmes, ultimately left the employ of Paine Webber was the deplorable condition of the back office records.

respondent had promised the customers that in order to minimize the potential for loss, he would use a computer to help him in monitoring the positions and to react quickly when circumstances required. This computer was kept in the office of Maeir. However, all entries were made therein solely by respondent and he alone was responsible for its operation. Respondent was unsuccessful in attempts to train secretarial persons to assist him in using the computer. Although he had obtained permission from the office manager to use the machine at his own expense for keeping his clients' records, he was instructed not to give them print-outs from this computer.

Finally, respondent also had available so-called "holding pages" in which he would post on a daily basis a record of each transaction executed on behalf of his clients, and the approximate profit or loss incurred on each closed position or transaction. He maintained a separate holding page in a looseleaf folder for each customer at his desk. The keeping of such records was required of each Paine Webber salesperson.

In evaluating the proof relating to this issue, reliance is made on the evidence of respondent's representations as to profitability in each account at particular times, and to the computations of profit and loss based on available records made by the Division's options expert, Stanley Whitten, and by respondent's securities accounting expert, Howard Sikorski.

The Hughes Account

The first account opened under the C-O-W program was that of Hughes who entered in January 1980. By the end of that month, respondent advised him orally that his account was running about $5,000 or $6,000 behind. In fact, at that time, according to Sikorski's analysis, the Hughes account was actually behind almost $9,600. During February, respondent advised that the losses had increased to about $12,000, although the Sikorski analysis does not show that high a sum.

Respondent told Hughes to keep the confirmation slips received from Paine Webber to check against his account statements in view of the problems in the back office. Because Hughes had difficulty in matching opening and closing confirmations, he sought respondent's assistance at various meetings. During these meetings, respondent would compute the results of the various closed positions as found in his records and verbally relay the total profit or loss to Hughes who would record them on the back of business cards. From time to time, respondent would total the amounts on these cards on adding machines and give them to Hughes. In the early part of June 1980, the tape made by respondent showed that the account was ahead approximately $48,000. A tape prepared by respondent in early July showed that the account was supposedly ahead $24,000.

At various times during July and August, Hughes had asked respondent about the status of his account. During the

second week in July, respondent told him that the account had eroded from a plus position of $24,000 to one of approximately $12,000. In August, respondent advised that the account was basically the same.

As compared to respondent's adding machine tapes and verbal statements, the analysis by his expert Sikorski showed that the Hughes account had cumulative losses of almost $1,300 in May of $17,763 during June, of $108,000 in July and of $91,000 by the end of August.

In addition, on June 24 respondent had prepared a status printout from his own computer which he gave to Hughes showing a realized profit of $55,768 as of May 16, 1980. However, respondent cautioned him that there was an open position in IBM which could result in a loss of $13,000, leaving a net profit of $43,768. Yet, Whitten computed the account as of that date showing a realized loss of $2,709. Sikorski found a net loss during May of $1,289.

In order to determine the basis for these wide discrepancies between respondent's printout and the actual profit/ loss statements, Whitten analyzed respondent's entries in his holding pages for the Hughes transactions. He found, as compared to the holding pages, omissions in the computer summary of both opening and closing transactions, the transposition of figures and columns whereby a loss became a gain, the mismatching of opening and closing positions, and the matching up of the same opening transactions with two different closing transactions.

In actual figures, some of the losing transactions amounted to unstated losses of over $16,000, and the transposition of long into a short position (i.e., a sale instead of a purchase) converted an actual loss of $1,313 into a profit of $2,560, for a total error of $3,873. Another instance involving the reversing of an opening and closing transaction had the effect of converting a loss of $1,544 into a profit of $1,545 for a total discrepancy of $3,089 (this last transaction was correctly recorded in the holding pages showing the actual loss sustained).

Examples of situations found in the computer summaries by Whitten where the same transactions were reported in two different places, include a purchase of 5 contracts of Amerada Hess on April 11 being shown as an initial transaction with respect to two different closing transactions, which had the effect of omitting a loss of $1,168 from the status report, and an instance involving two opening and two closing transactions from which a third pairing was created by using one of the opening transactions with another of the closing transactions resulting in a fictitious profit of $2,539.

The Mesirow Account

Respondent began trading for Mesirow in January, 1980. Mesirow noticed from the confirmations he received from Paine Webber that there were some slight losses in his transactions.

When he called this to the respondent's attention he was told not to worry, that over all he was making money. He was further advised that by increasing the amount of his $30,000 collateral he would be in a better position to make profits. As a result, he increased the collateral on deposit to $100,000 of municipal bonds.

Mesirow would call upon the respondent from time to time to find out the profitability in his account. On these occasions, respondent gave him printouts from his computer. Thus, the computer showed that as of April 23, 1980 there was a profit of $2,216; as of May 30 a loss of $772; as of June 24 a loss of $4,236. When Mesirow complained about this to respondent, the latter showed him how to recompute the figures so that the loss appeared to be only $3,341. According to Sikorski's computations, the losses in the Mesirow account, on a mark-to-market basis were $7,127 in April, $4,389 in May, and $18,180 in June. According to Whitten's computation, the Mesirow account had a total of realized and unrealized losses of $4,723 as of May 30, 1980, and losses of $9,455 as of June 24.

During the summer of 1980, when the Mesirows were vacationing in Aspen, Colorado they received several telephone calls from respondent who each time assured them that he was doing well in their account. Sikorski, however, computed that in July the account was losing $29,686 and in August $41,045.

Mesirow does not recall respondent ever telling him that his account was losing money. On the contrary, respondent was generally optimistic whenever he described the status of the account. In fact, on a cumulative basis, Sikorski, the respondent's expert, showed that the Mesirow account was never in a profitable situation.

The Weiner Account

With respect to the Weiner account, the customer was constantly being reassured by respondent that his account was doing well. Furnari frequently gave him computer printouts showing the status of his account between May 19 and July 1 which showed net profits from trading ranging from $6,000 to $8,500. He was orally told by respondent that by Christmas of 1980 his profits would amount to $25,000. At a luncheon meeting with respondent on a Friday in August, Weiner was told that his account was showing a profit of about $8,500. The following Monday, respondent advised him that his account was losing $18,000. According to Sikorski, Weiner's account showed cumulative losses in February, March and April, a small profit in May and June, and by July the cumulative loss had amounted to $13,550 which increased in August and September. Whitten's computations showed the Weiner account to have an aggregate loss of $1,741 as of May 27 and $1,887 as of July 1.

Finally, on four different occasions between June 2nd

and August 8, Weiner received mailgrams from Paine Webber asking him to put up more margin or collateral as his account was short in this regard. On each such occasion he called respondent and was told that the mailgrams were a mistake due to the inaccuracy of the Paine Webber recordkeeping and to ignore these margin calls.

The Resnik Account

Resnik was in contact with respondent about once or twice a week, particularly over his confusion with the confirmations he had been receiving from Paine Webber. Respondent told him not to be concerned since he would and did send him computer printouts which would be more revealing. The printouts sent Resnik, in addition to containing data as to transactions entered into, showed profitability status. The report as of April 19, 1980 showed a net profit of $2,422 with a handwritten "bond correction" by respondent reducing it to $1,713. The May 31 statement showed a total loss of $42,431. Yet, respondent added handwritten notes stating that by the middle of June "we'll be over the $10,000 mark," that he expected to show a profit by the end of the year of $75,000, and looked for a 30% return on the value of the collateral posted.

In the June 9 statement, the computer printout showed a total loss of $23,939. A printout 2 days later increases the loss to $29,528. About 2 weeks later, on a printout showing a slightly lower total loss of $27,359, respondent added a handwritten note that he was "looking to go over $10,000 for completed

transactions by the next report." By the next report, on July 1, the total loss stood at $25,856.

Resnik discussed the contents of each report with respondent as he received them, and was told that everything was good, that there were no problems, and that he was looking for profitable results. In July, he told Resnik that the options account was close to being even. Some time later in July of 1980 respondent called Resnik, who was then on vacation, to advise him that the account had sustained losses of about $5,000.

On the other hand, respondent's expert Sikorski found there was a cumulative loss of $244 in May, in June of $15,207, in July of $60,580 and in August of $80,150 in the Resnik account.

The same analysis with respect to the Hughes account was conducted by Whitten of the other three accounts. He found from the holding pages comparable examples in the computer printouts of incorrect pairings, transpositions, duplications, etc. although not of the magnitude as those found in the Hughes report. However, in all instances the holding pages maintained by respondent accurately reflected the transactions as they actually occurred, with some minor variations, and they reflected the correct losses where the computer printouts incorrectly reflected profits.

In support of the allegation that respondent entered trades designed to insure that losses would be concealed, the Division points to but two events. One involved instances where the profitable side of a combination or straddle was closed

leaving the losing side open, which then had the effect of showing only the profit and not the ultimate loss.[22/] The other was an example concerning a put in IBM stock which was assigned to the Hughes account. After the stock was purchased to satisfy the assignment, respondent disposed of it by buying and exercising another put rather than merely selling the IBM shares outright. In both of these examples, the record is not clear that they were done with any intent on the part of respondent to conceal losses. While the trading strategies might be criticized as being improper or not in keeping with the C-O-W program and with tending to incurr additional commissions, nevertheless there is not enough evidence from which to conclude that they were done with the intent ascribed to them.

The record herein establishes that during the 8-month period that respondent was managing the four accounts under the C-O-W program, he was providing his customers with summaries and printouts from his computer which grossly understated losses and exaggerated profits. The information from the computer (the input for which was the sole responsibility of respondent) was based upon data in many instances at variance with the correct information found in respondent's holding pages.

22/ However, Silorski found instances where the closing side of a transaction was entered on the books the month following the one in which it occurred, thus giving the impression that one side was still open in that prior month.

The record further establishes that respondent constantly reassured his clients that their accounts were doing well or were otherwise in a profitable state at the very time that severe losses were occurring, losses which he could readily have ascertained from his holding pages.

The conclusion is inescapable that respondent "willfully" misrepresented profitability to his customers for the primary reason of keeping them in the program. Had he disclosed the extent of their early losses, one or more of them might have pulled out, leaving him without customers, and unable to test his theories of long-term market actions, rolling up and rolling out techniques.

The conclusion is also justified that respondent was always aware of the true state of the account. He knew better than to rely upon the Paine Webber records, and chose instead to keep his own records in the computer. The consistent pattern of errors found in the computer statements as compared with the holding pages which respondent was keeping simultaneously could not, except for a few instances, have been accidental.

Under the circumstances, it is found that this allegation in the Order has been established.

Discussion and Conclusions

On the basis of the record herein, it has been found that respondent has willfully violated the anti-fraud provisions of the securities laws in all but one of the specifications

alleged in the Order for Proceedings. These include misrepresentations made during solicitations with respect to anticipated rates of return for the investors, respondent's success with other accounts in the C-O-W program, and the risks inherent in the respondents' trading strategy. It has also been found that respondent engaged in churning his customers' accounts and in misrepresenting their profitability during the time he was trading for them.

The respondent's defense is based upon contentions that the four customers involved were "experienced" and "sophisticated" investors who began options trading and continued to do so with full knowledge of the speculative risks involved; that none of them wished to follow strictly the program under which they were solicited; that he acted in good faith in promoting this program; and that the losses that resulted were not because of his failures but due to the customer's own investment decisions, the back office problems at Paine Webber, and the unusual direction taken by the market during the summer of 1979. Finally, respondent argues that he neither intended nor attempted to defraud any of the customers and that the necessary element of "scienter" has not been established.

The question of the experience and sophistication of the four customers herein has previously been discussed. This is an element that affects virtually all of the allegations in the order. Respondent points to the fact that these customers

had been investing in securities for a number of years, including occasional dabbling in covered options and some commodities, and were successful business men in their respective fields and therefore would have sufficient awareness to understand the risks in options trading. Moreover, they had periodically received confirmations and monthly statements.

Respondent, in support of his contentions, relies on a number of cases involving the issue of control in churning matters, typical of which are Follansbee v. Davis, Skaggs & Co., Inc., 681 F.2d 673 (C.A. 9, 1982) and Booth v. Peavey Company Commodity Services, 430 F.2d 132 (C.A. 4, 1970).

In the Follansbee decision, the court found that the plaintiff had extensive background in security trading, had changed his objectives to one involving short-term trading in an aggressive manner for short-term profits, had declined to follow his broker's suggestions and even made suggestions of his own and had the ability to interpret the information provided him. Thus, he was found to have maintained control of his account. In Booth, the plaintiff insisted upon entering into a commodities futures account with full knowledge that it would be heavily traded. Moreover, with respect to churning, the court also points to a lack of probative evidence, such as turnover rate, the type of trading, the dealers profits, and the lack of expert testimony.

The situation in this case is quite different. Despite their background in securities trading and their business and

professional background in securities trading and their business and professional successses, respondent's four customers were clearly lacking in the ability to understand the sophisticated strategies involved in the selling of naked puts and calls, "butterfly spreads," "silver straddles," "rolling up and out," all of which were strategies engineered for them by respondent.

The fact that the customers had signed forms and letters indicating that they knew the speculative risks involved and that they were prepared to assume them, is of no moment under the circumstances herein. They were reassured by respondent that his techniques of selling in combination would have the risks balancing each other and that his careful monitoring of positions with the use of the computer would prevent the normal risks associated with options trading to occur. In other words, his representation lulled them into a false sense of security.

As the Commission stated in Michael E. Tannenbaum, supra, 24 SEC Docket 799, 809:

> As for customers' sophistication, respondent notes that customers were requested to verify receipt of a prospectus, their income and net worth, and any previous trading history in options, and acknowledge that they wished to commit a portion of their funds to options trading, that they considered themselves sophisticated in investment matters, and that they had sufficient income or other assets to sustain the risk inherent in such an investment. *** In any event, such acknowledgements were no guarantee of customers' 'sophistication', ***.

Also as seen herein, the testimony by respondent that

these customers made their own investment decisions, that they were aware in advance of the trading to be done for them and that none of them wished to follow strictly the C-O-W program is directly contrary to their testimony and is not given any credence. The same can be said with respect to the other contentions that whatever happened to respondent in his handling of these accounts was due to situations beyond his control, such as his inexperience as a retail broker, the refusal by Paine Webber to give him retail broker's training, the difficulties in Paine Webber's back office, the alleged interference by Maeir, and the sustained market rally in the summer of 1980. These are all excuses designed to divert attention from his responsibilities in this matter. [23/]

Respondent argues that he acted in good faith in his expressions of opinions as to the anticipated results of his program because he relied upon the writings and conversations with others in the firm, specifically Dr. Pounds, Mr. Ferguson and Mr. Holmes concerning such a program. However, the record is to the contrary. It shows that he had

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23/ Respondent also complains about an alleged vendetta against him on the part of the Division, citing its refusal to accept the terms of his offer of settlement and attaching to his brief a copy of a newspaper article critical of the Commission in another matter. Apart from the fact that respondent fails to blame himself for his refusal to accept the terms of the Division's counter settlement offers, neither the terms of his offer nor an irrelevant newspaper article are part of this record and the inclusion of them in his brief is contrary to accepted principles.

been warned by these individuals about the previous bad experience at BEDCO in this program and that he should not undertake the same for retail accounts.

Finally, respondent raises the question of "scienter".

As stated, the conduct of respondent herein was fraudulent with respect to his customers, in the purchase and sale of securities. Moreover, his conduct involved the employment of a scheme to defraud.

In Aaron v. Securities and Exchange Commission, 446 U.S. 680 (1980), the Supreme Court held that scienter is necessary to establish a violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder as well as of Section 17(a)(1) of the Securities Act. This case also held that scienter was not required as an element of a violation of Section 17(a)(2) or 17(a)(3) of the Securities Act.

As was pointed out heretofore in the discussion of churning, scienter might also be established upon the showing of reckless conduct on the part of the broker. In this case the record establishes that respondent acted with scienter with respect to his fraudulent activities. Based upon his extensive background in the options field he should have been well aware of the risks involved, the multiplicity of commissions to be generated and the other allegations contained in the Order for Proceedings. Further indication of his intent to defraud is found in the furnishing of false status reports, both oral and written, rendered

subsequently to his customers. It has been held that a scheme to defraud may well include efforts to avoid detection of the fraud and this would include the lulling activities on respondent's part in failing to advise his customers of the full extent of their continuing losses. S.E.C. v. Holschuh, (1982 Transfer Binder) Fed. Sec. L. Rep. (CCH) ¶99000 (C.A. 7, November 23, 1982).

Moreover, as it was shown before, respondent handled the accounts of the four clients with a reckless disregard for their interests, which also satisfies the requirement for scienter.

Finally, the churning violation is in itself a scheme or artifice to defraud and a fraudulent and deceptive device within the meaning of Rule 10b-5. Mihara v. Dean Witter & Co., supra, at page 821.

The facts developed in the record of this proceeding are strikingly similar to those In the Matter of Ronald L. Brownlow, Securities Exchange Act Release No. 18257 (November 16, 1981) 23 SEC Docket 1554. In that case, Brownlow while employed by a brokerage firm induced people to invest in his "special options program" utilizing various option and margin techniques. The program called for a customer to purchase fully paid securities to be deposited in a margin account to secure the sale of listed options which were in effect naked call options, the premiums of which were used to

purchase debt securities to add to the yield promised by Brownlow. In that case, respondent misrepresented the risks involved, prepared a report describing the program and made the promise of a 20% yield on the investment. His customers like those in this case, wanted conservative investments to preserve their capital and produce income. In most respects, Brownlow is on all fours with the one at issue herein, including the finding of churning of some customer accounts and the effort by respondent to shift responsibility to others for such trading.

Public Interest

The violations which have been found herein to have been committted by respondent are quite serious ones. They resulted in losses to the four respondents herein in a brief 7 to 9 month period amounting to, at least, some $227,000.

The Division asks that respondent be barred from associating with any broker, dealer, investment adviser, investment company or affiliate thereof. This request is based upon the losses sustained, the knowing and intentional action of respondent, and his failure to recognize the wrongful nature of his conduct by trying to put the blame on his customers, his employer, his fellow broker, and the actions of the stock market in general. The Division further points out that respondent had previously been sanctioned by the CBOE in connection with a failure to disclose a financing arrangement. It lays emphasis

upon his untruthful statements during the hearing and urges that a strong sanction is necessary to convince respondent that he committed a serious fraud and to serve as a deterrent to others.

Respondent, on the other hand, urges that no public interest requires that he be sanctioned. He points to the fact that he has undergone considerable expense, disruptions in his employment and his earning power in defending himself in this proceeding "pitted against the might of the United States Government", that he no longer is the totally inexperienced stock broker he was at the time of the activities involved herein, and claims that his knowledge and appreciation of the retail segment of the securities business has grown immeasurably.

In assessing a sanction, due regard must be given to the facts and circumstances of each particular case, since sanctions are not intended to punish a respondent but to protect the public interest from future harm. See Berko v. S.E.C., 316 F.2d 137, 141 (C.A. 2, 1963) and Leo Glassman, 46 SEC 209, 211 (1975). Sanctions should also serve as a deterrent to others. Richard C. Spangler, Inc., 46 S.E.C. 238, 254 n.67 (1976).

It is quite clear that respondent is far from contrite and has persistently failed to recognize his part in the fraud committed on these customers. It is also

clear that throughout the hearing, his testimony was so at variance with the testimony of all the other witnesses and the facts which appear from this record as to warrant the conclusion that whether or not he was consciously lying, he was in one way or another ignoring the realities of the situation.[24/]

In this case the sanction must be of sufficient severity as to impress upon respondent and others that the type of violative conduct engaged in by him cannot be tolerated. Accordingly, it is concluded that respondent should be barred from association with any broker or dealer, with the proviso that, after one year he may become associated in a nonproprietary and nonsupervisory capacity upon making a satisfactory showing to the Commission that he will be adequate supervised.

Any lesser sanction will not suffice to protect the public investors from further harm caused by the type of conduct exhibited by respondent, to make him aware of the seriousness of his actions, and to discourage others

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24/ His sanction by the CBOE and the charge that he might have lied during the investigatory phase of this proceeding, are not given too much weight in assessing a sanction. On the other hand, it is noted that in the Brownlow case the Commission sustained a sanction barring the respondent from association with any broker or dealer with the proviso that after two years, he may become so associated in a non-proprietary and nonsupervisory capacity. However, no two cases should be followed blindly since each stands on its own facts.

from engaging in the unlawful conduct found to have been committed here. 25/

ORDER

Under all of the circumstances herein, IT IS ORDERED:

That respondent Thomas J. Furnari be barred from association with any broker or dealer, except that after one year from the effective date of this order he may become associated with a broker-dealer in a nonsupervisory, non-proprietary capacity upon making a satisfactory showing to the Commission that he will be adequately supervised.

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 Rule 17(f), this initial decision shall become the final decision of the Commission as to each party who has not, within fifteen days after service of this initial decision upon him, filed a petition for review of this initial decision pursuant to Rule 17(b), unless the Commission pursuant to Rule 17(c), determines on its own

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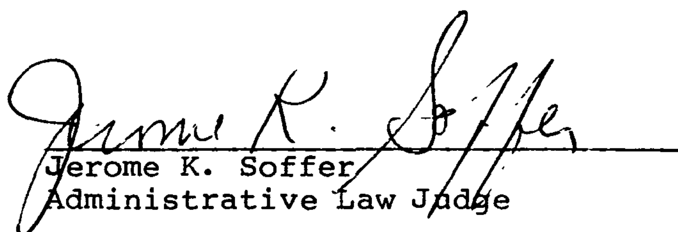
25/ In their briefs and arguments, the parties have requested the Administrative Law Judge to make findings of fact and have advanced arguments in support of their respective positions other than those heretofore set forth. All such arguments herein have been fully considered and the Judge concludes that they are without merit, or that further discussion is unnecessary in view of the findings herein.

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.



Jerome K. Soffer
Administrative Law Judge

Washington, D.C.
March 23, 1983