

ADMINISTRATIVE PROCEEDING  
FILE NO. 3-6332

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

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In the Matter of :  
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ROONEY, PACE INC., et al. :  
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INITIAL DECISION

*filed 5-24-85*

Washington, D.C.  
May 24, 1985

Max O. Regensteiner  
Administrative Law Judge

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APPEARANCES: Anne C. Flannery, Jason R. Gettinger,  
Elizabeth A. Barnes, Linda N. Cassano,  
Kenneth E. Leopold and Matthew W.  
Gottesfeld, of the Commission's New  
York Regional Office, for the Division  
of Enforcement.

Norman B. Arnoff, Jerome L. Merin and  
Diane B. Walker, of Arnoff & Merin, P.C.,  
for Rooney, Pace Inc.

Franklin D. Ormsten, of Ormsten &  
Evangelist, for Randolph K. Pace.

BEFORE: Max O. Regensteiner, Administrative Law  
Judge

In these proceedings pursuant to Sections 15(b) and 19(h) of the Securities Exchange Act of 1934 ("Exchange Act"), the issues remaining for consideration are whether Rooney, Pace Inc., a registered broker-dealer ("registrant"), and Randolph K. Pace, its president, engaged in misconduct as alleged by the Division of Enforcement and, if so, what if any remedial action is appropriate in the public interest. The order for proceedings also named as respondents Richard Nager and James E. Cohen, who are employed by registrant as registered representatives. The proceedings as to them were concluded on the basis of settlement offers accepted by the Commission. <sup>1/</sup>

The alleged misconduct relates to a best efforts "all or none" offering of 12 million units of Sequential Information Systems, Inc. in the last quarter of 1981. The units consisted of common stock and warrants and were offered at 25 cents each, for a total offering price of \$3 million. In connection with the offering, registrant and Pace (referred to collectively as "respondents") allegedly violated various antifraud provisions of the securities laws and Commission rules promulgated thereunder as well as credit-extension provisions of the Exchange Act and Regulation T of the Board of Governors of the Federal Reserve System. Respondents are also charged with failing reasonably to supervise Nager and Cohen.

Following extended hearings, the parties filed proposed

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<sup>1/</sup> Securities Exchange Act Release No. 21179 (July 27, 1984), 31 SEC Docket 8.

findings and conclusions and supporting memoranda, and the Division filed a reply memorandum, together with objections to respondents' proposed findings and conclusions. The findings and conclusions herein are based on the preponderance of the evidence as determined from the record and upon observation of the witnesses.

### Respondents

Registrant has been registered with the Commission since 1978. During the period in question, it was owned equally by Pace and Patrick J. Rooney. In 1983, registrant became a wholly owned subsidiary of Rooney, Pace Group, Inc., a publicly-owned corporation of which Pace is president. At relevant times, registrant has been a member of the New York and American Stock Exchanges and the National Association of Securities Dealers ("NASD"). It now has about 500 employees and some 20 branch offices, but was far smaller in 1981.

Pace, who is 39 years old, has been in the securities business in various capacities since 1969. He and Rooney founded registrant in 1978, and he has been its president at all times.

Reference must also be made to a second broker-dealer that was affiliated with respondents. This was State Street Securities, Inc., which was a registered broker-dealer from 1979 until January 1984, when the withdrawal of its registration became effective. Pace was its president, and in 1981

he and Rooney, directly or indirectly, were its sole owners. They were also State Street's only employees. State Street shared office space with registrant. As will appear even more clearly, whatever life State Street had was breathed into it by registrant and registrant's personnel.

### Outline of Contentions

The Division contends, in essence, that respondents, taking over for the original underwriter only days before the October 14, 1981 expiration date of the Sequential offering, purported to sell the offering, but did not in fact do so. Nevertheless, a closing was held on October 19, at which \$3 million was disbursed from an escrow account to the issuer and the underwriters. According to the Division, Pace induced Bear Stearns & Co., registrant's clearing firm, to wire the entire \$3 million to the escrow account on the expiration date even though only about one-third of that amount was available in customers' accounts. He did so, it is claimed, by misrepresenting the facts to Bear Stearns and by obtaining an opinion of counsel also predicated on misinformation. The Division contends that, as part of a scheme to give the false appearance of having completed the offering by October 14, Pace, Nager and Cohen, who together "sold" almost the entire offering, caused Sequential units to be placed in customer accounts without prior approval and without written discretionary authority, effected other non-bona fide transactions and, aware of the fact that customers had not yet received a prospectus, made material

misrepresentations and omitted material facts. Finally, it is urged, a large percentage of the units was not paid for until after the expiration date.

Respondents deny that there were any improprieties in the way they handled the offering. They state that when they took over the offering, Pace knew that even if they were able to sell the units, there was not time for customers to pay by the expiration date. Accordingly, they claim, Pace consulted counsel concerning the possibility of advancing funds to the escrow account on sales which he believed in good faith would be firm. They assert that he proceeded only after receiving counsel's "okay," and that he believed all sales were bona fide.

#### Provisions Allegedly Violated

Respondents allegedly violated the "general" 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 by, among other things, failing to deposit offering proceeds in the escrow account and closing the offering before all payments had been received, contrary to representations in the prospectus; engaging in a scheme to give the false appearance of having completed the offering by October 14; and making material misrepresentations and omitting to state material facts to investors.

Respondents are also charged with willfully violating or aiding and abetting violations of (a) Rule 10b-9 under

the Exchange Act, by representing to investors that the purchase price would be refunded unless all units were sold to and paid for by bona fide purchasers by October 14 and (b) Rule 15c2-4 under that Act by not promptly transmitting proceeds to the escrow account and by not refunding them when the complete offering was not sold. Finally, in connection with Bear Stearns' sending the \$3 million to the escrow account, respondents are charged with improperly arranging for the extension of credit to customers, in violation of Sections 7 and 11(d)(1) of the Exchange Act and Regulation T.

Rules 10b-9 and 15c2-4 deal specifically with conditional offerings such as that involved here. Rule 10b-9, as here pertinent, makes it a deceptive device for any person to represent that an offering is on an "all or none" basis unless such offering is made on the condition that the purchase price will be promptly refunded unless all of the securities offered are sold at a specified price within a specified time and the total amount due the seller is received by him by a specified date. As noted in the releases accompanying proposal and adoption of the rule, it was designed to prevent misleading representations concerning the conditions under which purchasers in such an offering are entitled to refunds. <sup>2/</sup> In a 1975 release,

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<sup>2/</sup> Securities Exchange Act Release Nos. 6864 (July 30, 1962) and 6905 (October 3, 1962).

the Commission stated that one of the primary purposes of the rule was to prohibit the designation "all or none" from being utilized where the underwriter is required only to get persons to agree to purchase the securities within the specified period and is not required to collect full payment within such period.<sup>3/</sup> The Commission further stated that it followed that, under Rule 10b-9, an offering may not be considered "sold," for purposes of the representation "all or none," unless all securities are sold in bona fide transactions and are fully paid for.

As relevant here, Rule 15c2-4, which applies to any broker-dealer participating in a best efforts "all or none" offering, requires that proceeds be promptly transmitted to a bank escrow account to be held there until the offering is either completely sold or is not completed by the expiration date, whereupon the funds are to be either transmitted or returned to the persons entitled thereto. The Commission has pointed out that under this provision the broker-dealer must ensure that funds are not disbursed from the escrow account to the issuer unless all the securities are sold in bona fide transactions and are fully paid for by the specified time limit.<sup>4/</sup>

#### The Sequential Offering: Background

Sequential is an electronic instrument manufacturer located

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<sup>3/</sup> Securities Exchange Act Release No. 11532 (July 11, 1975), 7 SEC Docket 403.

<sup>4/</sup> Ibid.



in New York State. On July 31, 1981, a registration statement for the 12 million unit offering became effective. As noted, the offering was on a best efforts, all or none, basis. That is, unless all units were sold by the offering's expiration date, September 14, 1981 (later extended to October 14), all funds received were to be promptly returned to the subscribers. In the interim, such funds were to be held in an escrow account at the Metro National Bank of Denver. The prospectus disclosed that at least 87 percent of the net proceeds of the offering would be used to pay delinquent income and payroll taxes, plus accrued interest and penalties. It also disclosed, in a lengthy recital of risk factors, that the company was "plagued" by cash flow problems and had sustained a net loss during the most recent nine-month period.

The designated underwriter for the offering was OTC Net Incorporated, a Denver broker-dealer. In July 1981, OTC Net distributed a substantial number of preliminary prospectuses to its various offices and to prospective selling group members. However, it received only a small number of indications of interest. None of these culminated in purchase orders. Consequently, OTC Net enlisted the aid of Lewis Schiller, Sequential's president, with a view to obtaining the assistance of other broker-dealers in the offering. Pace and Schiller were friends. And that is how State Street and registrant came into the picture.

Shortly before September 14, 1981, the original expiration date of the offering, Sequential and OTC Net agreed to a 30-day

extension. At or about this time also, OTC Net and State Street agreed that the latter would be "doing the entire offering." (Tr. 266) However, agreement on State Street's compensation was not reached until early October.

According to Pace, he and Rooney used State Street as the named underwriter or selling group member in relatively small, speculative offerings to which registrant did not want to lend its name. As noted, State Street's only employees were its two principals. When it participated in offerings, the sales were in fact effected by registrant's salesmen and to registrant's customers.

On or about October 7, State Street, through Pace, entered into a "selected dealer agreement" with OTC Net, under which State Street agreed to seek to sell the entire offering. A supplement to the prospectus dated September 25 stated that the offering had been extended for a month because only a limited number of indications of interest had been received as of the original expiration date; that State Street had agreed to be a member of the selling group; and that, because of the large number of units remaining unsold, many of which might be sold by State Street, that firm "may be deemed" to be a statutory underwriter. A further supplement, dated October 5, added the fact that, in addition to the 10 percent selling concession, OTC Net had agreed to transfer to State Street all warrants which OTC Net was to receive pursuant to the underwriting agreement and, upon the sale of at least 90 percent of the units, to

pay State Street a non-accountable expense allowance of \$40,000. This was out of a total expense allowance of \$75,000 provided for in the underwriting agreement.

I skip momentarily over the period between October 7 and October 14, the expiration date of the offering. What occurred or did not occur during that period provides the major focus of this decision and is treated in detail below. On October 14, Bear Stearns, the clearing firm for registrant and State Street, wired \$3 million to the escrow account at Metro National Bank pursuant to Pace's request. And on October 19, the closing took place at the bank. Present were representatives of the issuer and OTC Net, their respective counsel, and Steven Glusband, an attorney representing State Street. At the closing, certificates representing the 12 million units were delivered by the issuer to OTC Net, which was still the designated underwriter, and by OTC Net in turn to the "Selected Dealer" (State Street). The \$3 million in the escrow account was disbursed, including a payment of \$340,000 to State Street. This represented the 10 percent concession on the sale of all units and the \$40,000 expense allowance.

#### Circumstances Surrounding Sales of Sequential Units

As of October 7, it was Pace's understanding that some of registrant's customers who would be buying Sequential units would have credit balances in their accounts on October 14. But it was clear to him that because of the short time that remained, it was impossible for the entire proceeds of the

offering to have reached Bear Stearns by that date. Accordingly, Pace consulted Glusband, a partner in a law firm which had done legal work for registrant and a former Commission staff attorney, to explore a possible alternative. The alternative was that funds would be advanced by State Street or Bear Stearns to complete the offering. The Division claims that Pace misrepresented the facts to Glusband, who then passed on misleading information to a Commission attorney whom he consulted. However, the record does not show that Glusband was misled as to any material facts. <sup>5/</sup> According to Glusband, the question posed by Pace was whether State Street could "go forward with the offering" (Tr. 3684) even if all funds were not in by October 14, by having State Street or Bear Stearns advance funds on behalf of those customers who had agreed to purchase Sequential units and had received (or at least been sent) confirmations, but whose funds had not yet been received. Following his conversation with Pace, Glusband called the Commission's Division of Market Regulation "to get some input from them." (Tr. 3686) He was referred to an attorney in that Division, and put Pace's question to her. According to Glusband's contemporaneous memorandum of the conversation, she "indicated" that she knew of no rules or regulations which would prohibit such an advance and further "indicated"

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<sup>5/</sup> Nevertheless, as will appear below, this is of no avail to respondents because, wholly apart from the issue of payment, the offering was not completely sold in bona fide transactions.

that it appeared to be permissible under the Exchange Act (Pace Ex. B). <sup>6/</sup>

Glusband conveyed that response to Pace. Following that conversation Pace signed the selected dealer agreement. The Division claims that Pace misled Glusband by telling him, among other things, that the offering had already been partially sold, when in fact no orders had as yet been taken, and by not telling him that Pace had not yet asked Bear Stearns to clear the Sequential offering or that Bear Stearns had a policy against clearing best efforts all or none offerings. The materiality of these points to the advice sought by Pace is not apparent to me. <sup>7/</sup> Moreover, portions of the record cited by the Division do not bear out its assertion that Pace told Glusband on October 7

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<sup>6/</sup> Although the staff attorney appeared on the prehearing witness lists of both the Division and respondents, she was not called to testify. The memorandum refers to a conversation concerning the Sequential "best efforts" underwriting. Glusband nevertheless testified that he advised the staff attorney that it was a best efforts all or none offering. Glusband was a credible witness. The way the memorandum is structured, the "best efforts" reference appears on its face to be an identifying reference rather than an indication of precisely what he told the staff attorney. Thus, the Division's assertion that he did not disclose the "all or none" nature of the offering, predicated on the fact that that phrase was not used in the memorandum, is not persuasive.

<sup>7/</sup> Glusband testified that had he known of Bear Stearns' policy, it would have made a difference in the advice rendered to Pace. But he was not asked to, and did not, explain that answer. Bear Stearns could, as it in fact did, waive its policy. Had it refused to do so, on the other hand, the offering probably could not have proceeded. The policy simply had no bearing on the legal issue put to Glusband.

that some of the units had already been sold.<sup>8/</sup>

The Division asserts that Glusband's advice to Pace regarding the permissibility of an advance of funds was subject to certain conditions which he communicated to Pace, and that those conditions were not met. First, the Division refers to purported testimony by Glusband that, on the basis of his October 7 conversation with Pace, whatever customer moneys would be received by October 14 should be immediately deposited in the escrow account. In reality, at the pages cited (Tr. 3715, 3717), Glusband, when asked whether it was his understanding that customer funds would be immediately deposited in the escrow account, replied that he was not sure of the arrangements between Bear Stearns, which would have received the funds, and the escrow account, "[w]hether it would go into . . . Bear Stearns and then be transferred or not." (Tr. 3715) He further testified that it was his understanding, based on the prospectus and his conversation with Pace, that the escrow account "would be used" (Ibid) and that whatever money "could be in would be in." (Tr. 3717) This testimony reflects uncertainty by Glusband as to the transfer of funds to the escrow account; it does not

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<sup>8/</sup> Respondents state that Pace also brought his concerns to the attention of Sequential's attorney, a respected securities lawyer, who raised no questions about Glusband's advice. That attorney did not testify. And Pace's testimony concerning his conversation with him is general and vague. Moreover, the attorney was obviously not disinterested.

reflect the communication of any condition to Pace. Moreover, as further discussed below, to the extent customers who bought Sequential units had credit balances on October 14, I consider that these (up to the amount of their purchases) were incorporated in the \$3 million wired by Bear Stearns.

The second condition assertedly communicated to Pace by Glusband is actually Glusband's understanding that Pace was talking about an advance of only part of the offering proceeds. In fact, as just indicated, the advance was not for the total amount (though it was for a large proportion of the total).

Pace testified that while Glusband did not use "firm commitment" terminology, he construed the effect of Glusband's advice about the permissibility of prepayment to be that the offering would have turned into a firm commitment offering. Pace explained that upon Bear Stearns' prepayment, registrant would be responsible for repayment, and it, rather than the customers, would be at risk.

Bear Stearns had a policy, which it had communicated to correspondent firms only a few months earlier, not to clear best efforts or conditional underwritings. The stated reason was the complexity of NASD requirements governing such underwritings. <sup>9/</sup> On October 9, Pace discussed the Sequential

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<sup>9/</sup> An earlier, internal Bear Stearns memorandum on the same subject (and the NASD Notice to Members to which it referred) indicate that the primary concern was with offerings subject to a contingency such as the Sequential offering.

offering with two Bear Stearns officials.<sup>10/</sup> One was Richard Harriton, a limited partner with responsibility for supervision of the Clearance Services Department, the other Michael Zackman, his assistant. Pace asked them if Bear Stearns would clear the Sequential offering and in addition pay the \$3 million to the escrow account. The Division maintains that Pace deceived the Bear Stearns representatives by failing to tell them that this was an all or none offering and by representing (1) that almost all investor funds with the exception of a few delivery versus payment ("DVP") accounts had been received, when in fact money was due in substantially all of the accounts; (2) that the offering had been all sold when in fact many accounts had not yet ordered the securities; and (3) that Glusband had received S.E.C. approval and given his own approval to close the offering, when Glusband had himself been deceived.

I have already dealt with the last point, finding that Glusband was not deceived. As to the other points, I deem it unlikely that the Bear Stearns representatives were misled as to the nature of the offering or as to the extent of customer payments. The two officials testified that Pace did not tell them the offering was all or none. Pace testified that he did advise Bear Stearns of this fact, but could not recall whether it was in the course of a meeting or in another context. In any event, the Bear Stearns officials must have realized from

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<sup>10/</sup> October 8 was a major Jewish holiday.



the fact that funds had to be paid by a certain date and that they had to be paid to an escrow account, that a conditional offering was involved. <sup>11/</sup> Harriton and Zackman further testified that Pace told them the offering was fully sold; that most of the money was in (i.e., as credit balances in the customer accounts maintained at Bear Stearns); and that those funds that were not in represented DVP accounts, or mostly DVP accounts, where payment had to await delivery of the securities. He also told them that Glusband had gotten a ruling from the S.E.C. that it would be permissible for Bear Stearns to clear the offering and pay the \$3 million to the escrow account. Pace testified that he could not recall telling Bear Stearns representatives that the offering was fully sold. He stated that he told them simply that customer payments would not be in by the expiration date and that they should arrange to prepay. He denied referring to DVP accounts as the only ones that had not paid and pointed out that syndicate sheets and order tickets delivered to Zackman on October 12 indicated which accounts were DVP accounts. Since Harriton and Zackman knew that confirmations had not yet gone out, it must have been apparent to them that it was unlikely that all accounts other than DVP accounts would have already paid for the securities or had the necessary credit balances. And Pace of course knew that once he furnished the buyers' names to Bear Stearns,

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<sup>11/</sup> Of course, the Sequential prospectuses which Bear Stearns subsequently mailed out with confirmations disclosed the nature of the offering. However, the prospectus mailing was handled by a different department. Neither Harriton nor Zackman ever saw the prospectus.

the account balances could easily be checked.

Harriton did not have the authority to grant Pace's requests and directed Zackman to bring them to Bear Stearns' deputy managing partner. The latter gave his approval. Zackman promptly advised Pace of the Bear Stearns decision. He told Pace to get the Sequential order tickets to Bear Stearns as soon as possible, since October 14 was only a few days away. On Monday, October 12, the next business day, Bear Stearns received syndicate sheets and order tickets listing the purchasers. The initial confirmations prepared by Bear Stearns showed a trade date of October 12 and a settlement date of October 14. It appears they were mailed, together with prospectuses, on October 13. However, they mistakenly reflected common stock rather than units. Those confirmations were cancelled. Corrected confirmations still showed a trade date of October 12; a settlement date of October 20; and an "as of" settlement date of October 14. They were mailed on October 20 or 21.

As previously noted, on October 14 Bear Stearns wired \$3 million to the escrow account at Metro Bank. At that date, credit balances in the accounts of those of registrant's customers which had ordered Sequential totalled slightly more than \$1 million. <sup>12/</sup>

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12/ The Division states that this amount includes \$848,540 that was available to customers' accounts in the form of Dreyfus money market account balances. Some of registrant's customers kept credit balances in the money market fund. Registrant had the discretionary authority to transfer funds between the Dreyfus accounts and the brokerage accounts. However, the figure used by the Division is not supported by the cited exhibit (Ex. 1002) which shows a total of less than \$100,000.

The Sales Effort

Pace selected Nager, Cohen and a third salesman to assist him in selling the Sequential offering. He restricted participation to them, according to his testimony, because they were the most sophisticated representatives in the firm and would know which of their clients could invest in speculative securities; he could rely on them "to do the job properly" in the limited time available; and they were the ones to whom he was personally closest. (Tr. 4151) The Division, on the other hand, perceives a sinister purpose in this restriction. It asserts that by confining the selling effort to his "good friends," Pace was assured he would be able to create the appearance of registrant having sold the entire offering by its expiration date. Pace, Nager and Cohen sold (or purported to sell) 92 percent of the offering, with Pace himself accounting for 66 percent.

As previously indicated, for purposes both of Rule 10b-9 and Rule 15c2-4 an all or none offering cannot be deemed "sold" unless and until all the securities are sold in bona fide transactions and are fully paid for. The Division maintains that many of the purported sales were not of a bona fide nature and that in most cases the securities were not fully paid for by the expiration date of the offering. Respondents, on the other hand, contend that at the time the sales were made they believed in good faith that those were bona fide transactions. They further urge that full payment was timely made when Bear Stearns wired the \$3 million to the escrow account. I deal first with the sales, then with the

issue of payment.

With only a few days to sell the offering, Pace and the three salesmen he designated to participate obviously had to scramble to find purchasers. It is also pertinent to note that their customers had not received preliminary prospectuses and in most if not all cases did not receive the final prospectus until after the offering's expiration date. The sales which the Division claims were not bona fide fall into several categories. One category, encompassing principally a few sizeable transactions, consists of purported sales which respondents claim were based on orders entered by customers or other broker-dealers within the offering period, but which the Division claims were either simply unauthorized or at least not authorized until after the October 14 expiration date. In another group of transactions, also characterized by the Division as involving the exercise of unauthorized discretion, respondents do not claim that they (or Nager or Cohen) had been given purchase orders by the customers or had written discretionary authority, but do claim that the particular salesman had implied or informal discretion. Other purchases of Sequential units were directed by third persons without the customers' written authorization. Respondents assert that those purchases were nevertheless authorized. In yet other instances, the Division claims that transactions were not bona fide because purchasers were assertedly guaranteed against loss. Respondents deny that any such guarantees were made. Finally, there are a few transactions

which were assertedly not bona fide for other reasons. As detailed below, I find that the record supports the Division in some of its contentions and not in others.

It seems beyond dispute that a transaction in a customer's account that is not authorized and not ratified or adopted by the customer is not a bona fide transaction. <sup>13/</sup> I turn now to a consideration of several transactions which the Division puts in that category.

On October 12, Pace entered an order for 200,000 units, at a cost of \$50,000, for a small company by the name of Fingermatrix, Inc. There were significant ties between that company and Sequential. Fingermatrix's president, Michael Schiller, is the brother of Lewis Schiller, Sequential's president. Moreover, M. Schiller had himself been a founder and former president of Sequential, and L. Schiller was a financial consultant to Fingermatrix. Fingermatrix also had a relationship with registrant, in that registrant had assisted Fingermatrix in obtaining capital through private financing.

As of Saturday, October 10, Fingermatrix had no brokerage accounts. Its only investments were certificates of deposit. On that day, M. Schiller and Pace were at a party where L. Schiller

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<sup>13/</sup> The Division argues that, for purposes of the alleged violations, ratification could not make an otherwise invalid discretionary transaction valid. It fails to explain, however, why that should be so. On the other hand, while ratification generally operates retroactively, this cannot be the case as to ratification after the expiration date of an all or none offering, since, among other things, sales must be completed by the expiration date.

was also present. L. Schiller urged his brother to listen to a proposal by Pace regarding a possible Fingermatrix investment in Sequential. The testimony concerning the conversation between Pace and M. Schiller and subsequent events is materially conflicting.

M. Schiller testified as follows: Pace suggested a \$50,000 investment by Fingermatrix. Schiller responded that he would like to help Pace but would have to clear such an investment with the company's attorney and its board of directors. Pace responded that he understood the need for him to take those steps. Early on the following Monday, October 12, M. Schiller called Fingermatrix's attorney, Dan Goldwasser, to advise him and prepare him for an anticipated call from Pace.<sup>14/</sup> Goldwasser was also Sequential's counsel. M. Schiller told Goldwasser that he was very upset about the proposed investment, as to which he felt unduly pressured, and counted on him to block it. However, Goldwasser stated that Pace had already called him and had asked if it was legal for Fingermatrix to make the purchase, to which Goldwasser had replied in the affirmative.<sup>15/</sup> The witness then upbraided Goldwasser for not considering the ethical aspects of the proposed transaction, in light of the various interrelationships, or the "business prudence" aspects.

M. Schiller further testified that following his conver-

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<sup>14/</sup> That was his testimony on direct examination. On cross-examination he testified that he did not expect Pace to call Goldwasser.

<sup>15/</sup> As noted, this recital reflects Schiller's testimony. Goldwasser did not testify.

sation with Goldwasser, he began to contact other Fingermatrix directors to advise them of what had transpired and to get their reactions. A telephonic board meeting took place several days later. During the meeting, reference was made to the company's dependence on registrant and Pace when it came to financing for Fingermatrix. By verbal resolution, the board authorized Schiller to open an account and to make the investment. No minutes of this meeting were taken. He then instructed the controller to cash certificates of deposit in the amount of \$50,000 to buy the Sequential units, and to open an account. Payment was not made until October 28.

According to M. Schiller, about a month after the purchase, L. Schiller told him he could sell the securities at a profit and that "now" was the time to do it. He also told him to invest in another, specified, speculative security to make it look like the Sequential purchase was "more of a normal thing." On November 11, Fingermatrix sold the Sequential units at 27 cents a unit and invested part of the proceeds in the other security.

Pace, on the other hand, testified that when he told M. Schiller about the Sequential offering, Schiller said Fingermatrix would participate as long as counsel gave his approval. According to Pace, Schiller did not say he needed board authorization. Pace contacted Goldwasser on October 12 pursuant to Schiller's instructions. Goldwasser said he would check with Schiller and then called back to say they agreed to the purchase. (On cross-examination, Pace testified

that he asked Goldwasser whether Fingermatrix could purchase the units and that Goldwasser answered in the affirmative, but that he could not recall whether Goldwasser so responded immediately or in a later call after conferring with Schiller.) In his mind, he had a firm order prior to October 14. He did not discuss with Goldwasser the latter's possible conflicts of interest.

L. Schiller testified that he was present during the conversation between his brother and Pace on October 10, and that his brother told Pace that Fingermatrix would buy the Sequential units, subject only to the qualification that he would have to check with counsel whether the company could legally do so.

The question here is not whether there was a bona fide sale, but whether the sale was effected (or ratified) before or after the offering's expiration date. I credit M. Schiller's testimony that he did not have authority to place the order without prior approval of his board of directors and that he so advised Pace. Such approval was not given until after October 14. It may be that in the midst of a noisy party, Pace did not clearly understand what Schiller said. But he knew that Fingermatrix did not have an account with registrant, and that registrant had no corporate resolution of Fingermatrix authorizing the opening of an account. Moreover, in view of Pace's awareness that Goldwasser was counsel to Sequential as well as to Fingermatrix and had a strong interest in the success



of the offering, his reliance on Goldwasser for approval of the transaction was not reasonable. Under the circumstances, he was not justified in entering the order on October 12.

Another transaction which the Division claims was not bona fide and which is also the subject of conflicting testimony pertains to a broker-dealer by the name of Success Securities. On an order ticket of registrant showing a trade date of October 14 and an October 20 settlement date, Success is shown as purchasing 400,000 Sequential units at a price of 24 cents per unit. That price would reflect a selling group member discount. Subsequent to October 14, the 400,000 units were taken back into State Street's syndicate account and then sold to other accounts. <sup>16/</sup>

The then president of Success, Donald Hausman, testified that the first time he heard of Sequential was when the Division contacted him during its investigation; that he had never heard of or spoken to Pace; and that Success did not purchase Sequential units. He further testified that he was not

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<sup>16/</sup> On or about November 10, Pace contacted Glusband, told him that a block of 400,000 units had not been paid for, with the result that the transaction was cancelled, and asked for advice as to what he should do. Glusband, after consulting the same staff attorney he had spoken to earlier, gave Pace certain advice. The Division contends that Pace did not give Glusband the complete picture of the far more extensive "cancellation problem" and in addition did not follow his advice. However, in view of my findings herein, there is no need to deal with the disposition of units following the offering's expiration date.

contacted in October 1981 to buy Sequential units and did not attempt to have any of his customers buy such securities. However, between October 3 and 17, Hausman was at home recuperating from an operation.

According to the testimony of Joseph Nicolosi, who was employed as Hausman's "right hand man" in October 1981, Hausman told him to call registrant or State Street to put in "an indication" for Sequential securities, in the amount of about \$20,000. (Tr. 2864) He did so. Neither he nor Success had had prior dealings with registrant. Subsequently, again upon Hausman's instruction, he cancelled that indication. He did not recall receiving a confirmation from registrant.

According to Pace, he met Nicolosi through a mutual friend. Nicolosi said Success "did a lot of speculative and low priced offerings" (Tr. 4205) and, when told about the Sequential offering, said he thought he had customers who would be very interested in it. Nicolosi subsequently gave him an order for 400,000 units. Pace testified that the order was ultimately "dk'ed," i.e., Success had not advised its clearing broker of the order and the latter therefore issued a "don't know notice."

Nicolosi was a disinterested witness; I credit his testimony. It is likely that time had dimmed his memory of 1981 events, including Hausman's presence in or absence from the office. But Hausman could have given him instructions from home as well. In any event, Nicolosi would not be likely

to have forgotten placing an order for almost \$100,000. Even if the "indication" he testified about was really an order and was not cancelled until after October 14, this would account for only about \$20,000 or 80,000 units. Finally, if, as Pace testified, Success' clearing firm "dk'ed" the order, this would be corroborating evidence that no such order had been placed by Success. <sup>17/</sup>

A transaction which the Division asserts was not actually effected until after October 14 involved a small broker-dealer named LaJolla Securities. An order ticket of registrant shows a purchase by LaJolla of 800,000 units at 24 cents a unit on October 14. The Division maintains that the order was not placed until October 15.

According to a "declaration" by Gail Smith, one of LaJolla's two principals in 1981, which was stipulated into evidence together with his investigative testimony because of his terminal illness at the time of the hearings, Pace called him about the Sequential offering "at least several days" before October 15. (Div. Ex. 900-P) Pace told him that one million units or shares were available for sale and asked if Smith knew of anyone who would be interested

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<sup>17/</sup> In his investigative testimony, Hausman stated that he had learned that Success' clearing firm had "a trade or a confirmation or a comparison" (apparently relating to Sequential) in its possession; (Tr. 1480) that he did not know how it got there; and that to his knowledge it should not have been there. He was unable to shed further light on this matter at the hearings. Respondents are not aided by the earlier testimony.

in buying them. According to Smith, who had had no prior contact with Pace, the latter said he had heard that LaJolla had clients who liked to take sizeable positions.

Jack Smith, the other principal of LaJolla, had contacted Pace shortly after LaJolla came into being in early 1980 to introduce himself and the firm and to indicate a possible interest in participating in some underwritings. G. Smith was aware of J. Smith's prior contact with Pace. According to G. Smith, "at or around" the time of Pace's call (Ibid.), he asked Kabbaz, a major customer, whether he would be interested in buying the Sequential securities. Kabbaz agreed to buy 800,000 units, and G. Smith orally confirmed the transaction to Pace a day or two after Pace's call. The order was placed with LaJolla's clearing firm on October 15. The clearing firm's records reflect a purchase by LaJolla at 24 cents a unit, and a purchase by Kabbaz at 25 cents a unit, both on October 15. While G. Smith's daily "order entry form" (Div. Ex. 900-J) also reflects an October 15 transaction, J. Smith testified that the form did not necessarily show when the order was actually placed by the customer, but when it was forwarded to the clearing broker.

Kabbaz's check for \$150,000 in payment was written on October 22 and credited to his account at the clearing firm on October 23. (A \$50,000 check had been credited on October 21) The check was subsequently returned for insufficient funds. According to G. Smith, Kabbaz was fully prepared to pay for the securities and advised him that he intended to do so. Some

weeks after Kabbaz's purchase, Pace called G. Smith and asked him if Kabbaz wanted to sell at 28 cents per unit, as Pace had a buyer. Kabbaz thereupon sold the units on November 17, without having paid for their purchase.

Pace's own testimony is that he had a confirmed order from LaJolla on behalf of a customer several days prior to October 15, and that he did not know and had no contact with Kabbaz.

The evidence regarding this transaction is obviously far from clear. Under all the circumstances, I am unable to find that the order was not given to registrant on October 14 or that it was not a bona fide order at that time. Pace had no reason to believe that the LaJolla customer would not pay for the shares.

Another allegedly non-bona fide transaction involved customer Muller. The Division alleges that Pace used Muller's account to "park" 400,000 units and that subsequently he led Muller to believe the sale had been cancelled, but in fact sold the units to maintain the appearance that the offering had been fully sold.

Muller's testimony was as follows: He had an account with registrant during the period in question and had expressed an interest in new issues. Pace was his "broker." He had not given registrant written discretionary authority. However, Pace had effected some transactions for him without prior approval, in amounts up to about \$25,000, and Muller had not complained. Pace called Muller regarding Sequential and suggested he buy some units. Muller could not recall what Pace told him about

the issuer or what, if anything, he said about the use of proceeds or the past performance of the securities, but did not think use of proceeds was discussed at all. He asked Pace to send him some information about Sequential. He did not agree to purchase Sequential units.

The next thing that happened was that Muller received a confirmation reflecting a purchase of 400,000 units on October 12, 1981. He called Pace and said "something to the effect that there might have been some confusion" on Pace's part (Tr. 2349) and that he did not want to buy the units. Muller could not recall Pace's response. The confusion he referred to was that he "may have indicated" to Pace in the first conversation that he was buying the units. (Tr. 2555) According to Muller's account statement, the units were sold out at 25 cents on settlement date November 9.

Pace testified that at the time he suggested Muller buy the Sequential units, Muller agreed to buy them, based in part on the fact that within the next day or two he expected to sell a company he owned and would realize proceeds of several hundred thousand dollars. After settlement date, Muller told him that that sale had fallen through at the last moment and that he did not have sufficient cash to pay for the units.

While I credit Muller's version of events, in light of his concession that he may have led Pace to believe that he wanted to buy the units, the record does not support the Division's assertion that Pace simply parked securities in

the Muller account.

I come now to several Sequential purchase orders placed by third persons on behalf of customers, without written customer authorization. The reference here is to (1) orders placed by an H. Friedman on behalf and at the instance of customer Feinsod; (2) orders placed by customer Cohn on behalf of his sister and a friend; and (3) an order placed by customer White on behalf of customer Topping (these two being customers of Cohen).

As the Division points out, registrant's compliance manual did not permit orders to be accepted from third parties unless a third party authorization had been signed by the customer. It does not follow that the above transactions, which were concededly effected with the customers' consent and paid for by them, were unauthorized or non-bona fide in terms of the general antifraud provisions or the particular provisions of Rules 10b-9 and 15c2-4.

Another transaction claimed by the Division to be not bona fide involved customer Ostrau. Ostrau had known Pace for many years and had opened an account with registrant in order to participate in new offerings. Upon Pace's solicitation, he agreed to buy \$100,000 worth of Sequential units on October 12. He could not recall what Pace told him regarding Sequential or the offering. Pace did inform him about the speculative nature of the offering. Subsequently Ostrau received a prospectus. When he read it, he thought the securities (or the company) were "garbage" (Tr. 1993). He told Pace to sell the units. They were sold on October 30. Payment was made with the proceeds of the sale. The Division

contends that Pace "parked" units in Ostrau's account and that Ostrau's order was not a bona fide transaction for the additional reason that it was paid for with proceeds of the sale. <sup>18/</sup>

Respondents assert that there was no reason for Pace to anticipate at the time he obtained Ostrau's purchase order that he would not pay for the units. They state that Pace knew Ostrau as a friend and sophisticated investor and that he advised Ostrau of the speculative nature of the offering. And they point to Ostrau's testimony that when he ordered the units he intended to pay for them and had the capacity to do so. Respondents also refer to a brief filed in another proceeding by the Division of Market Regulation, in which that Division took the position that for purposes of Rule 10b-6 under the Exchange Act, a distribution is completed when selling efforts are finished and sales are reasonably understood to be firm, regardless of subsequent cancellations or resales.

I am in agreement with the Division's position as to this transaction, though the analysis underlying my conclusion is somewhat different. The key is Ostrau's reaction when he received the prospectus, after he had placed his order and after the offering's expiration date. As noted, Pace had advised him that this was a speculative offering, which in any event

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<sup>18/</sup> Inconsistently, the Division also states that Ostrau did not pay until November 20, when a \$100,000 payment was credited to his account. However, as reflected in his monthly statements, it was the credit upon his sale of the units that paid for their purchase.



was evident from the offering price. But it was only when Ostrau read the prospectus that he realized how speculative the securities really were. In the situation presented here, namely, (1) a highly speculative offering of an obscure issuer and (2) the customer first seeing a prospectus at or about the time he received the confirmation, respondents reasonably had to anticipate and assumed the risk that some transactions would be cancelled after the customers had had the opportunity to read the prospectus. While Ostrau directed a sale of the units, this was tantamount to cancellation. Respondents' argument that customers such as Ostrau were known to them to be interested in speculative securities and that rejection could therefore not be anticipated overlooks the fact that there are many degrees of speculation. Accordingly, I find that where the buyer, as here, disaffirms the transaction following receipt of the prospectus, the sale cannot be viewed as a completed or bona fide sale for purposes of Rules 10b-9 and 15c2-4.<sup>19/</sup>

This is so, in my opinion, wholly apart from the fact that the concept of "sold" under those rules encompasses the requirement of full payment. And if the practical effect of such a principle is that best efforts all or none offerings cannot be made at the last minute before the expiration date, that strikes me as neither an unreasonable nor an undesirable result.

The same analysis applies to customer Zises who ordered \$60,000 worth of Sequential units on October 12.

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<sup>19/</sup> There is no need for me to determine whether the boundaries of this principle should be even broader than enunciated here. On the other hand, it may be that a different result would follow if the oral solicitation were as informative as the prospectus.

Pace, an old friend, had told Zises that Sequential was a low-priced, speculative security related to technology. According to Zises' undisputed testimony, he received a prospectus a few days later. He then concluded that Sequential was below his "speculative criteria" (Tr. 1507), noting specifically that part of the proceeds of the offering was to be used to pay delinquent payroll taxes. The following day he told Pace to sell. For the reasons stated above, the sale to Zises cannot be viewed as a bona fide sale. A similar analysis applies to Cohen's customer White, who ordered 500,000 units and subsequently cancelled that order.<sup>20/</sup>

The Division contends that Pace's sale of 200,000 units to customer Rosen was not bona fide because he guaranteed Rosen a profit. In a previously noted release discussing the requirements of Rules 10b-9 and 15c2-4,<sup>21/</sup> the Commission listed as one type of non-bona fide sale "purchases by persons whom the issuer has agreed to guarantee against loss." Such purchasers do not have to make investment determinations based on the merits of the securities or take the risk which investment in securities normally entails. And of course the situation is the same where the guarantee emanates from an underwriter instead of the issuer. The question as to Rosen thus is whether Pace guaranteed him against loss or even guaranteed him a profit.

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<sup>20/</sup> Respondents claim that the Division's exhibits show that the units sold to White were not part of the offering. It is true that this transaction is missing from documents listing purchasers in the offering. However, White's account statement shows a purchase of 500,000 units with an "as of" date of October 6. And respondents at that point were only selling units that were part of the offering.

<sup>21/</sup> Securities Exchange Act Release No. 11532 (July 11, 1975), 7 SEC Docket 403.

Rosen testified that Pace called him concerning Sequential. While the witness stated that he was unable to recall specific words, he believed that Pace asked whether he would accommodate "them" and take the units, and told him that he would probably be out in a matter of weeks and "probably would make a profit" (Tr. 2666).<sup>22/</sup> In fact, he sold the units in November 1981 at a profit. Rosen's testimony falls short, however, of showing a guarantee of profit or against loss. The Division's attempted analogy to predicted increases in securities prices, which may be fraudulent even if couched in terms of a possibility or probability, is flawed. The focus here is on whether the customer is led to believe that investment risk has in fact been eliminated.

The Division claims that Cohen also guaranteed a profit to customer Finkelman. The latter bought 10,000 units. He testified that in substance Cohen told him that Sequential would be a good "stock" to buy and he would make money, or that the "stock" should do well. Again, these kinds of representations cannot be transformed into a guarantee of profit or against loss.

In the instances of several customers of Nager (Jacobs, Straci and Crusco), he entered purchase orders for Sequential units without first consulting the customers. The Division argues that since Nager did not have written authorization from these customers to exercise discretion in their accounts, the transactions were unauthorized and hence not bona fide. It points

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<sup>22/</sup> The Division's proposed finding (#75) omits the word "probably." I cannot overemphasize the importance of absolute accuracy in referring to testimony (or other record material). See also note 32, infra.

out that Bear Stearns' compliance manual, which also served as registrant's manual, required discretionary authority to be in writing. <sup>23/</sup> However, the record shows that Nager had oral authorization from the above customers to engage in transactions for their accounts. And they did not disavow the transactions when they learned of them. Nager's conduct clearly violated registrant's compliance manual and the rules of the New York Stock Exchange. But in view of the undisputed evidence that he had been given discretionary authority, and absent any evidence that he exceeded the authority given him, I cannot find that for purposes of the antifraud provisions these were unauthorized or non-bona fide sales. <sup>24/</sup>

In the case of Nager's customer Abrams, however, the

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<sup>23/</sup> This requirement reflected New York Stock Exchange Rule 408. Other provisions in the manual pertaining to the quality of securities placed in discretionary accounts would have ruled out the purchase of the highly speculative Sequential units even if written authorization had been given. Another category of transactions prohibited for discretionary accounts was principal transactions "including underwritings." I assume that this prohibition was intended to encompass best efforts underwritings, even though the underwriter there acts as agent and not as principal.

<sup>24/</sup> The Division's reliance on cases such as Armstrong, Jones & Co. v. S.E.C., 421 F.2d 359 (6th Cir.), cert. denied 398 U.S. 958 (1970), and Shelley, Roberts & Co. 38 S.E.C. 744 (1958), where confirmations of purchase were sent to persons who had not agreed to purchase, is misplaced.

An argument could be made that in all or none offerings, discretionary transactions should not be treated as bona fide purchases. The argument would be based on the concept that in such an offering investors expect to be protected by the fact that unless their judgment to take the risk is shared by enough others to sell out the offering, their money will be returned. See S.E.C. v. Blinder, Robinson & Company, Inc., 542 F. Supp. 468 (D.C. CO 1982), affd. (10th Cir. 1983, unpublished opinion) cert. den. \_\_\_ U.S. \_\_\_. The judgment that is contemplated is that of investors, not that of an underwriter's salesman. No such theory was advanced by the Division, however. And I am reluctant to adopt it absent an opportunity for the parties to address its merits.

record shows that Nager bought Sequential units for Abrams' account on October 12 without any authorization, written, oral or implied. Abrams testified that he first learned of this purchase on or about October 21 when Nager told him about it. Respondents challenge the credibility of that testimony, noting that Abrams was in frequent touch with Nager during this period, did not disavow the transaction and continued to do business with Nager. Abrams did testify that he complained to Nager about engaging in an unauthorized transaction. The factors cited by respondents do not detract from Abrams' credibility. While Abrams ratified the transaction, I find that as of October 14, the offering's expiration date, this was an unauthorized transaction.<sup>25/</sup>

Reference has already been made to Cohen's customers Finkelman, Topping and White. The remaining Cohen customer who testified is Lewis. He testified that the purchase of 32,000 units in his account was unauthorized -- that the first he knew of it was when he received the confirmation. Lewis further testified that after receiving the confirmation, he called Cohen to inquire about the transaction. Cohen told him not to worry, that he would not be in these securities very long and would not lose money. Lewis did not seek to cancel or otherwise disavow the transaction and continued to deal with Cohen. He testified that he was not sure if he had the right

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<sup>25/</sup> As an additional argument that this was not a bona fide sale, the Division claims that Nager guaranteed a profit to Abrams. The latter testified that after he heard from Nager about the Sequential purchase, Nager, in substance, told him not to worry, that he would be "out" before too long and that he would make a profit. As with customer Rosen, however, this is not a situation of a guarantee against loss or of a profit.

to cancel, and that he was reassured by what Cohen told him. As with Abrams, this transaction, though subsequently ratified, was unauthorized as of the offering's expiration date. <sup>26/</sup>

The Division further contends that in order to make the offering appear to be fully sold, respondents placed 810,000 units in new accounts whose first purchase was Sequential and placed over 1.2 million units in accounts that had been inactive for several months before. It also points out that of the 114 new account forms in evidence, 76 listed growth as the investment objective. However, with the exception of three accounts that have already been discussed, the customers in question were not called as witnesses. Pace testified that at least a number of the first-time customers were persons referred to him by L. Schiller, and that, to the best of his knowledge, they were spoken to prior to the transactions and agreed to buy. Aside from this, there is no evidence in the record as to the circumstances under which Sequential units came to be in the above accounts. While the circumstances presented by the Division raise suspicions, there is no sufficient basis for finding that the sales in question were not bona fide.

#### Payment by Customers

Not only were some of the sales not bona fide, but to a very large degree payment was not made within the specified

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<sup>26/</sup> Here, too, the Division claims that the customer was guaranteed a profit or against loss. However, there was no such guarantee.

time. For this reason as well, the offering could not be considered "sold" within the meaning of Rule 10b-9, and the contingency of complete sale as contemplated by Rule 15c2-4 never took place. Thus, the funds of those investors who had paid should have been returned to them.

The Division's undisputed evidence demonstrates that over 55 percent of the offering was not fully paid for by October 14, the expiration date, and that 90 of the 112 accounts in which Sequential units were placed paid late. The delays ranged up to 47 days.<sup>27/</sup>

The payment of the \$3 million by Bear Stearns to the escrow account, at a time when most of the investors had not yet paid, clearly did not meet the requirements of Rules 10b-9 and 15c2-4. To the extent the rules themselves leave any doubt that full payment by bona fide purchasers by the contingency date is required, the Commission's 1975 release

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27/ The Division also argues that even where money was available in customers' accounts on October 14, registrant did not take appropriate steps to ensure that funds were applied to the Sequential purchase or forwarded to the escrow account by that date. As I previously indicated, however, it seems that Bear Stearns did in fact apply such funds where customers had credit balances. Such a balance would automatically be applied against the debit created by the purchase of securities.

In that sense, the Division is also not correct in stating that no investor funds were ever deposited in the escrow account. And I don't understand the Division's argument that registrant improperly commingled purchasers' funds with its general revenues, since Bear Stearns and not registrant carried customers' accounts.

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( '34 Act Rel. 11532) made that point very clear. Respondents nevertheless argue that Bear Stearns' advance wiring of funds was permissible. They cite a 1984 NASD Notice to Members containing views of the Division of Market Regulation on frequently raised interpretative questions regarding Rule 15c2-4. One of the questions addressed was whether the Rule was complied with if a broker-dealer that received a check from an investor payable to it in turn promptly wrote its own check or wired funds to the escrow account. The answer given was that this complied with Rule 15c2-4. It went on to state that Rule 10b-9 would also have to be considered and that under that Rule investors' funds may not be forwarded to the issuer until the securities have been sold and fully paid for in customer funds that have cleared the banking system. It further stated that a broker-dealer may not satisfy the contingency by substituting its own good check for the check of a customer that has insufficient funds. Respondents translate this answer to mean that absent an intent to evade, the advance wiring of funds is permissible. What respondents ignore, of course, is that the question is predicated on the broker-dealer's receipt of customer payment and has nothing to do with an advance of funds. Indeed, the last part of the answer (which, it seems to me, applies to Rule 15c2-4 to the same extent as to Rule 10b-9) in effect makes the point that the broker-dealer cannot advance funds on behalf

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28/ See also FAI Investment Analysts, Inc., 46 S.E.C. 1134, 1136 (1977): "Rules 10b-9 and 15c2-4, when read together, make it clear that securities must not only be sold but paid for by the contingency date."



of the customer.

Respondents' major argument, of course, is that in proceeding as they did, they relied in good faith on the advice of counsel and therefore lacked the scienter which is requisite for most of the violations charged. This issue is addressed below, under the heading "Conclusions as to Antifraud Violations."

#### Alleged Misrepresentations and Omissions

The Division contends that the salesmen, including Pace, disseminated materially false and misleading information and withheld material information from investors. While respondents stress (and the Division agrees) that the prospectus made full disclosure, including appropriate disclosure concerning the speculative nature of the offering, it is also undisputed that investors did not receive a prospectus until they received their confirmations.<sup>29/</sup> Hence, those investors who made an investment decision made it on the basis of the information given to them orally. And the fact that full disclosure was made in the prospectus obviously could not excuse misrepresentations that may have been made orally.<sup>30/</sup>

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<sup>29/</sup> Respondents' further point that in mailing prospectuses with the confirmations they complied with Securities Act of 1933 requirements is not disputed, but is irrelevant to the allegations here.

<sup>30/</sup> See Underhill Securities Corporation, 42 S.E.C. 689, 694, n. 8 (1965); J.P. Howell & Co., Inc., 43 S.E.C. 325, 329 (1967) (where customers received prospectuses with their confirmations after misrepresentations had been made, such representations carried with them an implication that the salesmen had later or inside information contrary to that in the prospectus and supporting those representations).

Misrepresentations do not lie at the core of this case. In a number of instances, as noted, there was not even contact between the salesmen and their customers prior to orders being placed for Sequential units.<sup>31/</sup> Even where purchasers testified as to statements made to them, most had little or only a vague recollection of what they were told. It is clear, however, that they were told very little. The assumption can reasonably be indulged that with full disclosure it would have been very difficult to sell this offering. But findings cannot rest on assumption. Despite the sparseness of the record, however, there is sufficient evidence to warrant the finding that some materially misleading statements were made and material facts necessary to make statements made not misleading were omitted. The discussion that follows reflects the categories in which the Division places the alleged misrepresentations, which in turn reflect the allegations in the order for proceedings.

Turning first to asserted representations that the price of the units would increase, which the Division says lacked a factual basis or even were inherently fraudulent, the record reflects the following testimony by the customers cited by the Division: G. Smith, one of LaJolla Securities'

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<sup>31/</sup> Without citation of authority, the Division reiterates an argument that I rejected during the hearing, that because purchasers did not receive a prospectus until after purchase orders had been placed or entered, respondents were obligated to disclose material facts even where no affirmative representation or recommendation was made.

principals, testified that Pace told him "there might be some appreciation" in the Sequential securities (Div. Ex. 900, p. 39).<sup>32/</sup> As previously noted, Rosen testified (a) that he could not recall specific words used by Pace and (b) that Pace told him he probably would be "out" in a matter of weeks and "probably" would make a profit. In the case of Abrams, after the order was entered for him, but before he ratified it, Nager told him, in substance, that he would be "out" before too long and could or should make a profit. Finally, Cohen's customer Finkelman testified that he could not recall specifics of what Cohen told him, but that basically it was that this would be a good "stock" to buy and, as with other recommendations, that he would "make money."<sup>33/</sup> (Tr. 2988)

The statements made to Rosen, Abrams and Finkelstein amounted to predictions of price increases for the units. In light of Sequential's financial difficulties and the uses to which the proceeds of the offering were to be devoted, those

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<sup>32/</sup> In subsequent responses, Smith used somewhat different terminology in testifying as to what Pace told him, such as that Pace thought the units "would" appreciate (here Smith adopted the questioner's terminology) (Div. Ex. 900, p. 40); the units "would hopefully" appreciate (Id. at 105-6); and that they "should" appreciate (Id. at 107). These varying answers demonstrate that Smith could not recall Pace's exact words. The Division's proposed findings refer only to the "would" response (proposed finding #62).

<sup>33/</sup> Cohen's statement to Lewis that he would not lose money was not a representation that the price of the units would increase.

statements did not have a reasonable basis in fact. <sup>34/</sup>

The Division next urges that Pace and his salesmen failed to inform purchasers (a) that this was a best efforts, all or none, offering, (b) that the expiration date was imminent, and (c) that they had effected non-bona fide sales. In this instance the Division has not cited the testimony of particular customers. However, Zises and Cohn, for example, testified that in asking them whether they wanted to invest, Pace said nothing to them concerning the nature or the terms of the underwriting. Disclosure should have been made at least as to the first two of the above items.

The Division further urges that Pace and his salesman failed to make material disclosures regarding Sequential's financial condition and the use of the offering's proceeds to customers to whom they recommended the securities. The Division has provided no record references to customer testimony for this argument. My review of the record does show, however, that in some instances (e.g., Muller and Cohn) where Pace recommended or suggested a purchase of Sequential units, he failed to disclose the use which was to be made of the proceeds. The fact that most of the proceeds were to be used to pay delinquent taxes was obviously a factor (with others, of course) that a reasonable investor would have considered

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<sup>34/</sup> As I have already found, the Division's contention that some customers were guaranteed profits or guaranteed against loss is not supported by the record.

important in making an investment decision.<sup>35/</sup> Failure to disclose it rendered any recommendation or suggestion to buy materially misleading. Similarly, the disaffirmances by Ostrau and Zises after they received a prospectus show that even though Pace may have advised them that the Sequential units were speculative securities,<sup>36/</sup> he failed adequately to disclose the degree of risk involved.

Finally, the Division maintains that Pace and his salesmen misinformed customers that there was a strong public demand for the Sequential units, when in fact they were unable to sell the full amount except through non-bona fide transactions. The only specific reference, however, is to one investor (Finkelman) whom Cohen told that he was "selling a good deal" (i.e., a lot of units) and that there was "good interest" in the offering (Tr. 2988). I am unable to conclude that those statements were materially misleading.

#### Conclusions as to Antifraud Violations

It is clear that Rules 10b-9 and 15c2-4 were not complied with when the offering was treated as "sold" and the funds in the escrow account were disbursed on that basis even though not all of the securities had been sold in bona fide transactions or fully paid for by the specified expiration

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<sup>35/</sup> See TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976).

<sup>36/</sup> Zises testified that Pace told him Sequential was speculative. Ostrau could not recall specifically what Pace told him, but acknowledged that Pace was "informative" about the speculative nature of the offering (Tr. 2010).

date. Respondents seek to avoid responsibility by pointing out that OTC Net did not relinquish its status as managing underwriter and remained as the only broker-dealer signatory of the escrow agreement. They urge that since neither State Street, registrant nor Pace was a party to that agreement, they lacked the power to, and in fact did not, direct the refund or distribution of escrowed funds. Those arguments, resting on contractual arrangements, do not reflect the realities of the situation or the obligations resting on respondents under federal securities law. Rule 10b-9 applies to "any person" who represents that an offering is on an all or none basis, while Rule 15c2-4 applies to any broker-dealer participating in a best efforts all or none offering. In reality, respondents had taken over the offering. As noted, registrant sold, or purported to sell, all 12 million units, and Pace caused Bear Stearns to pay into the escrow account the \$3 million that was then distributed on October 19. At the closing, State Street's counsel received certificates for the 12 million units and the \$340,000. <sup>37/</sup>

It is well established that scienter is an essential

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<sup>37/</sup> Respondents point out that the closing was held in Denver, the location of OTC Net's principal office, rather than in New York, where State Street and registrant were located. The point is frivolous. Conforming to normal practice, the closing took place at the office of the bank where the escrow account was maintained.

element of a violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder as well as Section 17(a)(1) of the Securities Act. Although there does not appear to be any holding on the point, it would appear, and the Division concedes, that scienter is also required for a violation of Rule 10b-9 because it was adopted pursuant to Section 10(b). On the other hand, scienter need not be shown for violations of Sections 17(a)(2) and (3) of the Securities Act. Respondents argue that a scienter requirement should also be read into Rule 15c2-4, while the Division takes the position that there is no need to reach that issue because respondents in fact acted with scienter. I agree with the Division.

The term "scienter" has received a wide range of definitions.<sup>38/</sup> The most stringent is that it means intent to deceive, manipulate or defraud. However, consistent with the predominant judicial view, the Commission has repeatedly held that reckless behavior satisfies the scienter requirement.<sup>39/</sup>

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<sup>38/</sup> In its reply memorandum, the Division asks me to reconsider rulings excluding evidence of aftermarket transactions and to admit such evidence as bearing on the scienter issue. However, the Commission's Rules of Practice provide, as here pertinent, that exceptions to rulings by an administrative law judge may be raised only in proposed findings. 17 CFR 201.11(e). It would obviously be unfair to respondents to consider exceptions first raised in a reply brief to which they have no opportunity to respond.

<sup>39/</sup> See, e.g. Jesse Rosenblum, Investment Advisers Act Release No. 913 (May 17, 1984), 30 SEC Docket 857; Dan King Brainard, Securities Exchange Act Release No. 20408 (November 22, 1983), 29 SEC Docket 331; James E. Ryan, Securities Exchange Act Release No. 18617 (April 5, 1982), 24 SEC Docket 1859.

Respondents, stating that Sequential was the first best efforts all or none offering for State Street or registrant, contend that Pace not only did not intend to defraud, but sought legal advice from two sources in an attempt to stay within the law. However, even aside from the conduct of Nager and Cohen, Pace was at least reckless in treating the offering as completed on October 14 when the Fingermatrix purchase had not as yet been properly authorized; there was no legitimate order by Success Securities; and it was to be anticipated that customers would disaffirm or cancel transactions after receiving the prospectus.<sup>40/</sup> Moreover, Pace's own testimony makes clear that he took little if any interest in the manner in which Nager and Cohen were handling their sales activities.

In light of these findings, the questions whether respondents could reasonably rely on Glusband's advice concerning the advance of funds to the escrow account and whether reasonable reliance on counsel precludes the existence of scienter become largely academic. If the issue were limited to the advance of funds, it seems to me that the elements

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<sup>40/</sup> Investor testimony does not support respondents' argument that all customers were orally advised that the offering was "highly speculative." Nor is it supported by Pace's own testimony on the point:

"Q. Did you consider the Sequential offering to be a speculative offering? A. To some extent, yes. Q. Did you recommend it to various of your customers? A. Yes. Q. And did you communicate to them that it was speculative? A. I believe so" (Tr. 4164).



of good faith reliance on counsel were present.<sup>41/</sup> The Division urges most vigorously the non-existence of one of those elements, that of complete disclosure to counsel. I have found previously that counsel was not misled at the time his advice was sought. But that advice was obviously predicated on the assumption that the sales made by October 14 would be bona fide transactions. It was rendered meaningless when some of the sales were not bona fide sales at all or at least not as of that date.

In view of the nature of the offering, and the fact that customers did not yet have a prospectus when Pace or his associates approached them, he must have appreciated that it would be highly deceptive to recommend an investment without full disclosure of the speculative aspects. In failing to make such disclosure he, and through him registrant, acted with scienter in these respects as well.

Accordingly, I conclude that respondents willfully violated Sections 17(a)(1), (2) and (3) of the Securities Act and Section 10(b) of the Exchange Act and Rules 10b-5 and 10b-9 thereunder and that registrant, willfully aided and abetted by Pace, willfully violated Section 15(c)(2) of the Exchange Act and Rule 15c2-4 thereunder.<sup>42/</sup>

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<sup>41/</sup> This is so even though the advice was flatly erroneous.

<sup>42/</sup> A finding of scienter carries with it a finding of willfulness. First Pittsburgh Securities Corporation, Securities Exchange Act Release No. 16897 (June 16, 1980), 20 SEC Docket 401, 405, n. 19.

Alleged Failure to Supervise Nager and Cohen

The order for proceedings alleges that registrant and Pace failed reasonably to supervise Nager and Cohen with a view to preventing violations by them in connection with the Sequential offering. The Division and respondents disagree as to the merits of this allegation. However, in light of the fact that Pace himself played the central role in the offering and has been found to be a wilful violator and aider and abetter, it would be inappropriate and inconsistent to find him responsible for a failure of supervision with respect to essentially the same misconduct.<sup>43/</sup> Similarly, the Commission has held that where findings of substantive violations are made against a firm it is unnecessary to find the firm responsible for a failure of supervision with respect to the same misconduct.<sup>44/</sup>

Alleged Improper Extension of Credit

The order for proceedings includes an allegation that respondents violated Sections 11(d)(1) and 7(c) of the Exchange Act and Regulation T, in that they arranged for the extension of credit to customers who purchased Sequential

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<sup>43/</sup> See Fox Securities Company, Inc., 45 S.E.C. 377, 382-3 (1973); Anthony J. Amato, 45 S.E.C. 282, 286-7 (1973); Charles E. Marland & Co., Inc., 45 S.E.C. 632, 636 (1974).

<sup>44/</sup> Management Financial, Inc., 46 S.E.C. 226, 234, n. 20 (1976).

units. They did so, it is alleged, by arranging for Bear Stearns to wire \$3 million to the escrow account on October 14 when only about one-third of that amount had been received from customers or was available in their brokerage accounts or the related money market fund accounts. <sup>45/</sup>

As here pertinent, Section 11(d)(1) prohibits a broker-dealer from arranging for the extension of credit to a customer on a security which is part of a new issue, until 30 days after termination of its participation in the distribution. Under Section 7(c), a broker-dealer may not arrange for the extension of credit to a customer in violation of Regulation T. The Sequential securities were not within the categories of securities on which that Regulation permits credit to be extended.

The Division's position is that (a) the transmission of the \$3 million on October 14 constituted an extension of credit to customers who had not paid as of that date and (b) respondents arranged for such extension. Respondents counter that the Bear Stearns advance of funds was not an extension of credit to the customers and that in any event this was a matter for which Bear Stearns was responsible. Respondents further contend that customers actually had until October 26 to pay, and

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<sup>45/</sup> The Division has asked me to find additional violations of the specified provisions resulting from payment extension requests submitted by Bear Stearns to the New York Stock Exchange. There is no need to address the merits of this issue since the requested findings are not within the allegations of the order for proceedings.

that there is no evidence that respondents asked that credit be extended beyond that date. They derive the October 26 date by pointing to a provision of Regulation T pertaining to the purchase of unissued securities in cash accounts, under which the 7-day payment period only begins to run when the securities are made available for delivery to purchasers.<sup>46/</sup>

I agree with respondents' argument that Bear Stearns' transmission of the \$3 million to the escrow account did not amount to an extension of credit to registrant's customers. No customer who bought Sequential units requested a loan from Bear Stearns. Moreover, while October 14 was the expiration date of the offering and was shown as the settlement date on the original confirmations, the settlement date shown on the corrected confirmations as well as on the customers' account statements was October 20. Thus, customers who had not paid or did not have credit balances in their accounts on October 14 were not at that point late with their payments.<sup>47/</sup> Those customers would have been surprised to learn that Bear Stearns had extended credit to them or that they owed interest to Bear Stearns. In fact, they were not charged interest. As brought out in Zackman's testimony pertaining to Division exhibits 264 and 265, it was registrant to whom Bear Stearns charged

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<sup>46/</sup> In 1981, that provision was 12 CFR 220.4(c)(3). Today it is 12 CFR 220.8(b)(1).

<sup>47/</sup> Apparently customers had not even received their original confirmations by October 14.

interest on the portion of the \$3 million which exceeded customers' credit balances on October 14.

Under the circumstances, there is no basis for adverse findings on these allegations. <sup>48/</sup>

### Public Interest

In light of the findings of violations, the remaining issue concerns the remedial action which is appropriate in the public interest. The Division, asserting that respondents engaged in serious misconduct demonstrating inability or unwillingness to conduct a securities business in conformity with the securities laws and that there are no mitigating factors, urges that the public interest requires the imposition of substantial sanctions. It proposes that Pace be suspended from any association with a broker-dealer for six months and barred from such association in a supervisory capacity. As to registrant, it recommends a 90-day suspension from participation in any underwriting and a one-year suspension from participation in any conditional or best efforts offering, such suspensions to run concurrently. The Division contends that

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<sup>48/</sup> Cf. Professor Loss' statement, in his 1961 treatise, that, although Section 11(d)(1) outlaws any extension of credit, the Commission had raised no question about the brief extension necessarily involved in processing a transaction through a cash account under Regulation T. II Loss, Securities Regulation (1961), p. 1275.

such sanctions would be comparable to sanctions imposed in similar cases. It also points out that respondents have been previously sanctioned by the Commission. In 1983, the Commission censured them and ordered registrant to comply with undertakings to take certain measures designed to improve compliance procedures. <sup>49/</sup> Respondents, without admitting or denying the allegations in the order for proceedings, consented to the sanctions and to findings that in 1978-1979 they failed reasonably to supervise an employee who participated in a manipulative scheme. The Division maintains that any recent improvement in registrant's compliance program is attributable to the above order rather than to voluntary action by respondents.

Respondents urge that even if their contention that there were no violations is rejected, the "draconian" sanctions proposed by the Division are punitive rather than remedial and are plainly excessive. They claim that there are mitigating factors, among them the asserted fact that no customer lost any money, Pace's many years in the securities business with only the one censure to mar his record and respondents' reliance on counsel. Respondents assert that Pace has made a significant contribution to the securities industry, as reflected in the substantial growth of registrant and its raising of large amounts of capital for public companies. They point out that registrant itself is now part of a publicly owned company.

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<sup>49/</sup> Securities Exchange Act Release No. 19453 (January 27, 1983), 27 SEC Docket 208.

And they state that additional personnel has recently been hired to strengthen registrant's compliance capabilities. Respondents further urge that they have already been penalized as a result of the pendency of this proceeding. Finally, they maintain that the proposed sanctions would injure registrant and its many employees and public shareholders for a failure in 1981 which caused no harm, is not ongoing and has not recurred.

Even accepting that no customers lost money, respondents' violations were of a serious nature.<sup>50/</sup> In the previously-cited release on all or none offerings, the Commission specifically stated that violations of Rules 10b-9 and 15c2-4 are of a serious nature and that it intended to enforce the requirements of those rules vigorously "where the facade of a successful offering is created in derogation of responsibilities owed to public investors. . ." <sup>51/</sup> Pace's taking over of the offering at the last minute in order to help save the company headed by his friend may have been commendable, but does not mitigate the violations. In addition to his own failure to complete sales by the offering's deadline and to abort the uncompleted offering, Pace was derelict in failing to keep a close check on the manner in which Nager and Cohen were selling the units. Considering the time pressures under which they were operating, he

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<sup>50/</sup> See Lamb Brothers, Inc., 46 S.E.C. 1053, 1063 (1977) (In an administrative proceeding, as distinguished from a private action for damages, "actual loss is far from crucial.")

<sup>51/</sup> Securities Exchange Act Release No. 11532, 7 SEC Docket 403.

should have been particularly alert to the possibility that they would proceed as if they had discretionary authority over accounts notwithstanding the absence of written authorization as required by the firm's own rules or the absence of any authorization.

On the other hand, I have rejected many of the Division's specific contentions. The picture that remains is a far different one than that painted by the Division of an offering wholly permeated by fraud. Hence the sanctions proposed by the Division on the basis of that portrayal are not warranted.

Based on the violations and the other relevant factors cited by the parties, I conclude that the following sanctions are appropriate in the public interest: (1) as to registrant, a two-month prohibition of any new underwriting commitments, as underwriter or selling group member, and a six-month prohibition of any such commitment involving an all or none or other conditional offering, such prohibitions to be concurrent; (2) as to Pace, a three-month suspension from association with a broker or dealer.

SO ORDERED. 52/

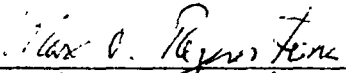
This order shall become effective in accordance with and subject to the provisions of Rule 17(f) of the Commission's Rules of Practice.

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



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.

  
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Max O. Regensteiner  
Administrative Law Judge

Washington, D.C.  
May 24, 1985