SECURITIES & EXCHANGE COMM
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ADMINISTRATIVE PROCEEDING
FILE NO. 3-7164

FILE COPY

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of THE STUART-JAMES CO., INC., et al.	))))))

INITIAL DECISION

Washington, D.C.
~~March 18, 1993~~
17 MAR 1993

Max O. Regensteiner
Administrative Law Judge

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In the Matter of THE STUART-JAMES CO., INC., et al.	)	INITIAL DECISION

APPEARANCES: Robert M. Fusfeld, James W. Nearen, Jr., David E. Graven and Glenn D. Wilkinson, of the Commission's Denver Regional Office, for the Division of Enforcement.

Donald T. Trinen and Christa D. Taylor, of Hart & Trinen, for The Stuart-James Co., Inc.

Arthur F. Mathews and W. Hardy Callcott, of Wilner, Cutler & Pickering, for C. James Padgett and Stuart Graff.

Burton H. Finkelstein, Bernard J. Barrett Jr. and Lisa E. Boehley, of Finkelstein, Thompson & Loughran, for Dirk Nye.

David A. Zisser, of Berliner Boyle Kaplan Zisser & Walter, P.C., for John M. Beaird, Robert E. Gibbs, Shaw P. Sullivan and John W. Sutton (Mr. Zisser also represented Ronald J. Lasek until after conclusion of the hearings, and then withdrew as his counsel. Mr. Lasek made no post-hearing submissions.).

Michael C. Czaja and Douglas P. Ward, pro se. (These respondents were represented by counsel until after conclusion of the hearings.)

BEFORE: Max O. Regensteiner, Administrative Law Judge.

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I. INTRODUCTION

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 (1) whether The Stuart-James Company, Inc. ("Stuart-James" or "the firm"), a registered broker-dealer, C. James Padgett and Stuart Graff, the firm's principal founders and at relevant times its principal officers, Dirk Nye and Douglas P. Ward, former regional vice-presidents, and John M. Beaird, Michael C. Czaja, Robert E. Gibbs, Ronald J. Lasek, Shaw P. Sullivan and John W. Sutton, who were branch office managers of the firm, engaged in misconduct as alleged by the Division of Enforcement, and (2) if so, what, if any, remedial action under the Exchange Act is appropriate in the public interest. Another former branch manager, Thomas R. Meinders, was also named as a respondent, but the proceedings as to him were disposed of by the Commission's acceptance of his settlement offer. 1/

Following lengthy hearings that resulted in an immense record, the Division and those respondents who were represented by counsel in the post-hearing stage successively filed proposed findings of fact and conclusions of law and supporting briefs. Respondents Padgett and Graff made joint submissions, as did respondents Beaird, Gibbs, Sullivan and Sutton. The Division filed a reply brief as well as a reply to respondents' proposed findings.

1/ Thomas R. Meinders, Securities Exchange Act Release No. 27927 (April 20, 1990), 46 SEC Docket 74.

Respondents Ward and Czaja, who were pro se in the post-hearing stage, filed more informal responses to the Division's initial submission. Lasek, whose counsel had also withdrawn after conclusion of the hearings, made no submission. 2/

The findings and conclusions herein are based on the preponderance of the evidence as determined from the record and upon observation of the witnesses. 3/

2/ The Division points out that of all the respondents, only Padgett and Graff specifically addressed its proposed findings and conclusions. Citing Rule 16(e) of the Commission's Rules of Practice, it urges that as to all other respondents those findings and conclusions should be deemed unchallenged and should be accepted. It is true that the rule provides that "any counter statement of proposed findings and conclusions must . . . indicate as to which paragraphs of the moving party's proposals there is no dispute." The rule does not, however, spell out the consequences of noncompliance with its terms. I am not prepared to adopt the drastic position urged by the Division, in light of the fact that those other respondents (with the exception of Lasek) have made submissions vigorously contesting the Division's arguments on the merits of the issues. With respect to Lasek, the Division contends that by making no post-hearing submission he has conceded its case. While there is merit to this argument, I have determined to base findings with respect to Lasek on my review of the record. A factor in that determination is that the allegation that other respondents failed reasonably to supervise Lasek in any event requires findings based on the record as to whether Lasek committed violations as alleged.

3/ Throughout these proceedings, I insisted that the Division clearly specify against which respondents particular evidence was to be or was being offered as well as the particular issue or issues as to which it was to be or was being offered. I imposed the latter requirement on respondents as well. Various respondents complain that the Division has proposed findings against them on the basis of evidence not received against them or not received on a particular issue. In a record as voluminous and complex as this one, it is difficult to avoid a few errors of this nature. I do not agree, however, with Nye's assertion that "the sorting out of this mass of evidence is now an impossible task." (Nye Brief at 38 n.18). I am reasonably certain that my findings in this (continued...)

<u>The Allegations - A Brief Summary</u>

Overall, the Division's allegations cover the period from about February 1984 to about October 1987. Certain of the allegations relate to firm-wide conduct and charge violations of antifraud provisions -- Sections 17(a)(1)-(3) of the Securities Act of 1933 and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder (referred to collectively hereafter as "the antifraud provisions") -- by the firm, Padgett and Graff. Thus, the Division alleges that in the immediate aftermarket for two securities issues that were underwritten by Stuart-James in 1986, the firm took excessive undisclosed markups. The other firm-wide allegation is that between August 1986 and October 1987, those respondents distributed and encouraged the use of fraudulent sales scripts by the firm's sales agents. Other allegations charge the branch manager respondents with violating the above antifraud provisions by establishing so-called "no net selling" and "tie-in" policies or practices in their offices at various times. The no net selling allegation also includes Ward, who was a regional vice-president. Finally, Stuart-James, Padgett, Graff and Nye are charged with failure reasonably to supervise persons subject to their

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3/(...continued)
decision with respect to particular respondents are based only on evidence received against them.

I have determined to deny requests for oral argument before me made by Padgett and Graff and by Nye. In my view, the issues can be adequately determined on the basis of the record and the papers filed by the parties.

supervision with a view to preventing the alleged no net selling and tie-in violations.

The Respondents

The Firm

Stuart-James was founded in 1983. Throughout the period under consideration, Padgett and Graff owned equal amounts of its stock, totalling between 90% and 95%. A third founder was Marc Geman, a lawyer with extensive securities experience, who became the firm's legal counsel and executive vice-president as well as a director and had varying small ownership interests. The firm grew rapidly, to the point where by 1986 it had more than 20 retail sales offices and about 800 sales agents. 4/ At its peak in 1987-88, it had as many as 56 offices and over 1,000 sales agents. Throughout its existence, Stuart-James' predominant business consisted of underwriting and retail trading of low-priced, speculative securities. In 1990, it ceased doing business. Subsequently, it filed a Form BDW with the Commission, seeking to withdraw its registration as a broker-dealer. 5/ The firm is now in liquidation

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4/ The term "sales agents" is used in the order for proceedings to describe Stuart-James' registered representatives. My use of it throughout this decision as an appropriate and convenient term is not to be taken as a comment on the firm's position that its salespersons were independent contractors rather than employees, a matter that is not at issue in these proceedings.

5/ When a Form BDW is filed during the pendency of a proceeding pursuant to Section 15(b) of the Exchange Act, the withdrawal notice does not become effective "except at such time and upon such terms and conditions as the Commission deems necessary or appropriate in the public interest or for the protection of investors." (17 CFR 240.15b6-1).

under the supervision of a court-appointed bankruptcy trustee.

The Principals

Padgett has been in the securities business since 1968. Immediately prior to the founding of Stuart-James, he was executive vice-president of Blinder, Robinson & Co., where his primary responsibility was in the corporate finance area. He was the Denver-based president and a director of Stuart-James throughout its existence, and he also became chairman of the board after Graff left Stuart-James in 1989. Padgett is currently a controlling person of another broker-dealer. 6/

Graff started in the securities business in 1962 and, aside from an interruption of 7 or 8 years, remained in that business until he left Stuart-James in September 1989. Prior to the founding of that firm, he was employed by Blinder Robinson as regional vice-president for sales. At Stuart-James, he was chairman of the board and had primary responsibility for the sales area. His office was in Boca Raton, Florida. When he left Stuart-James, he entered into a 15-year consulting contract with the firm.

Regional Vice-Presidents

Nye was at relevant times (beginning in May 1985) Western regional vice-president with supervisory responsibility over approximately 12 branch offices, including offices in Colorado Springs, Colorado, and Albuquerque, New Mexico. Branch office managers subject to his supervision at various times were Gibbs,

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6/ As requested by the Division and without objection by Padgett, I have taken official notice of this fact, as reflected in the Commission's public files. (File No. 8-43367).

Lasek, Meinders, Sullivan and Sutton. Nye, who had also come to Stuart-James from Blinder Robinson, was a branch manager before becoming regional vice-president. Alone of the individual respondents, he was not called as a witness by the Division, and he did not testify in his own behalf.

Ward, who is not charged with supervisory deficiencies, at relevant times was Southeast regional vice-president, with responsibility for several Florida branch offices and certain other offices. Prior to joining Stuart-James in 1983, Ward was a branch office manager for Blinder Robinson. With Stuart-James, he was a branch office manager before becoming regional vice-president in about December 1984.

Branch Managers

The pertinent positions of the respondent branch managers were as follows:

Beaird was manager of the Houston, Texas Post Oak office from March 1985 until July 1989.

Czaja was manager of the Pompano Beach, Florida office from April 1986 to April 1987.

Gibbs was manager of registrant's Albuquerque office from September 1985 to May or June 1986 and then became assistant manager of the Colorado Springs North Creek office.

Lasek was manager of the Albuquerque office from June 1986 to March 1987.

Meinders (who, as noted, is no longer a respondent) was manager of the Colorado Springs downtown office from January to August 1987.

Sullivan was manager of the Colorado Springs downtown office from July 1986 to January 1987.

Sutton was manager of the Colorado Springs downtown office from April 1985 to June 1986. He then became manager of the new Colorado Springs North Creek office. In late 1985 he also became an "area manager" responsible for Colorado Springs and Albuquerque. The allegations against him are limited, however, to his conduct as branch manager.

Nature of Business and Structure of the Firm

As noted above, Stuart-James' business consisted predominantly of underwriting and retail trading of low-priced, speculative securities. During the relevant period, it was an underwriter, in many instances sole underwriter, of some 30 initial public offerings ("IPOs"). The bulk of its aftermarket business involved securities that the firm had underwritten and in which it was also a market maker in the National Association of Securities Dealers Automated Quotation system ("NASDAQ").

Padgett and Graff jointly ran the firm on a day-to-day basis. Padgett focused on administrative matters, whereas Graff concentrated on the sales activities of the business. Each of the firm's branch offices had a manager who was responsible for day-to-day supervision in that office. Certain branch managers were designated as area managers with supervisory responsibility over

one or more branch offices in addition to their own offices. As of early 1985, the Stuart-James hierarchy was expanded to include the position of regional vice-president. Each of the regional vice-presidents, among whom were respondents Nye and Ward, had supervisory responsibility over a group of branch offices. The compensation of the branch managers, in addition to commissions on transactions of their own customers, was based on a percentage of their offices' gross commission. Area managers and regional vice-presidents also received an override on commissions generated in the offices under their jurisdiction. In addition, managers of profitable offices, as well as area managers and regional vice-presidents, shared in a profit pool.

Several times each year there were national managers' meetings, held either in Denver, where the firm's corporate headquarters and Padgett were located, or in Boca Raton, Florida, where Graff had his office. Generally, these meetings were attended by all branch managers and those above them in the hierarchy, including Padgett, Graff and Geman. In addition, after the position of regional vice-president was created, each Stuart-James region generally had a managers' meeting once a month, attended by the regional vice-president, the managers of branches within the region and occasionally by Padgett and/or Graff.

Pricing and Sales Compensation Policies

Under a pricing policy that was in effect from the inception of the firm until about September 1986, branch managers and sales agents had discretion to mark up the price on a customer buy

transaction to 5% above the lowest NASDAQ ask quotation and to impose a markdown of up to 5% below the highest NASDAQ bid on a customer sell transaction. 7/ If a sales agent wanted to share part of his or her commission, calculated under the Stuart-James system as the difference between the firm's "inside" bid or ask set by the firm's trading department (also referred to as the "strike price") and the execution price, 8/ he or she could execute transactions at prices more favorable to customers, even below the NASDAQ ask or above the bid. Under a new pricing policy that went into effect in or about September 1986, the discretionary aspect was essentially removed. Transactions were to be executed at the lowest NASDAQ ask quotation or the highest bid quotation, respectively, regardless of what Stuart-James' own NASDAQ quotations were. 9/ There were some exceptions to the new policy. The only one relevant here is that on a cross trade between customers of the same sales agent, the buying customer was to receive a 5% discount and the selling customer a 5% premium.

7/ While the Division maintains that the markups or markdowns could be as high as 8% above or below the NASDAQ quotations, the record indicates that as a general rule the limit was 5%.

8/ Stuart-James' inside prices, which were used to determine agents' commission, are not to be confused with inside quotations in NASDAQ, representing the best bid and asked quotations of those inserted by market makers.

9/ Geman testified that the change in policy was prompted by concern that the National Association of Securities Dealers ("NASD") would use the inside or strike price as the benchmark from which to compute markups or markdowns, resulting in markups or markdowns exceeding the NASD's 5% guideline.

Stuart-James' compensation structure also has a bearing on certain of the issues herein. Throughout the period under consideration, with minor exceptions, it used a system involving inside prices, under which, as noted, the sales agent's gross commission was based on the difference between the execution price to the customer, either on the buy or the sell side, and the inside price. 10/ The agent received 45% to 55% of the gross commission. As a result of the way the inside prices were set by the trading department, a sales agent realized a greater commission from a crossed trade, i.e., principal sell and buy transactions in which the sales agent had orders from both seller and buyer in hand, than from a net sale, i.e., a simple sale to the trading department, or even from a net sale and a net buy combined. By way of illustration, on a NASDAQ stock quoted at $.10 bid and $.20 ask, trading might set the inside prices at $.12 bid and $.16 ask. On a customer net sell, assuming that the transaction took place at the NASDAQ bid, the commission would be $.02 per share (the difference between the execution and inside prices). On a net buy, the gross commission would be $.04. Thus, total per share commission on the two transactions would be $.06. The remaining

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10/ Padgett and Graff urge that the way in which Stuart-James divided the bid-ask spread between itself and the sales agents is irrelevant. They also object to the designation of the portion received by the sales agent as a "commission," asserting that the firm did not charge a commission in the normal usage of that term. However, the compensation structure bears on certain of the issues. And, as Padgett and Graff acknowledge, "commission" was the term used within Stuart-James to describe sales agents' compensation. In any event, the name given to that compensation has no bearing on resolution of the issues herein.

$.04 of the spread would represent trading profit. On the other hand, if the same trades were crossed, gross commission would encompass the entire spread. 11/ In that situation, the firm deemed its inside bid and ask prices to be midway between the execution prices, or $.15 in this example. As a result, the commission was $.05 each on the sell and the buy side, a total of $.10, with no trading profit.

Credibility of Witnesses, Meinders in Particular

Respondents challenged the credibility of many of the former sales agents that were called as witnesses by the Division, in many instances asserting that those agents were biased against Stuart-James and the individual respondents. In their brief, Padgett and Graff argue that the time elapsed between occurrence of the facts at issue and the hearing was so long that virtually all of the witnesses had only dim or erroneous memories. They assert that this factor made the witnesses susceptible to being "refreshed" by the Division with recollections that were not true. And they urge that I should therefore be wary of basing findings on testimony elicited by the Division. (Padgett and Graff Brief at 143). The Division points out that its witnesses were subjected to extensive cross-examination, including examination concerning contacts with Division counsel in preparation for their testimony. It contends that there is no evidence of improper coaching of witnesses, and

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11/ There were some minor exceptions where the trading department took a small part of the spread. This was the case on the opening day of trading of Find SVP Inc., one of the securities issues involved in the markup allegations, where trading took 1/2 cent per share or warrant on cross transactions.

that, as a general rule, the testimony of particular witnesses was corroborated by the testimony of others, contemporaneous notes, or both. In making findings hereafter concerning the credibility of various witnesses, I have given consideration to these arguments.

The testimony of one witness, however, raises unusual credibility issues that warrant separate discussion. That witness is Meinders. Meinders first entered the securities business in 1976. In the ensuing 8 years, he worked for the most part for New York Stock Exchange firms, until joining Stuart-James in 1984. He remained with that firm until October 1988. During that time, he served variously as manager of two different branch offices, as a sales agent and as assistant manager of a third office. On April 20, 1990, the Commission accepted Meinders' offer of settlement and dismissed the proceedings against him with the proviso that, if he failed to comply with specified undertakings, the proceedings against him could be reinstituted. One of those undertakings was his agreement to testify in these proceedings "in substantial conformity with his proffer tendered with his offer of settlement." The proffer was contained in two letters addressed to the Division's lead attorney in this proceeding.

Various respondents thereupon filed motions seeking, among other things, to dismiss the proceedings against them and to foreclose Meinders' proposed testimony. They asserted in support of the motions that Meinders' proffered testimony contradicted investigative testimony that was favorable to respondents, and they argued that in accepting the offer the Commission had already

decided to credit the proffered over the investigative testimony and had therefore prejudged the case. The Commission denied the motions. 12/ It rejected the notion that it had credited the proffer, noting that in the first instance it was up to the administrative law judge whether to credit Meinders' testimony and what weight to give it, and that upon review of an initial decision it would evaluate Meinders' credibility in light of the entire record existing at that time. In the same vein, the Commission, in rejecting the motion to bar Meinders' proposed testimony, stated that his credibility had yet to be assessed. The Commission went on to state,

> [t]he fact that he may now seek to change his prior investigative testimony does not, in and of itself, establish which, if either, version is truthful. Whether or not Meinders testifies in a manner consistent with his proffer, respondents are free to impeach his credibility, refute his version of the facts, and offer whatever rebuttal evidence they deem appropriate. A law judge will hear Meinders' testimony including his cross-examination, observe his demeanor and determine his credibility. Once made, the law judge's determination cannot lightly be overturned. Under the circumstances, we see no basis for precluding Meinders from testifying.

48 SEC Docket at 28 (footnotes omitted).

Stuart-James, and Padgett and Graff, state that in order to preserve the issue for subsequent review, they repeat their objection to the use of Meinders' testimony against them. Stuart-James, as well as Nye, Beaird, Gibbs, Sullivan and Sutton, repeat arguments pertaining to assertedly improper ex parte contacts between the Division and the Commission and asserted Commission

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12/ The Stuart-James Co., Inc., Securities Exchange Act Release No. 28810 (January 23, 1991), 48 SEC Docket 19.

prejudgment in connection with the Meinders settlement. These objections pertain to matters resolved by the Commission's Order and are therefore not in issue before me. However, Padgett and Graff urge that to the extent I consider Meinders' testimony at all, I should not give it any weight. Their point is that under the terms of the Order Dismissing Proceedings Meinders faced reinstitution of the proceedings and a possible serious sanction if he failed to testify in conformance with his proffer. Under these circumstances, they assert, his "coerced inculpatory" testimony cannot be credited. (Padgett and Graff Proposed Finding 306). The proffer was not offered in evidence and is not part of the evidentiary record.

During extended cross-examination by counsel for various respondents, 13/ only a handful of inconsistencies between Meinders' hearing testimony and his investigative testimony, given in 1987, were brought out. Indeed, Meinders stood by substantial portions of investigative testimony that were read into the record. He did admit that in 1987 he had lied in certain respects relating mostly to transmission of anticipated aftermarket prices to sales agents in the Colorado Springs office when he was manager there. In explanation, he pointed out that during his investigative testimony he was represented by Geman and another Stuart-James compliance attorney, and that he was concerned about being fired and sought to protect himself. I had the opportunity to observe Meinders closely during the six days that he testified, including

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13/ Counsel for Stuart-James chose not to cross-examine Meinders.

cross-examination extending over three days. He impressed me as generally forthright and candid, as having good recollection of most of the matters and events he was questioned about and, by virtue of his intermittent status as manager and his lengthy experience in the securities industry, as having a broader understanding of those matters and events than some of the sales agents who testified.

II. MARKUPS

The Allegation

This allegation, which as noted names Stuart-James, Padgett and Graff and charges violations of the antifraud provisions, relates to two IPOs in 1986, for which registrant was the sole underwriter on a firm commitment basis. The offerings involved units consisting of common stock and warrants of UMB Equities, Inc. ("UMBE") and Find SVP Inc. ("Find"). It is alleged that in advance of aftermarket trading, sales agents were instructed (1) to solicit IPO customers to agree to resell the securities they were buying to Stuart-James on the first day of aftermarket trading at a specified price and (2) to solicit other customers to agree to buy those securities from the firm on that day at a higher price, both prices having been established by Padgett and Graff. The Division further alleged that the scheme was in fact implemented on the first day of trading in riskless transactions; that Stuart-James failed to disclose the above arrangements and transactions to its customers; that it dominated and controlled first-day trading in the UMBE and Find securities; and that it charged excessive

undisclosed markups ranging from about 38% to 200%. According to the allegation, Stuart-James acted at the direction of Padgett and Graff.

In a More Definite Statement submitted by the Division, it stated that "the transactions involving alleged excessive markups are limited to those in which securities were acquired from customers at or about the opening bid price and then resold to other customers in riskless principal trades at or about the opening ask price."

Summary of Contentions

The basic issue raised by the markup allegation and the parties' contentions concerning it is the appropriate basis from which markups are to be computed. As the Commission stated in Alstead, Dempsey & Company, Incorporated, 47 S.E.C. 1034, 1035 (1984),

> [a]s early as 1939, this Commission held that a dealer violates antifraud provisions when he charges retail customers prices that are not reasonably related to the prevailing market price at the time the customers make their purchases. The key issue in cases involving allegations of unfair pricing has always been how to determine the prevailing market price, on the basis of which retail markups are computed. Once that price is determined, we have consistently held that, at the least, markups more than 10% above that level are fraudulent in the sale of equity securities.

(Footnotes omitted). 14/ The Commission went on to state that by

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14/ In other cases, the Commission has said that undisclosed excessive markups violate the antifraud provisions. See, e.g., Paul C. Ferguson, 39 S.E.C. 260, 263 (1959). And that is the wording of the allegation in this case. In a recent decision, where it was argued that adequate disclosure was made, the Commission, finding that disclosure was not adequate, stated (continued...)

"prevailing market price" is meant the current interdealer market; that for a dealer not making a market, contemporaneous cost is the best evidence of the current market, absent countervailing evidence; and that, in the case of an integrated dealer, i.e., a firm that both makes a market in a security and sells the security to retail customers, markups may be computed on the basis of the contemporaneous prices charged by the firm or other market makers in actual sales to other dealers or, if no such prices are available, on the basis of representative ask quotations. However, where an integrated dealer dominates and controls the market to such a degree that it controls wholesale prices, then the dealer must use its contemporaneous purchase price. 15/

The Division contends that under these well-established principles concerning dominated and controlled markets Stuart-James' markups should be computed on the basis of its

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14/ (...continued)
that it did not have to address the issue whether excessive markups, if fully disclosed, are fraudulent. Meyer Blinder, Securities Exchange Act Release No. 31095 at 25 n.60 (August 26, 1992), 52 SEC Docket 1436, 1460 n.60.

In its recent decision in Kevin B. Waide, Securities Exchange Act Release No. 30561 (April 7, 1992), 51 SEC Docket 323, the Commission, in a limited context, departed from the principle that the base price for computing the fairness of a retail securities price is the wholesale market price. It held that in a sale made on a riskless principal basis of stock obtained in an arm's length inter-dealer trade not involving a concession, assuring a fair price for customers required that a firm's markups be based on a price no higher than its cost, even if there was evidence that the market price was higher than that cost.

15/ Alstead, Dempsey & Company, Incorporated, 47 S.E.C. at 1035-37. See also Meyer Blinder, Securities Exchange Act Release No. 31095 (August 26, 1992), 52 SEC Docket 1436.

contemporaneous cost in retail purchases. Respondents, on the other hand, urge that markups should be calculated from prices charged in contemporaneous interdealer sales or from representative ask quotations in the NASDAQ system. The difference in result, as discussed infra, is vast. What follows is a more detailed summary of the parties' contentions.

Division

During the first minutes of aftermarket trading in the UMBE and Find securities, Stuart-James executed thousands of pre-arranged, riskless cross trades, in which it took excessive, undisclosed markups ranging from 38% to 200% over contemporaneous cost and totalling almost $5.5 million. It dominated and controlled this internalized market, arranging that customers would trade with each other at arbitrary prices established by Padgett and Graff and unaffected by normal market forces. Stuart-James created the appearance of "hot issues," leading IPO customers to believe that there was almost a guaranteed profit. Those customers were solicited to sell at a substantial profit when trading started. Aftermarket buyers were encouraged to pay before trading started. Customers who had given aftermarket indications of buying and selling were not called back for confirmation when trading started. The pre-arranged trades were executed as soon as trading started. Aftermarket buying blocks were used to absorb excess buying indications. In Find, Stuart-James was not yet a market maker at the time it executed the retail trades in the internal market.

Stuart-James

The Division's position would deprive the firm of the spread between the bid and the ask, which represents the usual reward of a market maker for taking the risk of making a market. Market makers' markups are to be determined on the basis of interdealer transactions or validated quotations and not on the basis of contemporaneous cost. Because it was a market maker, Stuart-James' transactions cannot be viewed as riskless principal transactions. In Find, it had been granted market maker status before any retail transactions were executed. Stuart-James did not dominate and control the market for UMBE or Find securities. It determined opening prices based on anticipated supply and demand. Prior to aftermarket trading, customers were not given specific prices, only price ranges. It is also not true that Stuart-James "locked" IPO customers into selling at the opening of aftermarket trading, or that indications of interest were not confirmed before trades were executed. Stuart-James did not unilaterally set prices; those resulted from an active and competitive market. The Division ignored the wholesale market which was far from insignificant. Registrant's share of that market for the four securities (UMBE and Find stock and warrants) was only 22.5% to 39.7%. The firm reasonably relied on the advice of Geman, who closely followed SEC and NASD pronouncements in the securities pricing area.

Padgett and Graff

Stuart-James did not dominate and control the market for UMBE or Find securities. Even if it did, however, it would have been required to calculate markups from prices in interdealer sales and not from its own retail purchase prices. In the UMBE and Find securities, there was a broad and active wholesale market on the first day of trading, which was not controlled by Stuart-James. No other indicia of control are present. The markup rule proposed by the Division is economically irrational and would have an adverse effect on the securities markets. Customers were not given aftermarket prices, but only estimates, before trading began. IPO customers were not required to sell out on the first day of trading. The evidence does not establish that aftermarket order tickets with prices were prepared in advance of trading or that trades were executed without obtaining customer confirmations of their indications of interest. Since Padgett and Graff are not charged with selling their own securities, they can only be found secondarily responsible. Thus, scienter must be proven against them even where the primary violations would not require such a showing. Because they reasonably relied on the advice of counsel and for other reasons, there is no basis for finding scienter.

Division Reply

In reply to respondents' contentions, the Division argues, among other things, that (1) the interdealer market stressed by respondents is irrelevant because the pre-arranged trades were executed independently of that market and before that market

developed and Stuart-James is not charged with dominating and controlling the entire first day trading market, and (2) Padgett and Graff directly caused the violations and are therefore directly, and not secondarily, liable.

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In the sections that follow I turn initially to findings, largely undisputed, describing the UMBE and Find offerings and outlining the retail and wholesale transactions as well as the NASDAQ quotations on the first day of trading. I then step back chronologically to consider the sharply controverted issues regarding preparation by the various Stuart-James offices for the opening of trading. The markup section of this decision ends with my factual and legal conclusions.

The UMBE Offering; First-Day Markets in UMBE Securities

UMBE, which had been incorporated in 1985, was a "development stage enterprise" that intended to syndicate and participate as a general partner in partnerships to develop, own and manage various types of medical buildings. As respondents point out and the Division does not dispute, UMBE was not a shell company, but a legitimate company with a real business. The same was true for Find. The UMBE IPO consisted of 1,610,000 units to be offered to the public at $2.50 per unit. Each unit consisted of five shares of common stock and two redeemable Class A common share purchase warrants. Thus, the offering encompassed 8,050,000 shares of

common stock and 3,220,000 warrants. 16/ No value was attributed to the warrants for purposes of computing dilution; hence, the cost of the common stock was computed as 50 cents per share.

The effective date of the offering was Friday, March 14, 1986. Stuart-James sold the entire offering to its customers on that day. Aftermarket trading began the following Monday, March 17. That morning, Stuart-James entered the NASDAQ system as a market maker for the common stock and warrants. 17/ In the course of the day, it executed a tremendous number of retail transactions, most of them at or near the opening of trading. Overall, it purchased about 4.4 million shares of stock from IPO customers in some 2,200 transactions and sold 4.5 million shares to other customers in some 2,800 transactions. It also purchased 1.4 million warrants in some 1,700 transactions and sold approximately the same number in over 900 transactions. Stuart-James' opening NASDAQ quotations for UMBE stock were 1 1/2 bid and 2 1/4 ask. Its opening quotations for the warrants were 7/8 bid and 1 1/2 ask. In each case, these quotations represented or equalled the high bid and the low ask at the time they were entered. Even though the NASDAQ quotations changed throughout the day, the bulk of the retail transactions was concentrated at or near Stuart-James' opening quotations. Thus, of the common stock purchases from customers,

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16/ In addition, UMBE'S registration statement covered Class B warrants that were to be issued to the shareholders of its affiliate, Universal Medical Buildings, Inc. These warrants are not pertinent to the issues herein.

17/ The units were also traded, but not by Stuart-James.

Stuart-James bought approximately 3.7 million shares from about 1,900 customers at $1.50 per share. 18/ It re-sold about the same number of shares to more than 2,200 customers at prices ranging from $2.25 to 2.375 per share, with the vast majority of the sales taking place at $2.25. 19/ Of the warrant purchases, Stuart-James bought approximately 1 million from more than 1,200 customers at the price of $.875 (7/8) per warrant. It re-sold almost the same number to 700 customers at $1.50 per warrant. The record shows that although Stuart-James' opening quotations represented the best quotations for only a very short time, many transactions were executed at the above prices even after those quotations were no longer in effect. At least in part, this was attributable to the failure of a system designed to speed the process of order execution, that had been put in place for the first day of trading in the UMBE securities. Under this system, instead of the branch offices calling in their orders ticket by ticket to the trading department, where duplicate tickets were filled out, those offices were to send in orders by "faxing" specially created sheets containing the same information as would normally be on order tickets. The experiment proved to be a total failure, because some offices could not get through to busy fax lines; some faxed

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18/ A relative handful of purchases were effected at prices somewhat below $1.50.

19/ At the time of the UMBE offering, sales agents were permitted to mark up the price on customer purchases 5% above the lowest ask quotation. The $2.375 price, representing a markup of slightly more than 5% from $2.25, probably represented the outer limit of that range.

incompletely filled-out order sheets or attempted to fax the order tickets themselves; and some order sheets were faxed multiple times. The fax system was abandoned after about half an hour. As a result of the inability of the branch offices to get their customers' orders executed promptly, Stuart-James apparently decided to honor the tickets that had been prepared at its opening prices.

Under the markup approach urged by the Division, using contemporaneous cost in Stuart-James' retail purchases as the basis for computation, the sale prices reflected markups of 50% and more for the stock and 71% for the warrants. On the other hand, respondents' approach, under which Stuart-James' opening ask quotations would be the base price in the computation, yields markups of mostly zero and almost none exceeding 5%.

I turn now to findings concerning the first day aftermarket in the UMBE securities away from Stuart-James' retail market. It is respondents' position that the interdealer market for the UMBE securities was a free and competitive market involving a substantial number of market makers and other broker-dealers and was not dominated and controlled by Stuart-James. The Division points out that it has not charged Stuart-James with dominating and controlling the entire first day trading market, but with creating a dominated and controlled internalized market. It contends that the interdealer market is irrelevant because the assertedly pre-arranged trades were executed independently of that market and before that market developed. While my conclusion essentially

adopts the Division's approach, I set forth below findings regarding the interdealer market in the event these should be considered material at a subsequent stage of these proceedings.

The NASDAQ market for UMBE common stock was opened by another firm, with a bid of 1 and an ask of 3. About 1 1/2 minutes later, at 9:38 Eastern time, Stuart-James entered its initial quotations of 1 1/2 and 2 1/4. 20/ Its opening bid remained the best NASDAQ bid for only 62 seconds and its ask quotation the best for only 81 seconds. 21/ In each case the better quotations were inserted by another firm. 22/ In the course of the day, about ten broker-

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20/ Findings regarding NASDAQ quotations for the UMBE and Find securities are based on Division exhibits 3, 4, 6 and 7, which are Market Maker Price Movement Reports prepared by the staff of the NASD. While relying on these documents for certain of their own proposed findings, Padgett and Graff object to the Division's reliance on information included in them on the ground that the NASD employee through whom they were offered was unable to attest to their accuracy or to explain certain entries contained therein. I overruled similar objections when I received the Reports in evidence and I find no reason to question their accuracy now. It is clear that they were printouts of information routinely maintained by the NASD on a computer and were furnished at the request of the Division.

Where times at which certain quotations were entered are noted, I have deemed it sufficient to cite hours and minutes and to omit seconds. Because they are self-evident, I have also not deemed it necessary to include the designations "a.m." and "p.m." Except where otherwise indicated, all times are Eastern time.

21/ The Division relies on these facts to support its argument that the sales agents would not have had time to confirm indications of interest with their customers once trading began.

22/ Respondents assert that with the exception of Stuart-James' opening quotations for the UMBE stock, none of the opening day price changes for the UMBE or Find securities were initiated by the firm. They contend that this demonstrates the firm's (continued...)

dealers in addition to Stuart-James entered quotations for the stock in the NASDAQ system and many additional broker-dealers engaged in trades. Stuart-James sold 150,475 shares to other dealers in 26 transactions, and it bought 5,000 shares from another dealer in a single transaction. Its sales began at 9:39 with a 1,000-share transaction at 2 1/4; the purchase, at 2 3/16, took place shortly after noon. 23/ By the end of the day, the spread between the high bid and low ask quotations had narrowed drastically, to 1/16. In the course of the day, the high bid was generally above 1 1/2, closing at 2 3/16; the low ask, while closing at 2 1/4, was at times below that figure. While Stuart-James accounted for the overwhelming number of retail transactions, including 100% of retail purchases, it accounted for less than a quarter of the wholesale market. In terms of number of shares,

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22/(...continued)
lack of control over the markets in those securities. The Division, on the other hand, claims that Stuart-James initiated many price changes. My review of the Market Maker Price Movement Reports indicates that, aside from its opening quotations in the UMBE stock and warrants, Stuart-James initiated ten price changes in those securities; it did not initiate any price changes in the Find securities.

23/ The Division maintains that the times stamped on the trade tickets (Div. Exs. 264m and n) represent Mountain time, not Eastern time. Padgett and Graff assert that the record does not support the Division's position. No evidence was presented specifically directed to this question. However, comparison of the prices in the sales transactions with the then current ask quotations indicates that the time stamps probably reflect Eastern time. Even stronger evidence for this view is the fact that bid and ask quotations written on a number of the tickets match the inside quotations only if the times on the tickets represent Eastern time. Moreover, it seems logical that Stuart-James' initial wholesale sales would take place at about the time it entered its first quotations in NASDAQ and not two hours later.

Stuart-James accounted for 100% of retail purchases, 1.4% of wholesale (i.e., interdealer) purchases (consisting of the 5,000-share purchase) and 92.5% of all purchases, wholesale and retail. On the sell side, Stuart-James accounted for 95.9% of retail sales, 41.2% of wholesale sales and 92.1% of total sales. 24/ In terms of the total trading market, however, the wholesale market accounted for only some 724,000 shares (purchases and sales combined) as compared to a retail market of over 9 million shares.

With respect to the UMBE warrants, Stuart-James opened the NASDAQ market at 9:39 on March 17 with quotations of 7/8 bid and 1 1/2 ask. Its bid was the best NASDAQ bid for only 56 seconds; another firm raised the bid to 1. The 1 1/2 ask was raised by Stuart-James to 1 5/8 some 8 1/2 minutes later, but other firms stayed at the 1 1/2 level for a few more minutes after that. Here, too, there were a substantial number of market makers in the NASDAQ system and other broker-dealers who engaged in trades in the warrants. In the course of the day, Stuart-James sold 46,800 warrants to other dealers, beginning with a 5,000-warrant transaction at 9:39 at 1 1/2; it bought 500 warrants at 9:52 for 1 19/32 ($1.59375). 25/ By the end of the day, the spread between

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24/ The above figures and the figures for the UMBE warrants market on March 17 are based on Div. Exs. 237(a) and 237(b). Padgett and Graff Ex. 95, although based on those exhibits, includes some slightly different numbers. As far as I can determine, the record does not indicate the reasons for these discrepancies. In any event, they are not material.

25/ This transaction, involving a purchase from First Jersey, looks like an aberration. At 9:52, the inside market was 1 3/8 bid and 1 19/32 ask. The low ask quotation was First (continued...)

the high bid and the low ask had narrowed to 1/8. In the course of the day, the high bid was consistently above 7/8; the low ask was above 1 1/2 for part of the day before closing at that figure. As with the common stock, Stuart-James accounted for 100% of retail purchases; it accounted for .5% of wholesale purchases (consisting of the 500-warrant purchase) and 93.1% of all purchases. On the sale side, Stuart-James accounted for 96.3% of retail sales, 44.9% of wholesale sales and 92.9% of total sales. In terms of the total trading market, the wholesale market accounted for some 209,000 warrants as compared to a retail market of more than 2.8 million warrants. Stuart-James' total wholesale market share in the warrants was about 23%.

Taken together with the fact that the dollar amount of interdealer trading in the UMBE securities on the first day of aftermarket trading totalled in the hundreds of thousands of dollars, respondents' point that such trading was not insignificant as measured either in volume or dollar amount is well taken. In terms of the total trading market, however, it is apparent that, as urged by the Division, the wholesale market was dwarfed by the retail market.

25/(...continued)
Jersey's. Stuart-James' own quotations were 1 and 1 5/8. It is most unlikely that Stuart-James, which was the dominant dealer in the market, would buy at the contra dealer's ask and far above its own bid. This becomes even more unlikely in light of the fact that at 9:47 and again at 9:59 Stuart-James sold warrants to other dealers at 1 1/2.

The Find Offering; First-Day Markets in Find Securities

Find, which was incorporated in 1969, was engaged in the development and marketing of information services and products. The Find IPO consisted of 621,000 units to be offered to the public at $7 per unit. Each unit consisted of 100 shares of common stock and 25 redeemable common stock purchase warrants. Thus, the offering encompassed 62,100,000 shares of common stock and 15,525,000 warrants. No value was attributed to the warrants for purposes of computing dilution; hence the cost of the common stock was computed as 7 cents per share. Stuart-James was sole underwriter, on a firm commitment basis. The effective date of the offering was Friday, October 31, 1986. Stuart-James sold the entire offering to its customers that day. Aftermarket trading began the following Monday, November 3.

In the morning of November 3, Stuart-James entered the NASDAQ system as a market maker for the common stock and warrants. On that day it executed a very large number of retail transactions, most of them at or near the opening of trading. Overall, it purchased about 43.1 million shares of stock from IPO customers in some 2,500 trades and sold 42.3 million shares to other customers in some 3,500 transactions. Stuart-James also purchased on that day 9.3 million warrants in 2,300 transactions and sold about 9 million warrants in 715 transactions. Stuart-James' opening NASDAQ quotations for the stock were 1/8 bid and 3/16 ask. Its opening quotations for the warrants were 1/16 and 1/8. In each case, these quotations matched the high bid and the low ask at the time they

were entered. However, the opening bid and ask quotations for the warrants, by another dealer, had been 1/32 and 3/32. The bulk of the retail transactions was concentrated at the best opening prices or within 5% thereof. 26/ Thus, of the common stock purchases from customers, Stuart-James bought approximately 33.3 million shares from about 2,200 customers at 12 1/2 cents (1/8) or 13 cents per share. It resold approximately 31.8 million of these shares to about 2,500 customers at prices of 18 cents or 18 3/4 cents (3/16) per share. With respect to the warrants, Stuart-James bought approximately 7.6 million from almost 1,900 customers at prices ranging from 3.125 cents (1/32) to 4 cents each. It resold approximately 7.4 million to 561 customers at prices ranging from 9 cents to 9.375 cents (3/32) per warrant. Using the same markup approach as with UMBE, the Division calculated markups of 38% or 50% to purchasers of the stock and 157% to 200% to purchasers of the warrants. The Division approached its markup calculations as follows: Noting that at the time of the Find offering Stuart-James' pricing policy provided for a 5% premium and discount, respectively, where securities were crossed in a sales agent's own book, it assumed that customer sales of stock at 13 cents were crossed with customer purchases at 18 cents, and that customer sales at 12 1/2 cents were crossed with customer purchases at 18 3/4 cents. The latter series of transactions presumably involved trades crossed between different sales agents. The Division's

26/ By this time Stuart-James had a new pricing structure, under which customers received a 5% break on a cross trade within an agent's "book."

analysis for the warrants is similar. The analysis has not been challenged and appears to be reasonable. As with UMBE, respondents take the position that it is inappropriate to calculate markups on the basis of contemporaneous cost.

I turn now to a description of the first day interdealer market in the Find stock and warrants. The market for the common stock was opened by another firm at 10:49 with quotations of 1/8 bid and 3/16 ask. Some eight other dealers matched those quotations within the next few minutes, prior to Stuart-James entering its initial quotations, also at the same level, which were then the best NASDAQ quotations, at 11:03. At 11:20 the best bid was raised to 5/32, by another market maker. Stuart-James increased its quotes to a bid of 5/32 and an ask of 7/32 at 11:25, following the lead of several other market makers. At 11:29, these became the best NASDAQ quotes. Unlike the situation in the UMBE securities, the inside spread at the close of the day had not narrowed over the opening spread. Some 15 other market makers entered quotations for the stock in the NASDAQ system on the first day, and many additional broker-dealers engaged in trades. While Stuart-James accounted for the overwhelming number of retail transactions, including 100% of retail purchases, its wholesale market share amounted to only about 24%. That share consisted of sales of 662,000 shares, beginning with a sale of 50,000 shares at 11:01 at $.1875 (3/16). In terms of number of shares, Stuart-James accounted for 100% of retail purchases, 0% of wholesale purchases and 97.3% of all purchases, wholesale and retail. On the

sell side, it accounted for 98.5% of retail sales, 55.5% of wholesale sales and 97.3% of total sales. 27/ In terms of the total trading market, however, the wholesale market accounted for only some 2.4 million shares as compared to a retail market of almost 86 million shares.

With respect to the Find warrants, the market was opened by another dealer at 10:50 with quotations of 1/32 bid and 3/32 ask. One and a half minutes later, the high bid had increased to 1/16. By the time Stuart-James entered its first quotations, at 11:12, several other dealers had entered quotations and the market had moved up to 1/16 and 1/8. Along with other dealers, Stuart-James later increased its quotations to 3/32 and 5/32, and it remained there to the close of the day, while the lowest ask went down to 1/8. The closing inside spread was 1/32, as against the opening spread of 1/16. Here, too, there were a substantial number of market makers in the NASDAQ system and other broker-dealers who engaged in trades in the warrants. As with the common stock, Stuart-James accounted for 100% of retail purchases; it made no wholesale purchases and accounted for 91.8% of total purchases. On the sale side, it accounted for 94% of retail sales, about 74% of wholesale sales and 92.5% of total sales. Its wholesale sales totalled 616,000 warrants, beginning with a sale of 100,000 warrants at 10:55 at 1/16. In terms of the total trading market, the wholesale market accounted for about 1.7 million warrants as

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27/ The above figures and the figures for the Find warrants market on November 3 are based on Div. Exs. 238(a) and 238(b) and on Padgett and Graff Ex. 95.

compared to a retail market of some 18.9 million. Stuart-James' total wholesale market share was about 40%.

As with the UMBE securities, the record shows that the interdealer market in the Find securities was not insignificant but was dwarfed by the retail market.

Preparation for First-Day Trading

The most vigorously contested factual issues in the markup area relate to the activities that took place in the various branch offices in the days preceding the effectiveness of the UMBE and Find public offerings and the commencement of aftermarket trading, as well as contacts with customers or the absence thereof following opening of the aftermarket. Among those issues are the following: Were sales agents given specific aftermarket prices by their managers well in advance of trading and, if so, did they use these in soliciting indications of interest from their customers, also in advance of trading? Or were the sales agents and their customers given only estimated prices or ranges of possible prices, as respondents contend? Did the sales agents, in advance of trading and based on indications of interest, prepare sell and buy order tickets which included execution prices? Were customers who had given indications of interest contacted again after trading began to confirm that they wanted to go through with the transaction, or were they contacted only after transactions had already been executed? As the Division sees the answers to these questions, they add up to completely pre-arranged cross trades

whose execution once trading began was essentially a formality. Respondents, of course, have a different view of the evidence.

A vast amount of evidence was adduced from a multitude of witnesses on these and related questions. Not surprisingly, there are significant conflicts. In large measure, these conflicts are attributable to witnesses' inability to recall specifically events that had taken place years earlier. Because the IPOs brought out by Stuart-James during the period 1985-1987 were handled essentially the same way, those former employees who participated in a number of offerings understandably had difficulty distinguishing among them in their recollections. Generally speaking, UMBE left a greater impression on the witnesses than Find. In UMBE there was an unusually great demand for the securities, the price projections kept increasing in the days preceding the beginning of trading and the opening bid price was triple the IPO price. On the other hand, for most of the witnesses the Find offering and aftermarket did not stand out from many other IPOs. Although the UMBE and Find offerings included both stock and warrants, the testimony for the most part was concentrated on the stocks, which were the more valuable part of the units packages. This is partly a result of the questions that were asked and partly a result of witnesses having considerably less recollection about the warrants.

In subsequent pages I undertake a detailed analysis of the evidence regarding certain aspects of the activities leading up to and on the first day of trading of the UMBE and Find securities.

As to some of those matters, the evidence is often less than clear. However, the consistent testimony of the former sales agents who testified, representing a number of branch offices, leaves no doubt that in certain basic respects the approach, during the period under consideration, regarding preparation by the sales force for the opening of trading was essentially the same throughout the firm and for all issues brought out by the firm, including UMBE and Find. Thus, I cannot credit the testimony of Padgett and Graff that there was no firm-wide approach or training regarding such preparation, and that every branch and sales agent probably handled things a little differently.

Almost without exception, the issues underwritten by Stuart-James were so-called "hot issues," which opened for trading at a premium above the offering price. Thus, the favored customers who were permitted to buy the new issues were provided with the opportunity for immediate profits. In UMBE and Find, as has already been noted, those profits were very substantial. The basic and common plan of the various branch managers, which was a logical consequence of registrant's pricing and compensation policies, was to encourage sales agents (1) to encourage IPO customers to sell their new issue securities as soon as trading started and (2) to solicit other customers, also days or even weeks prior to the opening of trading, to buy those securities in the aftermarket at still higher prices. 28/ To that end, generally beginning as soon

28/ An alternative plan recommended by at least some managers for IPO purchasers who wanted to retain their IPO securities was (continued...)

as the sales agents began placing the new issue, the agents obtained indications of selling interest from many of the IPO purchasers and indications of buying interest from projected aftermarket buyers. Many of the latter were told to get in checks right away, well before trading began. The indications ripened into actual sell and buy transactions once trading began. Respondents do not dispute that it was the goal and practice of the branch offices to execute trades for which there were indications as soon as possible after the market opened.

In UMBE and Find, the spreads between the prices at which the IPO customers sold their stock and warrants and the prices paid by aftermarket buyers - - reflecting for the most part Stuart-James' opening bid and ask quotations - - were enormous; they are the basis for the markup allegations. As noted, under Stuart-James' compensation structure the entire spread was treated as gross commission in the case of crossed trades. Thus, by crossing stock from IPO purchasers to aftermarket buyers, sales agents as well as managers and vice-presidents, who had their own customers and in addition received a percentage of the agents' commissions as an override, could earn huge commissions. Additional commissions were earned by causing the IPO customers to reinvest the proceeds of their sales. Richard Evans, who worked as a sales agent in Houston and participated in a substantial number of new issues, testified

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28/(...continued)
to buy additional amounts of the same securities at the opening of the aftermarket, provided such securities were then available.

that "the bulk of our business was . . . the new issue day." (Tr. 7498). Among evidence putting this in concrete terms is Meinders' testimony that when he was manager in Colorado Springs in the first half of 1987, the office's gross commissions on days other than first days of trading of new issue averaged about $7,000 or $8,000, whereas commissions on first days of trading of new issue amounted to $40,000 to $45,000. He further testified that this was typical of the situation throughout the firm. Sullivan, who was Meinders' predecessor as manager, testified that on some occasions the office did more than $100,000 production on the first day of trading of an IPO. Moreover, the fact that the allocation of subsequent new issue to sales agents was based largely on prior production provided added incentive to take advantage of the opportunity that the first day of trading presented.

While Stuart-James generally went short on the first day of trading of a new issue, the various branch offices did not know until after trading began whether they would receive blocks of stock from which buy orders could be filled, or whether such blocks would be adequate to fill the demand. Thus, the IPO purchasers were the only assured source of supply from which to fill purchase orders. As one former sales agent put it, "the only source of production you got for the opening market [was] . . . the IPO." (Tr. 9285-86). While the manner in which IPO purchasers were approached to sell out on the first day of trading varied, that they were widely encouraged to sell is clear notwithstanding

denials by some of the former managers. 29/ Even managers who denied training their sales agents to encourage new issue clients to sell at the opening of trading acknowledged that the commission structure provided an incentive for the agents to cross new issue at that point. For example, Beaird, who was manager of a Houston office at relevant times, when asked whether he would encourage sales agents to have their IPO customers sell to other customers in cross trades on the first day of aftermarket trading, answered, "I think that took care of itself. There's obviously a big commission advantage if they had buyers in the aftermarket." (Tr. 7022-23). Meinders testified that as manager in Colorado Springs he did not require sales agents to arrange to cross the IPO securities when trading opened, but that he showed them what the results would be if they did so.

In approaching IPO customers to sell as soon as trading started, it was common for sales agents (and common for managers to train their agents) to ask if the customers would sell or to suggest that they sell if a certain percentage of profit could be achieved. At the same time, buy indications were commonly solicited by asking customers or prospective customers a question such as the following: "If I can get you [the security] at [x

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29/ Padgett and Graff contend that IPO customers were not required to sell out on the first day of aftermarket trading. But such a requirement is not, as they claim, part of the Division's markup theory. Whether, as the Division alleges in the so-called "tie-in" allegation, IPO customers of certain branch offices were not simply encouraged to sell on the first day of trading, but were required to agree to do so as a condition of being permitted to buy the IPO securities, is the subject of Part V of this decision.

price] or better, how much are you good for?" For example, Lasek, who became assistant manager of the Albuquerque office in March 1986 and manager in or about June of that year, testified that before trading started on a new issue, he expected the sales agents to line up selling indications of interest from the IPO buyers and aftermarket buying indications from others, by asking the former whether they wanted to sell if a certain percentage profit could be obtained and the latter how much they would be interested in buying if the security could be obtained at a certain price or better. Certain former sales agents testified that by using a figure substantially higher than the expected ask price, they would then "look like a hero" when the purchase was actually effected at a lower price.

The focus in the discussion that follows is on the questions noted at the outset of this section, with reference to the way in which the UMBE and Find offerings were handled. As to these questions, the pertinent evidence is not as clear or consistent as it is with respect to the matters discussed above. Hence, a more detailed look at the evidence and more detailed findings are necessary. My findings are based principally on the testimony of (1) former sales agents who participated in one or both of those offerings and who appeared to have a reasonably good recollection about them or at least about routine practice in their offices; 30/

30/ I have not relied on the markup testimony, among others, of Frances Dollen, who worked in the Houston Post Oak office at the time of UMBE and Find. Dollen's business was almost entirely in listed securities, and she had no specific recollection regarding UMBE or apparently of Find.

(2) the respondents; and (3) a number of customers. Many of the former sales agents testified at great length, some for several days each, including very extensive cross-examination and introduction into the record of portions of their investigative testimony. The summaries that follow represent an effort to distill the essence of their testimony focussed on the questions noted above.

Graff testified that he and Padgett set Stuart-James' opening aftermarket bid and ask prices based on information received from the firm's vice-presidents as to selling and buying indications at various price levels. He testified that in terms of timing, the "actual hard information with regard to indications on which we determined the opening price level was received shortly prior to the opening of the stock." (Tr. 644). Graff explained that by "shortly" he meant half an hour or less. Padgett's testimony was to similar effect. Graff further testified that it was his practice, when asked a couple of days or less in advance of trading by a vice-president or manager as to his opinion of the opening bid and ask, to give his opinion or his "best guess." (Tr. 658). He insisted that he was more often wrong than right. Padgett testified that when asked before trading started on a new issue, he gave his opinion regarding a range of possible bid prices, but never gave an opinion as to a specific price.

As has been noted, Stuart-James' opening quotations for UMBE stock on March 17, 1986 were 1 1/2 bid and 2 1/4 ask. These prices coincided with figures given out by Graff at a regional vice-

presidents' or managers' meeting on Saturday, March 15. 31/ According to Graff's testimony, he told the attendees that he believed the market would open at "approximately around" those prices. (Tr.656). Graff testified that he could not recall whether he also gave anticipated prices for the warrants. It is clear that the estimated aftermarket opening ask prices for UMBE stock and possibly warrants changed upward more than once during the days preceding the opening of trading, presumably in response to indications of additional buying interest.

Jan Blair, who at the time of the UMBE offering was assistant manager of an Atlanta office and at the time of Find was manager, testified that in 1985 she was trained "in the opening of a new issue," and that she used the method that was taught in both of those IPOs. (Tr. 702). The system involved (1) selling the IPO securities to clients they felt would "work with the system" (tr. 706); (2) finding aftermarket buyers before trading began; (3) lining up crosses; (4) writing up tickets and giving them to the manager, still in advance of the opening of trading; and (5) calling the customers after the orders had been executed and encouraging the IPO customers to buy other Stuart-James securities with the proceeds. With particular reference to UMBE, Blair testified that she was given opening bid and ask prices several days before the effective date and passed them on to the sales agents so that they could solicit buyers and line up crosses. She

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31/ Graff testified it was a regional vice-presidents' meeting. Ward, a regional vice-president, testified that it was a managers' meeting.

further testified that in advance of the opening of trading she received tickets from the agents, complete with execution prices, and reviewed them, but that the ask price changed on Monday morning, before trading began, with the result that buy tickets had to be changed. Blair testified that customers were called only after the transactions had been executed. She testified that other IPOs, including Find, were handled the same way. 32/

Anna Snook, who was employed as a sales agent in the Albuquerque office from February 1986 to March 1987, testified that the prices given by Gibbs, the manager, at which the sales agents were to solicit aftermarket purchase indications of interest for UMBE stock, gradually increased from $1.50 to $2 to $2.50. According to Snook, on the night of Saturday, March 15, 1986, Gibbs called a meeting of the sales agents for the following morning. At the Sunday meeting, Gibbs wrote a series of numbers on the blackboard concerning the UMBE offering. Snook, who was in the habit of taking copious notes during office meetings, testified that her notes that are Division Exhibit 27 reflect exactly what Gibbs wrote on the board. As explained by Snook, figures under a heading "Crosses" represented the opening aftermarket prices for the common stock and the warrants. The figures were 1.50 and 2 1/4

32/ With respect to respondents' attacks on Blair's credibility, including the facts that at the time of her testimony she had pending a sex discrimination suit against respondents, and that there were a few discrepancies in her testimony during the four days she was on the stand, I am of the view, based in part on my observation of her demeanor, that she testified truthfully to the best of her ability.

for the common stock and 7/8 and 1 3/8 for the warrants. 33/ As previously noted, Stuart-James' opening NASDAQ quotations for the stock were 1 1/2 bid and 2 1/4 ask for the stock (the same figures written by Gibbs on the board); they were 7/8 bid and 1 1/2 ask for the warrants (compared to figures of 7/8 and 1 3/8 written on the board). Snook testified that at the Sunday meeting the sales agents prepared trade tickets using the above figures. She further testified that early in the morning of Monday, March 17, before trading opened, she called her aftermarket buying clients to tell them that the price had changed. 34/ While Snook testified that, as a novice in the securities business, she did not understand what was going on at the time of the UMBE offering, and that as of the time of her testimony "that time [was] very vague" to her (Tr. 2086), I be..ieve the above testimony, which in important respects

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33/ In 1987 investigative testimony, Snook stated that at the Sunday meeting, Gibbs wrote examples on the board, maybe as many as ten, "of how to cross and where your crosses were likely to run." (Tr. 2100). At the hearing, while stating that her answers at that time were truthful, Snook testified that the information reflected on Exhibit 27 was exactly what Gibbs put on the board for all sales agents, and that only later, after the more experienced sales agents had left, Gibbs, for the benefit of the newer agents, erased that information and put various "examples" on the board. (Tr. 2104).

34/ In her 1988 investigative testimony, Snook stated that on Monday morning Gibbs told the sales agents that the ask price had changed again, and that as a result the tickets prepared on Sunday had to be redone. At the hearing she could not recall whether the prices on the tickets had to be changed again on Monday, but stated that she "would have recalled it better" in 1988. (Tr. 1943).

is corroborated by other witnesses, to be essentially reliable. 35/

Kathleen McFadden, who was also a sales agent in the Albuquerque office for most of 1986, testified that she began soliciting aftermarket indications of interest from potential buyers about 10 days before the UMBE effective date, using a range of possible prices. 36/ She further testified that at the Sunday

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35/ Respondents contend that many of Snook's notes reflect her lack of understanding of what was going on around her and are therefore not reliable, and that she was unable to provide independent recollection concerning the circumstances under which the notes were written. (Padgett and Graff Proposed Finding 305). However, the only notes specifically cited by respondents are Division Exhibit 57. I agree that Snook erroneously identified Graff as the speaker when those notes were taken. However, there is no question that Division Exhibit 27 reflects material written on the blackboard by Gibbs.

Respondents make a broader attack on Snook's credibility, predicated on her asserted bias. That claim is based principally on the fact that she was fired and then filed a sex discrimination suit against Stuart-James and contacted this agency as well as other federal and state agencies with complaints against the firm. While it seems clear that Snook is not favorably disposed toward Stuart-James, based on my observation I believe that she conscientiously sought to testify truthfully. (Cf. Gilbert F. Tuffli, 46 S.E.C. 401, 404 n.12 (1976) (the fact that a customer is suing the respondent broker to recover money lost on his investment is no basis for rejecting his testimony)). It should also be noted that her notes were taken at a time when there was no question of bias.

36/ Padgett and Graff assert that McFadden and Deneen Cordova, another former sales agent in the Albuquerque office, met with each other before testifying to compare stories, and that I should therefore find that any corroboration they offer one another is the result of collusion rather than separate and independent recollections. However, there is no factual predicate for this argument. Each of these witnesses testified, in my judgment credibly, that she did not discuss her proposed testimony with the other, and McFadden, who testified after Cordova, further testified that she had no communication with Cordova after the latter's testimony about that testimony or the subject of her own testimony.

meeting, Gibbs wrote bid and ask prices for the common stock and the warrants on the blackboard, which were to be the opening aftermarket prices. When shown Division Exhibit 27, McFadden testified that if it was not exactly what Gibbs wrote on the board, "it's awfully close." (Tr. 6372). She further testified that the sales agents, who had already prepared tickets on Friday using prices of $1.50 for customer sales and $2 for customer buys, changed the buy tickets to reflect the higher price of $2.25. McFadden further testified that she believed that on Monday morning, Gibbs instructed the new sales agents to confirm aftermarket orders with customers, and that she did so.

Deneen Cordova was originally hired as a receptionist in the Albuquerque office in late 1985, then assumed clerical and back office functions prior to becoming a sales agent in October 1986. 37/ She testified that on Friday, March 14, she saw fully prepared aftermarket order tickets on the desks of the sales agents, with the crosses clipped together. When she arrived for work the following Monday, she heard sales agents stating that they had been called in for a meeting on Sunday because the price had changed, and that they had had to contact their clients and redo their tickets. She testified that at that point, before trading had

37/ Padgett and Graff assert that because Cordova was not a sales agent for much of her time with Stuart-James, including the time of the UMBE offering, she was less likely to have paid attention to matters involving sales agents, and that her testimony should be discounted accordingly. I base no findings concerning UMBE on Cordova's testimony except to the extent it is corroborated or reflects what she saw with her own eyes.

begun, the tickets were in Gibbs' office, fully made out and initialled by Gibbs.

Gibbs, who was still employed by Stuart-James at the time of his testimony, acknowledged that there was a strong possibility that Snook's notes (Div. Ex. 27) reflected what he had written on the board on March 16. However, he characterized the figures as "an example of possible projections" (Tr. 6047) and stated that he had given the sales agents "examples" using other figures on other days as well, which were to be used in soliciting aftermarket indications of interest. Gibbs further testified that he was advised by Nye and/or Sutton on Sunday morning that "these [numbers on Div. Ex. 27] might be parameters where the stock, in the event it opened, might open. These were to be used as guidelines, as examples, to our brokers." (Tr.6057). Gibbs also characterized the figures provided by Sutton or Nye as "estimates." He further testified that on Monday morning, before trading started, he had the sales agents call customers who had given them indications of interest to confirm that those indications were still good. He testified that if an indication could be "filled" when trading opened, it was viewed as an order and executed, and the customer was not called again until after execution. Gibbs maintained that while the sales agents filled out portions of order tickets on March 16, the boxes for execution price, strike price and commission were left blank. He also testified that it was his practice, which he shared with sales agents, to write on top of the ticket the dollar amount the customer was willing to invest and the

maximum price he or she was willing to pay. He denied seeing any tickets with execution prices on them before UMBE opened for trading or having tickets stacked in his office. He testified that once trading started the sales agents put the prices on the order tickets and brought them to him to be initialled. Gibbs admitted that he did not call his own UMBE customers once trading started until after their trades had been executed.

Richard Evans, who was a sales agent in registrant's Houston Post Oak office from September 1985 until July 1986 and then worked a few more months in another Houston office of the firm, testified that in UMBE, as in other new issues, his managers (in the Post Oak office his manager was Beaird) did not give the sales agents specific opening prices in advance of trading, but merely indications of where they expected the opening prices to be. He further testified that the indications were often wrong, but that "most of them were very, very close." (Tr. 7525). He did not solicit prospective aftermarket buyers in terms of specific prices, but in terms of a dollar commitment based on an approximate price. As in Albuquerque, Beaird held a meeting on the Sunday before trading in the UMBE securities opened, at which they "narrowed down where the price of these stocks was coming out." (Tr. 7447). It was his recollection that particular prices were discussed, although he could not recall what they were. Evans further testified as follows: He filled out his tickets in advance of the opening of trading, but not the spaces for execution and strike prices and commission. Because he could not be sure of the opening

prices, he did not fill in those spaces until trading began. He did not call his customers back until after the transactions had been executed. In that connection, Evans testified that the first day of aftermarket trading was a very quiet day in the office, at least for him, since he was not talking to his customers. "The way we were going to trade was pretty much . . . pre-arranged. Unless something totally out of the ordinary was going on with the stock, I didn't call them. Maybe I would call them . . . at the end of the day, but not while all this was going on, not when the stock came out." (Tr. 7440).

Beaird testified that in the UMBE situation he received no estimate of opening prices from his superiors, that with UMBE it was particularly difficult to anticipate the opening prices, and that he and the sales agents in his office solicited both potential sellers and buyers by giving them an estimated range and taking indications at different price levels. He disclaimed any connection between the Sunday meeting and Graff's increase of the estimated ask price the day before. According to his testimony, the meeting took place "[b]ecause we all had no idea where UMBE was going to open," and he and others at the meeting gave their estimates of opening prices. Beaird further testified that he wanted the sales agents to have their sell and buy tickets ready for opening day, filled out except for the prices, but noting dollar maximums and maximum price per share on buy tickets and minimum price on sell tickets. He also testified that he believed

he did call back customers who had given him indications of interest when trading opened.

Wilfred Lefebvre, who was a sales agent in the North Miami office at the time of the UMBE offering, testified that a week or so before the UMBE stock opened for trading, his manager (not a respondent) gave the sales agents a "range" of prices, but that on Friday, March 14, they were given specific prices of 1 1/2 and 2 and prepared order tickets based on those prices. According to Lefebvre, on Monday morning, before trading began, the sales agents were told that the ask price had been increased to 2 1/4, and they had to revise the buy tickets accordingly. Buy tickets received in evidence reflect an original execution price of 2 that has been crossed out and 2.25 substituted. (Div. Ex. 273). Lefebvre testified that he did not call his customers back before executing the buy orders, and that he could not recall whether he had given specific prices to them, but that it was his usual practice to mention a higher price than the expected ask so as to "look good" to his customers. He further testified that he obtained commitments from his customers to invest a certain amount, however many shares that turned out to buy. 38/

Jason Kates, who worked in the same office, testified that the sales agents received specific bid and ask prices for the UMBE

38/ Lefebvre acknowledged that he had told the staff of the Commission that he believed the penny stock industry "should be shut down." (Tr. 5910). While that could be taken as evidence of bias against respondents, it was my observation that his opinion on that subject did not color his testimony or affect his credibility.

stock the morning of the first day of trading, before trading began, and filled out the tickets at that time. He did not call his selling customers until after the sales had been executed.

Paul Joyce, a sales agent in the Boca Raton office at the time of the UMBE offering, testified that generally on IPOs the manager gave the sales agents specific bid and ask prices in advance of trading, and that the agents in his office generally prepared order tickets in advance. According to Joyce, the manager suggested using a higher figure in soliciting aftermarket buy indications so that the agent would then "look like a hero" when the purchase was effected at a lower price. As to UMBE, Joyce testified that because of the great demand "it was just total chaos when that stock opened." (Tr. 5746). And he indicated that in the UMBE situation the sales agents were not given specific prices in advance of the opening of trading. He did not fill out order tickets in advance. And in his investigative testimony, apparently inconsistently with his trial testimony, he stated that he reconfirmed indications of interest with his customers once aftermarket trading began before putting the orders through.

Ward, who as noted was vice-president for the Southeast region, which included the Boca Raton office, testified that on new issues, including UMBE, he gave ranges of bid and ask prices, but not specific prices, to the managers under him in advance of trading, and that these usually came from Graff. He further testified that he wanted the sales agents to solicit indications of interest, particularly buy indications, and that prospective

buyers were asked how much they would invest if the security could be obtained at a certain price or less. In addition, Ward testified that he expected sales agents to contact their customers when trading opened to confirm the indications, and that he did not want trade tickets made out in advance of trading.

Thomas Brasley was a sales agent in the Colorado Springs downtown office at the time of the UMBE offering, when Sutton was the manager and Sullivan the assistant manager. He testified as follows: Prior to the time trading began in UMBE, Sutton encouraged the sales agents to solicit buy and sell indications and to cross the securities when trading began. Sutton provided the agents with approximate bid and ask prices, which changed as the effective date approached. Brasley's IPO allocation was bought by only one customer. He asked this customer if he would sell out if a certain percentage profit could be achieved, using a figure below the approximate bid. In using this percentage approach, he emulated the approach he had observed Sutton and Sullivan using with their customers. On March 14, the Friday before trading began on Monday, he filled out sell tickets for the stock and warrants, but did not fill out the execution price because he was not sure what the prices would be when trading began. 39/ He did not call the IPO

39/ In its proposed findings, the Division cites Brasley as testifying that when he prepared the order ticket on Friday he filled out the execution price and left only the strike price and commission spaces blank. (Div. Proposed Finding 1711). Brasley did testify on direct examination that the sell tickets were complete with the exception of the strike price. On cross-examination, however, he acknowledged that he did not put the execution price on the tickets until (continued...)

customer after trading began, before selling both the stock and warrants on Monday. Brasley explained that he felt he had a limit order and therefore did not need to call the customer to confirm. He crossed the stock with another agent and net sold the warrants. Although he ultimately decided not to have his customers buy UMBE stock in the aftermarket, he had earlier solicited buy indications, using the approximate ask price given by Sutton and asking customers how much they would like to invest if the stock could be acquired at a price of x or better.

Robert Rada, who was also a sales agent in the Colorado Springs downtown office at the time of UMBE, testified in a similar vein as Brasley: In anticipation of every IPO, Sutton encouraged the sales agents to cross the IPO securities in order to maximize commissions. The only offering that was "a little bit different because we had so many changes in prices, right up to the time of trading" was UMBE. (Tr. 10223). Sutton generally gave the sales agents "ballpark" or estimated prices "where they felt the stock was going to trade on opening day." (Tr. 10224). In the case of UMBE Sutton successively gave the agents two or three "ballpark" prices reaching 1 1/2 bid and 2 1/4 ask by Friday, March 14. In talking to IPO customers about selling at the opening of trading,

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39/(...continued)
Monday. (Tr. 9755 and 9549). In fact, the order tickets that were received in evidence as Stuart-James Exhibits 199 and 200, which were apparently the sales agent's (Brasley's) copies, are blank in the space for "execution price." When asked about this, Brasley testified that "Denver"(presumably referring to the trading department) put in the execution price. (Tr. 9552).

he spoke in terms of a percentage of profit. And in talking to prospective aftermarket buyers, his approach was to ask them how much they wanted to invest if the securities could be bought at x price or less. The x would be higher than the anticipated ask price so that the agent would then "look like a hero." (Tr. 10247). With reference to the tickets, he filled them out in advance except for the execution prices which he filled in on Monday morning just before trading began. 40/ And he did not contact either selling or buying customers once trading began until after the trades had been executed.

Sutton, who was still manager of the Colorado Springs North Creek office at the time of his testimony, testified that prior to trading in any IPO, including UMBE, Nye gave him "guesstimates" of opening prices, which he passed on along with other estimates, but that it was up to each sales agent to figure out "what price they wanted to buy it up to, what price they thought their customers might want to buy it up to." (Tr. 8508). He testified that, based on the issuer's fundamentals and where they thought the price might go, each agent was to determine "whatever they felt that the price deserved to be." (Id.). Sutton testified that tickets with execution prices were not to be made out before

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40/ In fact, Rada's UMBE tickets, like Brasley's, have no price in the execution boxes. He testified that the sales agents did not put prices in the execution box and that "prices in the execution boxes if there were ever any entered were done by the trader within the office." (Tr. 10492). This reflects an unexplained inconsistency with his earlier testimony that he entered the execution price just prior to the opening of trading.

trading began, and that he expected the sales agents to call their customers for confirmation after trading began. With particular reference to UMBE, Sutton testified that he did not give any prices to anybody before the stock opened, and that he could not recall whether he gave any estimates of where it would open or what such estimates might have been. Sutton further testified that after trading began, the agents in his office called their customers to confirm indications, wrote out order tickets, brought those order tickets to him to initial and then brought them to the administrative assistant to call them in to trading.

According to Sullivan, who was assistant manager of the Colorado Springs office at the time of UMBE, as of the time trading began he had only a general idea as to which of his IPO customers wanted to sell and which of his customers wanted to buy in the aftermarket, and at what price levels, and that the execution price was not known until trading began.

At the time of UMBE, Meinders was a sales agent in a Denver office managed by Nye. He testified that Nye gave the agents specific bid and ask prices in advance of the opening of trading, and that these changed as the opening approached. He did not solicit any indications to buy UMBE securities in the aftermarket. To his best recollection, he prepared his sell tickets before trading began on Monday, March 17, using a price of 1 1/2 for the stock that the sales agents were given by Nye that morning. Once trading began, he did not contact his selling customers for confirmation, but had the sales executed based on an understanding

with them that he could sell if there was "a nice profit." (Tr. 11672-73).

Curtis Haderlie, a sales agent in the Greeley, Colorado, office at the time of UMBE, testified that he and his colleagues were given specific prices in advance of the opening of trading, but that in his dealings with customers he used a range of prices so that even if the price changed he could execute transactions on the first day of trading without calling them again. He testified that at an office meeting on Sunday, March 16, they were told that the projected ask price for the stock had increased from 2 to 2 1/4. Haderlie testified that he prepared tickets with execution prices on them at or even prior to that meeting. It was brought out that in his investigative testimony, which of course was closer in time to the events in question, he had stated that usually aftermarket buy tickets were prepared in advance, "everything except the price because you never knew for sure until it actually opened what the prices were going to be." (Tr. 7654). He reiterated, however, that in the UMBE situation, the tickets were completely filled out on March 16. He further testified that he did not contact his customers after trading opened until after the trades had been executed.

Alan Bovee, who was a sales agent in the same office as Haderlie, testified that at the Sunday meeting the manager wrote certain prices on a board. According to his recollection, the bid prices for stock and warrants were 1 1/2 and 7/8, respectively; on the ask side the manager gave ranges of 2 1/4 to 2 1/2 for the

stock and 1 1/2 to 1 3/4 for the warrants. Bovee testified that at the meeting the agents were instructed to prepare tickets and to turn them in to the manager. He further testified that in discussions with prospective aftermarket buyers, he did not give them a specific price and asked them to commit a dollar figure. Finally, he testified that on the opening day he called customers only after the trades had been executed. 41/

Turning now to the testimony of customer-witnesses who bought or sold UMBE stock or warrants on the first day of aftermarket trading, customer H.A. testified that he purchased 400 units in the public offering, and that Gibbs recommended he sell the warrants and buy additional stock when trading opened. On Friday, March 14, when Gibbs confirmed the purchase of the units, he told H.A. that the stock would be an excellent buy if they could get it at $2.50 per share or better and recommended a purchase of 40,000 shares. On the following Monday, H.A. authorized Gibbs to buy 40,000 shares at $2.50 or better. H.A. did not know whether trading had started at that time. The actual purchase price was $2.375.

41/ Padgett and Graff assert that Bovee was biased against Stuart-James and that I should be reluctant to credit his testimony. It is true that Bovee, like a number of other witnesses, was concerned about the propriety of certain of the firm's practices and that he contacted the Commission's staff shortly after UMBE began to trade to express his concerns. It is also true, as pointed out by respondents, that he was unhappy during his employment with Stuart-James and was not financially successful. These matters do not, however, compel a conclusion of bias. In my observation, Bovee was completely candid in his testimony. While he had some problems with recollecting the events of March 1986, in major respects his testimony is consistent with that of Haderlie.

Customer J.T., who was an UMBE IPO purchaser through both the Albuquerque office and one of registrant's Denver offices, testified that the agents in both offices established a "ground rule" at the outset that if they gave him IPO allocations that he wanted, he would have to follow the agents' directions as to when to sell. He further testified that on the weekend before trading in the UMBE securities opened, he was told by the agents that his IPO allocation, both common stock and warrants, would be sold at the opening of trading at specified prices. 42/ These proved to be Stuart-James' opening prices, and the sales were effected at those prices.

J.H., a customer of one of the Denver offices, was called by a sales agent on March 10 and told that the UMBE stock should open at $2 or less. At that time the customer committed to purchase $2,000 worth. According to the customer's recollection as well as his contemporaneous notes, the next contact was on March 18, when his agent called to say that UMBE stock had been purchased for J.H.'s account at $2.38 per share. Although the customer was surprised and expressed concern concerning the price, the agent assured him that it was still a good buy, and he "went ahead with my purchase." (Tr. 2514).

42/ J.T. initially testified that he was told the sale price for the units, but subsequently testified that he was not certain whether he was given a unit sale price or prices for the stock and warrants that comprised the units. As noted, Stuart-James did not deal in the units in aftermarket trading. Hence, I consider it probable that the prices given the customer related to the shares and warrants separately. This is also consistent with statements in an affidavit executed by J.T. in 1988. (Padgett and Graff Ex. 44).

Customer D.M., who dealt with another Denver office, testified that he contacted a sales agent on March 7 concerning a possible purchase of UMBE stock. According to his testimony, the agent told him that he thought the price would be $1.50 per share. On Friday, March 14, the agent told D.M. that he thought trading would begin the following week, and that the price would be $2.25. They discussed the customer's sending a check in payment, and he decided to send in $7,000 which they figured would more than cover 3,000 shares. The following week, the agent advised D.M. that he had bought 3,000 shares for D.M.'s account at 2 3/8 and that the customer needed to send an additional check for $130.

W.T., a customer of one of the Denver offices at the time of UMBE, made out a check for $25,000 to Stuart-James on March 9 for the purchase of UMBE stock. He testified that the sales agent indicated at that time that the stock would open between $2 and $2.50 per share. On March 17, 10,500 shares were purchased for his account at $2.375. It was only later that the agent called him to tell him of the purchase.

J.Z., a customer of the Boulder, Colorado office, testified that on March 4, he was told by a sales agent that he could buy UMBE stock at $2.50 per share. When J.Z. balked at the price, the agent said he could have the stock for $2.38. He thereupon sent in a check for $1,250. The purchase was made at $2.38 without further contact.

Customer C.D. testified that as a result of being solicited to buy UMBE stock on March 8, she sent a check for $1,500 to

Stuart-James that day. The sales agent told her that the price was $2.50 and that the amount she was investing would buy 600 shares. She testified that he led her to understand that the purchase was made at that point. The purchase was in fact made on March 17, at the $2.50 price, without further communication between C.D. and the agent.

Customer R.G., who dealt with the Houston branch office, was solicited to buy UMBE stock on March 6 or 7. He testified that he agreed to buy 650 shares at $2.25 a share and he sent in a check for $1,500. The next communication he received from Stuart-James was the confirmation of a purchase on March 17. With reference to the difference between the amount of his check and the purchase price of his shares ($1462.50 plus a $5 fee), R.G. acknowledged that it was possible that the sales agent had been unable to give him an exact price for the stock before it opened for trading or said that the stock would be in "the $2.25 range." (Tr. 7376-77).

R.T. spoke with a sales agent from the Boca Raton, Florida office on March 6 concerning a purchase of UMBE warrants. He was told that the minimum investment was $500 and that this would work out to about 300 warrants at about $1.50 each. R.T. delivered a $500 check to another Stuart-James office that day. The purchase of 300 warrants was effected at that price on March 17, leaving a credit balance of $45 (after the $5 service charge).

J.C. bought 200 units on March 14 through the manager of the Boca Raton office. He testified that to obtain the units he had to agree to sell the stock and warrants as soon as trading began.

The stock and warrants were in fact sold on the first day of trading for $1.50 and 87 1/2 cents, respectively, without the customer having been called to confirm. While J.C. at first testified that the manager had told him on March 14 that he would get $1.50 a share for the stock part of the units, he acknowledged that the manager may have referred to a range of $1.40 to $1.50. He insisted, however, that as the outcome of their conversations and by the time he agreed to buy the units, he was certain that he was going to get $1.50.

I turn now to Find. As noted, the registration statement became effective on Friday, October 31, 1986, and trading began the following Monday, November 3. Undated notes taken by Snook at a sales agents' meeting in the Albuquerque office that she testified took place on October 14 or 15 reflect that Lasek, at that time the manager, gave the following figures to the agents concerning Find: "3/32 x 5/32 open, 1/8 x 3/16, 5/32 x 7/32." (Div. Ex. 58). Snook testified that the first set of numbers represented the anticipated opening price of the warrants, the second set the anticipated opening price of the common stock and the third set the anticipated first uptick on the stock. She went on to testify that based on these numbers, she "set up [her] aftermarket buyers" as well as the sales by the IPO customers. (Tr. 1693). She testified that in soliciting aftermarket buyers based on the figures that Lasek gave, she rounded fractions off and spoke in terms of 18 cents or, where she wanted to sell at the first uptick, 25 cents or better. She further testified that she filled out order tickets completely

several days before the Find securities opened for trading, and that the transactions were subsequently executed at the prices written on the tickets. Finally, she testified that she did not call her aftermarket customers on the first day of trading until after the transactions had been executed. Investigative testimony given by Snook in 1987 raises serious question, however, as to the date of the meeting in which Lasek gave out the above figures as well as concerning the meaning of those figures. Thus, Snook testified at that time that (1) the notes were taken the day before Find opened for trading and (2) the first set of figures represented the opening prices of the stock, the second set the opening prices of the warrants and the third set another possible set of opening prices for the stock. As she put it at that time, "they didn't know if they were going to open it [the bid] at 5/32 or 3/32." (Tr. 2173). She added that by that night, "I would have had exact prices." (Ibid.). On the question of the date when Lasek gave out the figures, Snook indicated that she was clearer at the time of the hearing in 1989 than in 1987. As to the meaning of the figures, the investigative testimony lends some support to respondents' contention that the three sets of figures, the second and third of which each involved an increase of 1/32 on both bid and ask sides, represented different possible opening quotations for the Find common stock.

According to Cordova, who was in the same office, Find was the first issue that commenced trading after she became a sales agent. She testified that Lasek gave out prices of 12 1/2 cents (1/8) and

18 3/4 cents (3/16) for the stock (which proved to be the opening quotations) before trading began and showed how he wanted the crosses set up. She was insistent that Lasek put only one set of prices, not three possible scenarios, on the board, and she further testified that the sales agents prepared their tickets in advance of trading.

Dirk Tinley, a sales agent in the Albuquerque office from May 1986 to January 1987, testified as follows: Several days before the effective date of the Find registration statement, Lasek instructed the agents to solicit aftermarket buyers and to prepare order tickets, including execution prices which Lasek had provided. In the case of the Find stock those prices were 1/8 bid and 3/16 ask. Lasek also showed the agents that the crosses would be priced at 13 cents bid and 18 cents ask. When Lasek gave prices in advance of trading for Find as well as other securities, he said that they were not "etched in stone," (tr. 3879), but inevitably the securities opened at the prices he gave.

Lasek denied that he ever gave the sales agents only one projected bid or ask for a particular security. With reference to Find, he testified that he gave them three different sets of prices, including 1/8 by 3/16 for the stock. Lasek testified that as one of several examples he told the agents that a cross could be 13 by 18. Lasek insisted that he required the agents to call their customers on the first day of trading, after trading began, to reconfirm the transactions and that he did not expect them to prepare tickets in advance of trading.

Evans, who had transferred to another Houston office by the time of Find, testified that the sales agents received indications of where the securities would open, but that the prices were not "carved in stone," although they were very close to the actual opening prices. (Tr. 7481). Evans added that based on the record of earlier offerings, "it was kind of easy to figure where the aftermarket would be and you're going to be off maybe 1/32." (Ibid.).

Lefebvre, who worked in the North Miami office, testified that in advance of trading the manager gave the agents specific prices where the securities would open.

At the time of Find, Brasley was a sales agent in the Colorado Springs North Creek office, to which Sutton had also moved as manager. On direct examination, Brasley testified that at a meeting that took place a week to ten days before the effective date, Sutton gave the agents "an approximate price of where the stock would open." (Tr. 9277). It was his recollection that Sutton gave prices of 12 3/4 cents bid (not 12 1/2 cents as stated in the Division's Proposed Finding 1991) and 18 3/4 ask. However, his testimony on cross-examination and his investigative testimony indicate that he was in California preparing to open another office at that time and that he got those numbers from another Colorado Springs agent shortly before trading began.

Rada, who was also in the North Creek office at the time of the Find offering, testified that although he could not recall the

prices, the Find stock traded at the exact prices that Sutton had given the sales agents in advance of trading.

Alice de la Torre, who was a sales agent in the Colorado Springs downtown office, testified that Sullivan, who was manager at the time of Find, gave the sales agents indications of where he thought the stock would open, on both the buy and the sell side, and that she used the indicated ask price in soliciting an aftermarket purchase. Her testimony does not indicate the prices given by Sullivan, but she testified that she believed the indicated ask price was higher than the actual opening price. De la Torre further testified that Sullivan indicated the price indications were coming from Nye or Sutton, and that it was her general practice (1) to prepare aftermarket tickets in advance of trading, but without the execution price which she filled in when the security started trading, and (2) once trading began, to contact aftermarket customers only after the market had closed on the first day of trading.

Sullivan testified that in Find, as with other IPOs, he gave the sales agents in his office his guesses as to what the opening prices would be. He also insisted, among other things, that it was the customers who suggested prices at which they would be interested in selling or buying and not the sales agents, and that the agents were instructed not to pass on price estimates to customers. Sullivan also denied that he ever encouraged sales agents to have IPO buyers sell out when trading opened or that he stressed crossing.

At the time of Find, Meinders was assistant manager of a Denver office. He testified that the aftermarket tickets, including execution prices, were in the manager's office several days before trading began. He further testified that a day or so before trading began, the tickets for the stock were changed because the projected bid and ask prices had gone up to 1/8 bid and 3/16 ask, and that subsequently tickets that were part of crosses had to be further redone to reflect the 5% premium and discount, respectively, under the new pricing policy.

Michael Czaja, manager of the Pompano Beach, Florida office for about a year beginning in April 1986, testified that he did not specifically recall the events surrounding the opening of trading in the Find securities. However, he testified as follows concerning the general practice while he was manager: A few days before trading began in a new issue, Ward gave him a range of possible opening prices both for the bid and the ask, which he passed on to the sales agents. These ranges proved to be invariably accurate. Potential sellers and buyers were asked if they wanted to sell or buy, respectively, if the security opened within that range. When the security in fact opened within that range, the trades were executed when trading began, and the customers were called afterwards. To the extent agents prepared order tickets in advance of trading, he instructed them not to put prices on them, because those were not known until trading began. As many as possible of the aftermarket trades were executed at the opening prices.

When the Find offering took place, Haderlie had transferred to the Salt Lake City office, where the manager's name was Benjamin Croxton. According to Haderlie's testimony, the sales agents were given specific prices in advance of the opening of trading.

Croxton, a defense witness, testified that everyone in the office had his own guess as to opening prices, that he did not discuss the subject with any superiors, and that his own estimates proved to be totally inaccurate. He further testified that sales agents in his office never filled out order tickets in advance of trading.

Testimony was also taken from several persons who bought or sold Find stock or warrants on the first day of aftermarket trading. C.B. testified that on or about October 10, 1986, he was told by a Stuart-James sales agent in Colorado Springs that he could buy 3200 shares of Find stock for $600, or $.1875 per share; he agreed to do so. Since he had a credit balance in his account, the agent told him to send in a check for $500, which he did. The next communication was a confirmation that C.B. received on November 11 and that showed a purchase at the above price.

About October 21, a sales agent in one of the Denver offices recommended the purchase of Find stock to G.B. at 22 cents per share. A week later, G.B. gave the agent a check for $2,205 (including a $5 service charge) to cover the purchase of 10,000 shares. The transaction was actually executed at $.21875 on November 3.

G.D. testified that on October 28 or 29 he made a payment of $1,000 to open an account with the Albuquerque office, following discussions with an agent in which the agent had indicated a price of around 18 cents and that the customer's investment would buy 5,000 shares, with something left over. The 5,000 shares were in fact purchased for G.D.'s account on November 3 at 18 cents per share.

On October 24, customer D.D. was offered Find stock at 22 cents per share by a Denver sales agent. He sent in a check for $2,200 to purchase 10,000 shares. On November 3, 10,000 shares were purchased in his account at .21875 per share. D.D. testified that he was not contacted by anyone from Stuart-James on November 3 to confirm that he still wanted to buy the shares at the specified price.

R.H. testified that a sales agent from the Boca Raton office told him on October 15 that the price of Find stock was approximately 18 1/2 cents per share. The customer sent in a check for $1,505, figuring that that would buy between 7,500 and 8,500 shares. The next communication he had from Stuart-James was when he received his November statement, which showed a purchase of 8,000 shares at 18 3/4 cents.

On or about October 20, a sales agent in the Albuquerque office, in discussing Find with M.P., told him that he expected the stock to come out at around 16 cents per share. M.P. sent in a check for $1,605, as payment for 10,000 shares. According to M.P., the next communication he had from Stuart-James was a confirmation

showing the purchase of 9,000 shares at 18 cents per share, on November 3.

Customer J.S. testified that a few days prior to the beginning of aftermarket trading, a sales agent in the Pompano Beach office told her that the price of the Find common would be 18 3/4. She sent in a check in payment for 10,000 shares. After the transaction was executed at the above price, the agent called to say that the stock had been purchased.

According to customer D.W., on October 22 a Denver agent quoted him an estimated price of 15 to 18 cents per share for Find stock, and on October 27 he quoted a price of 18 3/4. He sent in a check that day, and 10,000 shares were purchased in his account at that price.

Conclusions

I return now to the factual issues set forth at the beginning of the preceding section, in order to make further findings, based on the testimony summarized above and other record material, with respect to those and related issues.

On UMBE, the preponderance of the evidence is that by March 16, 1986, the day before trading in its securities began, the definitive opening prices had been determined by Graff and Padgett and that by that day or at the latest by early the next morning, before trading began, they had been communicated to the managers throughout the firm and by them to the sales agents. 43/ While the

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43/ Respondents contend that because the Snook notes (Div. Ex. 27) of the Sunday, March 16 meeting in the Albuquerque office (continued...)

record is less clear in the case of Find, the evidence again preponderates in favor of the conclusion that, at least with respect to the common stock, 44/ sales agents in a number of offices received from their managers, well in advance of trading, specific prices which were equal to the opening quotations. As is evident, on these points I have given more credence to the former sales agents' testimony than that of the respondents or of Croxton, who simply did not strike me as credible. 45/ Padgett and Graff point out that in the case of Find there is no direct evidence that

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43/(...continued)
show that the ask price for the warrants was given as 1 3/8 rather than the actual opening ask of 1 1/2, it indicates that the prices given to the sales agents were still estimates and is inconsistent with the Division's argument that Gibbs had received fixed opening prices. I agree with the Division, however, that the fact that one of four prices was slightly off is equally consistent with the possibility that that price was incorrectly transmitted.

44/ The record is essentially devoid of evidence concerning prices at which transactions in the Find warrants were solicited. As previously indicated, the bulk of the warrant transactions was executed at or near the opening quotations on November 3. However, those were the quotations of another dealer, and Stuart-James' initial quotations were at a higher level. Assuming that the warrant transactions were solicited at or about the prices at which they were subsequently executed, that course of dealing does not fit the Division's theory that Stuart-James solicited aftermarket indications at arbitrary prices and then selected opening quotations consistent with those prices.

45/ It is my impression that the respondent managers and Ward considered it to be against their interests to admit that they passed on specific aftermarket prices to the agents under them. In this connection, I note Ward's testimony that it was brought to his attention that "the SEC was concerned with a specific price on a specific security," and that as a result he instructed managers under him not to use specific prices in connection with soliciting aftermarket indications of interest. (Tr. 4374).

either one gave "estimates of possible opening prices" to anyone. (Padgett and Graff Brief at 45). They also note that "the evidence is equivocal as to whether [they] were even in the country" at the time Find opened for trading. (Ibid.). However, even if they were away at or around the time Find opened, 46/ there is no indication that they could not and did not determine the opening prices.

It is true that in some offices the prices that were given out were characterized by the managers as estimates or approximations. In those instances, however, the opening prices were generally equal to the prices given. And the only consequence was that agents in those offices, unlike agents in offices where the manager did not hedge, did not fill in the execution prices until trading began.

The testimony of customers J.T. and J.C. (in the case of UMBE) and customers C.B., J.S. and D.W. (in the case of Find), and possibly a few others, lends support to the above-stated conclusions. They were quoted specific prices in advance of trading, and transactions were effected in their accounts on the first day of trading at the prices specified. The testimony of the other customers is inconclusive. For example, most of the other UMBE customers were contacted by, or spoke to, Stuart-James agents between March 4 and March 10 concerning the aftermarket purchase of UMBE stock or warrants. The prices for the stock quoted to them ranged from $2 or less to $2.50. While some of these customers

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46/ Blair's testimony which respondents cite is to the effect that Padgett and Graff were in England but flew back on the weekend before aftermarket trading began.

were given specific prices, in some instances the exact prices at which stock was subsequently purchased for their accounts, those were not prices at which the stock was projected at that time to begin trading.

As previously noted, the testimony of the former sales agents indicates that they commonly did not quote a specific price to prospective aftermarket buyers, but asked for a dollar commitment if the agents could get them the security at a specified price or better. The specified price was often higher than the anticipated ask price, to allow for possible price changes before trading began or to enable the agent to "look like a hero" when the purchase was effected at a lower price. Thus, even if, as respondents claim, customers were approached in terms of estimates or price ranges, this is not at all inconsistent with the agents having been given specific prices by their managers in advance of trading. For the same reason, I do not attribute significance to the fact that sums remitted by customers in advance of trading were often not in the exact amount of their purchases, leaving them with credit or debit balances. Because of the way they were solicited, it was natural for customers who paid in advance to send in a round amount to buy whatever number of shares or warrants the amount would cover when trading began.

The evidence is overwhelming that customers were not called back on the opening day of the aftermarket before transactions were executed in their accounts. Almost every former sales agent and every customer who testified on the subject testified to that

effect. The agents considered that there was no need to call back, on the theory that customers had given them limit orders or that it was otherwise within the scope of the authorization given by customers to execute orders for them. The Division cites as further support the fact that Stuart-James' initial quotations remained the best for only a brief time, in the case of UMBE stock for little more than a minute, arguing that it would have been physically impossible for the agents to call the many customers to confirm orders within that time. Respondents, on the other hand, assert that because of the large number of Stuart-James' sales agents, this was not an impossible task. Respondents also assert that it would have been perfectly proper for agents to confirm indications of interest once the registration statements became effective on the Friday before trading opened and to take firm market orders or limit orders at that time.

The argument about the time available for reconfirmation on opening day loses much of its impact when considered in light of the fact that, as noted below, transactions were executed at Stuart-James' opening quotations long after those quotations were no longer in effect. With reference to the argument concerning possible reconfirmations between the effective and opening dates, it is likely that in UMBE, where the opening ask price for the stock was increased on the weekend, firm market or limit orders were taken from some buying customers who were contacted again as a result of the price increase. There is no evidence whatever to support this thesis with respect to UMBE stock sellers or with

respect to UMBE warrants or Find stock or warrants. Clearly, when trading began, the trades were executed without further contact with customers. 47/

Reference has already been made to the fact that the "faxing" system used in UMBE at the opening of trading substantially delayed execution of orders. Despite the fact that the best bid and ask quotations changed during this time, Stuart-James executed a huge number of transactions at the opening quotations. There is also evidence in the record, with respect to aftermarket trading in Stuart-James IPOs generally, that trades which had been arranged to be crossed when trading opened were executed at Stuart-James' opening quotations even if the "box prices" (the best NASDAQ quotations) had moved bv the time the trades were executed. (See, for example, Ward's tescimony at Tr. 4397, Geman's testimony at Tr. 12451-52 and Tinley's testimony at Tr. 3921-22).

I turn now to the conclusions that follow from the findings previously made. The Division originally took the position that Stuart-James not only created and controlled an artificially priced internal market, but dominated and controlled the entire first day trading market in the UMBE and Find securities. (See, e.g., its Brief at 24). Respondents addressed their arguments largely to

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47/ Padgett and Graff point out that according to notes taken by Blair at a national managers' meeting on December 13, 1986, subsequent to the UMBE and Find offerings, Graff said, "make sure broker contacts clients on opening day to reconfirm that client does want to buy this aftermarket stock." (Padgett and Graff Ex. 4). Graff testified that this had always been the firm's policy, while Blair testified that it was a new policy. Even if it was an existing policy, however, the record shows that the agents did not abide by it.

this contention and argued, with some justification, that Stuart-James, while it may have dominated the UMBE and Find markets on the first day of trading, did not control those markets. 48/ The Division subsequently receded from its broad position, urging that the interdealer market was irrelevant and that the focus should be on the internalized market in which pre-arranged trades were executed. (See e.g., Reply Brief at 5-6). I agree with the Division that at least as to the UMBE securities and the Find stock, 49/ Stuart-James created an internal market insulated from normal market forces and dominated and controlled by it. 50/ The opening prices were pre-arranged, and the transactions were simply

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48/ Respondents' arguments focussed on the entire first day of trading. Those arguments are much less persuasive, however, if the focus is limited to the first hour or so of the aftermarkets when the crossed trades were being executed. The domination and control cases cited by respondents do not deal with analogous circumstances. It should also be noted that, contrary to respondents' assertion, Stuart-James did initiate several price changes in the UMBE securities. (See supra, note 22). Hence, respondents' reliance on the asserted absence of what they characterize as a primary indicium of control is not well grounded.

49/ With respect to the Find warrants, see supra, note 44. While it seems unlikely that these securities were treated differently from the others discussed in the text, the record is simply inadequate to make findings concerning preparation for trading them.

50/ Respondents are not aided by the testimony of Padgett and Graff's expert witness, Daniel Fischel, a renowned authority in the application of economics to legal and regulatory problems. As part of his testimony concerning the economics of IPOs, Professor Fischel testified, among other things, to the normality of the premiums, spreads and volume of trading of the UMBE and Find securities on the first day of trading and the undesirability of denying a sole or dominant market maker the same spread as other market makers. He did not address the kind of internal market that existed here, which was not only dominated but controlled by Stuart-James.

executed at those prices when aftermarket trading began. That is not to say that prices were plucked out of the air or were completely unresponsive to forces of demand and supply. Indeed, as noted, in UMBE the projected opening prices were increased more than once in apparent response to an indicated heavy demand. And the Division itself has argued that Padgett and Graff "decided opening prices in an effort to match buying and selling indications." (Reply to Padgett and Graff Proposed Finding 111). The fact remains that there was no market when the prices were established. Analytically, the case is no different than if the transactions had been executed the day before the market even opened.

This is, as far as I can determine, a case of first impression. But the principle that a dealer who dominates and controls the wholesale market for a security must compute markups on the basis of contemporaneous cost applies with even greater force in the present setting. 51/ Here, the only contemporaneous

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51/ Padgett and Graff assert that to the extent customer purchases were not completed because of the "faxing debacle" before Stuart-James' opening ask price for the UMBE stock changed, the customers got a better price than the prevailing market price. Specifically, they assert that, "far from charging the buy-side customers an impermissible markup," some of the purchasers who paid $2.25 in fact got a lower price than other dealers were paying in interdealer trades at the same time. Even if factually correct, this argument would have no bearing on the size of the markup. It does not appear to be factually correct, however. The record shows that the best ask quotation was initially lowered, not increased. It remained below 2 1/4 for several minutes and later that morning was again lower for about 44 minutes. Moreover, the best bid quotation went up steadily and was above 2 almost the entire day.

cost to which reference can be made is the cost in Stuart-James' retail purchases. As noted, the firm's only wholesale purchase of UMBE stock on the first day of trading took place after noon; it made no purchase of either of the Find securities; and the price at which the UMBE warrant purchase was effected was an aberration.

My conclusion that markups should be computed from the firm's retail cost further rests on the finding that the crossed transactions were, as the Division contends, riskless principal trades. As the Commission pointed out in a recent decision, when a firm buys only to fill orders already in hand and immediately "books" the shares it buys to its customers, as was the case with the cross trades here, it does not risk its capital and provides no liquidity to the interdealer market. (Kevin B. Waide, 51 SEC Docket 323, 328). Those statements were made with respect to a dealer which was not a market maker. Respondents take the position that by definition a market maker is always at risk and therefore cannot effect riskless transactions, pointing to the exclusion of market makers from the confirmation disclosure requirements of Rule 10b-10(a)(8) under the Exchange Act (17 CFR 240.10b-10(a)(8)). However, as urged by the Division, Rule 10b-10 only relates to disclosure. And, as discussed below, the Commission has in fact indicated that there is no inherent inconsistency between being a market maker and engaging in riskless transactions.

Rule 10b-10 requires a dealer other than a market maker engaging in a riskless principal transaction to disclose in

confirmations the amount of any markup or markdown. 52/ In its release accompanying the adoption of amendments to Rule 10b-10 which among other things added the disclosure requirement for riskless transactions, the Commission explained the exemption of market makers from this requirement on the basis that inclusion of market makers might create substantial compliance problems for them, in determining whether a particular set of transactions constituted riskless principal trades. More recently, the Commission, in explaining the exemption of market makers from a portion of Rule 15g-4 under the Exchange Act (17 CFR 240.15g-4), one of the "Penny Stock Disclosure Rules," requiring pre-transaction disclosure of the dealer's compensation in riskless transactions, relied on the same reasoning. (Securities Exchange Act Release No. 30608 (April 28, 1992), 51 SEC Docket 557). As the rule was originally proposed, it provided no such exemption. (Securities Exchange Act Release No. 29093 (April 25, 1991), 48 SEC Docket 1168). 53/

52/ The rule does not use the term "riskless transaction," but refers to a situation where a dealer, after having received an order to buy from a customer, purchases the same security from another person to offset a contemporaneous sale to such customer, or vice versa. That description fits the crossed trades in this case.

53/ Stuart-James points to Professor Fischel's testimony to the effect that crossing of stock is part of a market maker's normal function of linking buyers and sellers. Moreover, Professor Fischel compared the market maker's function in crossing stock to that of a real estate broker in finding a buyer for a seller. He noted that the broker is not making an investment, but is still performing a valuable service. That description also fits a riskless transaction.

In Meyer Blinder, supra, 52 SEC Docket at 1451 n.39, the Commission pointed out that matched customer sell and buy orders present very limited market risk to the dealer because it does not hold the securities in inventory. There is also pertinent language in an 1981 NASD markup decision that Padgett and Graff themselves cite, though for other reasons. In a proceeding against Blinder Robinson, Padgett and others, a District Business Conduct Committee noted that the Blinder firm, which was a market maker in a security, engaged in offsetting buy and sell transactions submitted at the same time by the same representative. 54/ In language that applies equally well to the instant facts, the Committee noted that "in such instances there is no apparent element of risk to the [dealer] which could justify it in taking a market-maker's spread on those transactions." (Committee Decision at 14). The Committee went on to hold, however, that because Blinder Robinson held itself out as a market maker and carried significant inventory positions, it was "in an overall risk position" which entitled it to take a market maker's spread on all principal transactions. In my view, the Committee was right when it found an absence of risk. Its explanation for backing away from this position in its conclusion is not persuasive. 55/

54/ District Business Conduct Committee No. 3 v. Blinder, Robinson, & Co., Inc.,et al., Complaint No. D-465, October 13, 1981.

55/ In explaining the policy under which customers in a cross trade got a better price, Geman stated that this was because "the transaction had more of a riskless nature to it than a straight purchase or a straight sell." (Tr. 12394). He added, however, that in his view a market maker was always at risk.

As noted, the Division has another theory with respect to the Find securities, namely, that Stuart-James was not a market maker until it entered its first quotations for the stock and warrants at 11:03 and 11:12, respectively, and that many tickets for retail transactions were time stamped before then. At that point Stuart-James was not a market maker. Respondents, on the other hand, citing Division Exhibit 6, the NASD's Market Maker Price Movement Report, assert that Stuart-James applied for and was granted market maker status for Find common stock even before the NASDAQ system opened at 9:30. That Report shows, at the time the firm first entered quotations in NASDAQ at 11:03, a time of 9:28 under the heading "Time of Last Update Entry." Respondents can point to nothing comparable with respect to the warrants, where the earliest time referred to under that heading is 11:10. Division counsel explained on the record, and Geman (the witness at the time) agreed, that this type of entry meant that at the earlier time Stuart-James "enter[ed] on the screen in . . . name only," i.e., without submitting quotations. (Tr. 12446). Whether this is equivalent to being "granted market maker status" is not clear to me. It does seem to me that a firm is a market maker for markup purposes only when it is actually acting as such (with the attendant risks) and that its status as a market maker does not depend on whether NASDAQ may have conferred "market maker status." 56/

56/ See Century Capital Corp. of South Carolina, Securities Exchange Act Release No. 31203 at 3 n.5 (September 17, 1992), 52 SEC Docket 2023, 2025 n.5: "In order to be treated as a marketmaker for markup purposes, a dealer must be engaged in (continued...)

However, the evidence concerning the time when retail transactions were executed is simply not clear. With reference to the tickets referred to by the Division in note 190, page 62 of its brief, in most instances the trading copies of the tickets have a different and much later time stamped on them than the branch office or agents' copies to which the Division points. That may be the time when the transactions were actually executed. Even some of the branch office or agents' copies have different times stamped on them.

Padgett and Graff have called my attention to certain Commission decisions issued since they filed their brief, two of which deal with issues of markup computation. However, I cannot find in these decisions the support for their positions that respondents claim to find. Kevin B. Waide, 51 SEC Docket 323, involved a dealer that engaged in riskless principal transactions in 1983. The NASD, in finding that the dealer's markups were excessive, used contemporaneous cost as the basis for its computations. On appeal, the Commission found that there was countervailing evidence demonstrating that the current market price was higher, and it accordingly set aside the NASD's findings. It went on, however, to enunciate a new approach to determining the propriety of markups in retail sales on a riskless principal basis. The Commission pointed out that a riskless principal transaction

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56/ (...continued)
actual wholesale trading activity in the security in question, *i.e.*, regularly or continuously buying the security from other dealers at or around its bid quotation and selling it to other dealers at or around its ask quotation."

is "the economic equivalent of an agency trade," since "a firm engaging in such trades has no market making function" and essentially "serves as an intermediary for others who have assumed the market risk." It held that "for this limited role, a firm is adequately compensated by a markup over its cost." The Commission went on to hold, however, that the language of the NASD's Mark-Up Policy did not sufficiently put applicants on notice that the prices charged would be improper. 57/ Hence, the new approach would only be applied prospectively.

Padgett and Graff urge that the decision is important because (1) it "illustrates the importance of the Division's error" in referring to the trades at issue in this case as "riskless principal" trades rather than as trades by a market maker, and (2) it demonstrates that markup law and regulations in 1986 were uncertain and did not give respondents adequate notice of what was proper. However, in my view respondents are not aided by Waide. For the reasons already stated, in the cross trades Stuart-James was not acting as a market maker and was in fact engaged in riskless principal trades. Its role as a market maker was separate and apart from its role in these transactions. The Commission's comments in Waide regarding uncertainty of markup law related only to the specific issue addressed there.

57/ The Commission noted that not only did the NASD Mark-Up Policy include language from which it could be concluded that a market price test would apply even to riskless principal transactions, but that dicta in Commission opinions appeared to confirm the implications of the NASD's language.

The other recent decision dealing with markup computation, also on appeal from an NASD decision, is Meyer Blinder, 52 SEC Docket 1436. There is no need to set out the facts of the case. Padgett and Graff point to the Commission's statement that "prevailing market price" is "the price at which dealers are willing to, and do, buy and sell securities." They assert that in this case, large amounts of interdealer trading in the UMBE and Find securities occurred at or about the NASDAQ ask price, the same price at which Stuart-James retail customers purchased the securities during first-day aftermarket trading. From this factual premise these respondents conclude that the retail purchases occurred at the prevailing market price, not at an impermissible markup. The record, while reflecting the prices of interdealer transactions, does not indicate, other than for Stuart-James, the times of those transactions. Moreover, the characterization of interdealer trading as involving "large amounts" is arguable. Even accepting the premise, however, the critical market here was the internal, pre-arranged retail market. For that reason, another argument that respondents base on Blinder is also beside the point: that is the argument that the factors that led the Commission in that case to find that the dealer controlled the market lead to the opposite conclusion here. It merits noting, however, that language used by the Commission to explain "control" fits the nature of the internalized market here: "A firm that controls a market exercises a substantial influence over the price of the stock such that, as

a practical matter, the firm, and not competitive market factors, determines the price of the stock." (52 SEC Docket at 1441 n.15).

I further find that the excessive markups were undisclosed. As the Commission said in the Blinder case, "[a]dequate disclosure must provide a public customer with sufficient information to make an informed decision about whether to buy . . . securities at the dealer's price." (Id. at 1460). Clearly, no such disclosure was made here. Graff testified that it was firm policy to advise customers of inside bid and ask prices and of the fact that "a mark-up or a mark-down commission" was built into the price, but that sales agents should not volunteer information concerning the commission on a particular transaction and should "not necessarily" disclose inside prices. (Tr. 666-69). Respondents do not even contend, however, that any of the customers who bought UMBE or Find securities on the first day of aftermarket trading were told the prices at which Stuart-James had acquired those securities on the other side of crossed transactions. While some customers may have been advised of bid and ask quotations and were thus made aware of the loss they would sustain upon an immediate resale, none was advised that the very large spreads also reflected the firm's markups. Although it is not necessary to decide the point, even such disclosure might not have been adequate. While the case of Norris & Hirshberg, Inc., 21 S.E.C. 865 (1946) is factually distinguishable, language used in the decision is applicable here as well:

> Each of respondent's sales carried with it the clear - though implied - representation that the price was

> reasonably related to that prevailing in an open market (citations omitted). Without disclosure fully revealing that the 'market' was an internal system created, controlled, and dominated by the respondent that representation was materially false and misleading.

(Id. at 882).

The remaining questions on the markup issue relate principally to scienter and to the basis for imposing responsibility on Padgett and Graff. It is well established that scienter must be found as a predicate to finding 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, while no such finding is required to find a violation of Sections 17(a)(2) and (3) of that Act. Padgett and Graff contend that they cannot be found liable for primary violations of the above antifraud provisions in connection with the markup charges, since they are not charged with selling their own securities and had no contact with customers. Accordingly, it is argued, their liability, if any, must be predicated on an aider and abetter theory. And, as they correctly point out, the Commission has held that that requires a finding of scienter, even where the underlying violation does not. Stuart-James, as well as Padgett and Graff, urge that there was no scienter here, and that, in fact, there was not even negligence.

In the markup allegation Padgett and Graff are charged with primary violations of the antifraud provisions. Any findings against them must be confined to what is charged. However, these respondents take too narrow a view of the circumstances under which a primary violation by the principal officers of a broker-dealer

can be found. This is illustrated by a case they themselves cite, First Pittsburgh Securities Corp., 47 S.E.C. 299, 307 (1980). In that case, the Commission found a direct markup violation by the president (in addition to the firm), noting that he was responsible for the firm's pricing policies. Here, it was Graff and Padgett who were responsible for Stuart-James' pricing policies, not (as claimed by them) Geman. 58/

The Commission, relying on federal court decisions from throughout the country, has repeatedly held that scienter is established by showing that a respondent acted intentionally or recklessly. Most recently, it so stated in the Blinder case, 52 SEC Docket at 1460. Respondents assert that they reasonably relied on the advice of Geman, who was an experienced securities lawyer, kept abreast of developments in the law regarding markups, and kept Padgett and Graff advised. Among other matters, Geman was familiar with the Alstead decision and was of the view that the circumstances under which the Commission had found domination and control with respect to one of the securities involved there were

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58/ See also, e.g., Joseph Elkind, 46 S.E.C. 361, 363 (1976) (president who also served as cashier and bookkeeper and checked all order tickets held primary violator of antifraud provisions by reason of excessive markups). Universal Heritage Investments Corporation, 47 S.E.C. 839 (1982), cited by respondents, does not aid their position. In that case, involving an appeal from NASD disciplinary action against Padgett, who was executive vice-president of the Universal Heritage firm, and others, the Commission set aside, as unsupported by the evidence, findings that Padgett participated in the firm's misconduct including the charging of unfair prices. It found him responsible for deficient supervision. The decision in no way supports respondents' argument that there can be no findings of direct violations against Padgett and Graff on the markup allegations.

clearly distinguishable from those present in the markets in which Stuart-James was a market maker. Geman was of the opinion that accordingly Stuart-James, as an integrated dealer, was entitled to use the inside ask price as the basis from which markups were to be computed. Respondents also note that on the first days of trading of the UMBE and Find securities, they had no way of knowing how much trading was being done by other dealers or what percentage of trading was being done by Stuart-James. On the other hand, they point out, they did know that many other market makers and dealers were buying from Stuart-James and that other market makers were changing quotations, and they assert they therefore had reason to believe that these were active and competitive markets.

Respondents' arguments simply do not address the internal markets in which the pre-arranged cross trades were executed. Graff and Padgett were responsible for the creation of those markets and for the prices at which transactions were executed. Geman's advice did not deal with the kind of markets in question.

Based on the above, I find that Stuart-James, Padgett and Graff willfully violated the antifraud provisions by charging undisclosed excessive markups. 59/

59/ The Commission has consistently held that willfulness means no more than intentionally committing the act which constitutes the violation. (See, e.g., First Pittsburgh Securities Corporation, 47 S.E.C. 299, 304 n.19 (1980)). And a finding of scienter encompasses a finding of willfulness. (Ibid.). Respondents contend that this standard is no longer tenable in light of recent Supreme Court decisions. Padgett and Graff have also called my attention to a recent Commodity Futures Trading Commission decision adopting a more stringent willfulness standard, roughly equivalent to scienter, and urge (continued...)

III. SALES SCRIPTS

The Allegation

The Division of Enforcement alleged that Stuart-James, Graff and Padgett, from about August 1986 until about October 1987, willfully violated the antifraud provisions by distributing and encouraging the use of telephone solicitation scripts by the firm's sales agents "in connection with solicitation of purchases of securities by retail customers." The use of the scripts was allegedly fraudulent in that (a) the agents were encouraged to use them in connection with all stocks underwritten by Stuart-James, without regard to the nature or merits of the particular securities, and (b) the scripts called for agents to make predictions of unfounded specific gains which could be expected from investing in the securities.

In response to certain motions and to an order issued by me requiring further clarification, the Division clarified and to some extent narrowed the allegation. In a motion for more definite statement, Padgett and Graff claimed that it was not alleged that the scripts were actually used and urged that, if the scripts were not used in connection with actual purchases or sales, no securities law violation was alleged. The Division responded that the evidence would show that certain scripts in the Stuart-James Training Manual ("the Training Manual" or "the Manual") and similar

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59/(...continued) me to apply such a standard. This is an argument more appropriately addressed to the Commission, in view of its long and consistent adherence to the above-noted standard.

scripts were used in a fraudulent manner. (Reply to Motions to Dismiss or For More Definite Statement, May 3, 1989, at 3). In responding to a further motion by respondents, the Division urged that the allegation did charge that the scripts were used. (Division of Enforcement Opposition to Motion to Reconsider Order Denying More Definite Statement, May 16, 1989, at 2). Finally, in response to my order requiring a "clear and definitive statement" regarding the scope of this and other allegations (Further Order Regarding Delineation of Issues, June 29, 1989), the Division stated the following:

> The evidence will prove that scripts contained in the Stuart-James sales agent training manual were fraudulently used in connection with the solicitation of sales of securities to Stuart-James customers in two respects. First, all the scripts in the manual were used generically for all Stuart-James underwritten stocks without regard to the merits of particular securities. Second, certain scripts called for sales agents to make predictions of unfounded specific gains which would be expected from making the recommended investment. The Division will limit its evidence to scripts contained in the training manual and those which were closely and substantially derived from such scripts.

(Division's Summary of Allegations and Evidence, July 7, 1989, at 2-3). 60/

To make its case on this allegation, it is not sufficient for the Division to prove that the scripts were misleading, although

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60/ The scripts allegation was the subject of a motion to dismiss by Padgett and Graff, filed at the close of the Division's case in chief. I deferred a ruling on the motion until after conclusion of the entire hearing. In their briefs, Padgett and Graff and the Division incorporated by reference their submissions on the motion.

that is an essential element, 61/ or that sales agents made unfounded price predictions. Rather, it must demonstrate that misleading scripts contained in or derived from the Training Manual were in fact used by agents in the offer or sale of securities. In addition, of course, it must show culpability on the part of the respondents. The Division maintains that respondents are liable because they had actual knowledge that the Manual contained fraudulent scripts, or that, alternatively, they were reckless in distributing and promoting use of a manual containing fraudulent scripts. Respondents deny responsibility on either theory.

The Training Manual

During the period under consideration, Stuart-James had a manual entitled "Training Program for New Brokers." The focus here is on a chapter entitled "Telemarketing" and a section in the chapter entitled "Making Presentations," where the scripts at issue are found. In an introduction to that section, the Manual advocated use of a "good script" to help the agent guide the conversation in the direction in which he wanted it to go. It urged the use of a three-call method for selling securities that was designed to allow "the prospect sufficient time to become interested and eager to do business with you." (Div. Ex. 188, Telemarketing at 17). Sample scripts were provided for each of the three calls. Agents were

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61/ Stuart-James is incorrect in stating that the Division claimed that the mere dissemination of documents that could, standing alone, be misleading is sufficient to establish securities fraud.

encouraged to pick out "stuff" they liked and to develop their own scripts to suit their individual styles. (Id. at 19).

The purpose of the first call was stated as "get[ting] the lead interested and to make sure he is qualified to be a client." (Ibid.) The first call scripts introduced the firm and the agent to the prospect and inquired as to the amount of money the prospect was able to invest. One of the scripts had the agent stating that he or she was "currently following a company [the agent] believe[s] looks excellent." (Id. at 20). Another stated that the agent was not calling to sell anything, but wanted to know if the prospect would like to hear about "the next interesting opportunity [that] develops." (Id. at 21).

The second call was designed, among other things, to build rapport with and get information about the prospect. Second call scripts emphasized that the agent was watching stocks closely and was just waiting for the right price. One type of script stated that the agent did not have an investment recommendation to make that day but was following several "promising" or "interesting" situations. (Id. at 31-32). One script had the agent telling the prospect that he was recommending a company and instructed the agent "do not name company, just hot news or some exciting action." (Id. at 27). This script also stated that "[o]f the other issues I am following now, I don't know when they will make a move into prime buying positions, but in anticipation of these moves, I am building a list of people to get back to. Tell me, would you like to be on this list?" (Ibid.).

The purpose of the third call was to get the order. One script referred the prospect to a previous call when the agent had told the prospect that he would call "when something great came up." (Id. at 37). The script then stated that "it came up." Another suggested close was the "A.B.C. Close," in which the prospect was told that by taking a position in a stock, as recommended, he had the opportunity "to take a 50% short-term gain on 1/2 of your holdings and keep the rest of the stock for long-term performance." (Id. at 38). The third call segment of the Manual also included a series of "power phrases," among them that in the recommended "situation," the prospect had "the potential of seeing a return of 25-100% within 6 to 12 months." (Id. at 39).

In the "Making Presentations" section, another segment, entitled "Handling Objections," set forth suggested responses to prospects' objections. For example, if the prospect stated that he or she was not interested, part of the suggested response was "[w]ould the possibility of getting a 30% return on your money be of interest to you?" (Id. at 47). Other responses to various hypothetical objections included statements such as that "you can make 50, 100, 500, even 1000% on your money" in penny stocks (id. at 55), and that Stuart-James specialized in underwriting emerging growth companies "with the potential of explosive growth of 20% to 50%." (Id. at 49).

The Training Manual was prepared and used because senior management felt that the firm had reached a size where it needed a formal training program. While the Division asserts, and

respondents dispute, that distribution of the Training Manual began in May 1986, reliable evidence of when it began to be used is reflected in the Minutes of Western regional managers' meetings of June 16 and July 19, 1986. (Div. Exs. 108 and 109). At the earlier meeting the managers were told to use "the new Stuart-James Training Manual"; at the subsequent meeting it was stated that use of the Manual was to begin the following Monday. There is no indication that the situation was different in the other regions. It is therefore probable that by August 1986, the beginning of the period specified in the order for proceedings, the Manual was in use throughout the firm. It continued to be used (with the deletions noted below) well beyond October 1987, the end of the period specified in the Division's allegations.

In addition, there is no doubt that the scripts were intended to be used by the sales agents. Ward, a regional vice-president, testified that he recommended to personnel in his region that the scripts be used as a guideline for new agents. As noted, the Manual specifically encouraged agents to use the scripts as a basis for developing their own scripts. This concept was also reflected in a Stuart-James internal newsletter of November 12, 1986, included in the Training Manual, which recommended the use of scripts and discussed how they should be used:

> The Stuart-James Training Manual contains examples of basic scripts that can be used as guidelines. By design, this Manual does not contain pre-prepared presentation scripts. Management believes that in order to insure product knowledge, brokers need to create their own sales text. Thus, whenever brokers compose their own script, they are able to polish their skills, enhance the quality of their presentations and reduce the possibility of

> inadvertently making misleading statements. Because people are different, no "script" will suit all of your needs or all of your clients' needs. Realistically, there are individuals who should not be in our market (low-priced, speculative issues). However, there are also many other individuals who are able to participate. Remember that it is important to tell it like it is.

(Div. 183 at bates 1466).

Many of the scripts were materially misleading. In decisions issued well before the events at issue here, the Commission held that the making of predictions and representations which are without a reasonable basis violates the antifraud provisions. (See, e.g., M.V. Gray Investments, 44 S.E.C. 567, 571 (1971)). A subsidiary concept of this broad principle, frequently enunciated, is that predictions of specific and substantial increases in the price of speculative securities (such as those marketed by Stuart-James) within a relatively short time are inherently fraudulent and cannot be justified. (See, e.g., Irving Friedman, 43 S.E.C. 314, 320 (1967). See also Lester Kuznetz, 48 S.E.C. 551, 553 (1986): "Predictions of specific and substantial increases in the price of a security that are made without a reasonable basis are fraudulent.").

This principle was reflected in the Training Manual's Compliance chapter, where it was stated that "indications [to customers] of where a stock may open, prices it may reach from time to time, either short or long term specific price projections, etc. are the hallmark of fraud in our industry. Any salesman heard making specific price projections or unwarranted statements regarding a stock's performance will be terminated." (Div. Ex. 188,

Compliance at 5). This was an abbreviated and somewhat different version of a September 1985 compliance memorandum from Geman to the sales agents, that was included in Stuart-James' Compliance Manual. The memorandum referred to the long-established rule that a specific price prediction of a security and its performance in the aftermarket is fraudulent unless there is a reasonable basis in fact, and stated that, generally, there are almost no circumstances where a reasonable basis will exist. "Therefore, it is the policy of [the firm] that specific price predictions cannot be made with respect to the market activity of any security." (PG Ex. 6 at 2). The use of opinions, on the other hand, was endorsed by the memorandum.

Inconsistently with these instructions and counter to the above-noted legal principles, scripts in the Manual predicted substantial price increases. Moreover, certain of those scripts, if used generically, i.e., in connection with all stocks underwritten by Stuart-James, without regard to the nature or merits of the particular securities, had the potential to be misleading because the statements in them would not have a reasonable basis.

Padgett and Graff attempt to distinguish the statements made in the Training Manual from those at issue in Commission decisions involving price increase predictions, on the bases that the securities underwritten by Stuart-James were all listed on NASDAQ; some of the firm's earlier IPOs had appreciated very substantially, thus providing sales agents with a reasonable basis for asserting

that other securities might have similar returns; and, unlike prior cases, the agents had access to extensive due diligence files including financial information. However, these factors cannot justify the kinds of predictions of price increases contained in the scripts. And while Padgett and Graff point to the fact that the scripts were phrased in terms of the possibility or potential of certain returns rather than firm predictions, they acknowledge that the Commission has held that stating predictions in the form of opinions or potential returns "does not automatically insulate those statements from liability." (Brief at 78). 62/ Moreover, contrary to Padgett and Graff's argument, the Commission has held predictions of ranges of price increases to be fraudulent. 63/ Contrary to their further contention (see Response to Division Proposed Findings 973-974, which apparently was intended to be directed to Proposed Findings 971-972), the script in the "A.B.C. Close" does not merely refer to selling 50% of one's holdings, but predicts a 50% appreciation in the price of the securities within

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62/ The case they cite, Armstrong, Jones & Co., 43 S.E.C. 888, 896 (1968), actually held that predictions of specific and substantial increases in the price of a speculative security were inherently fraudulent, and that it was "irrelevant that such predictions were couched in terms of opinion . . . ."

63/ See, e.g., Alfred Miller, 43 S.E.C. 233, 235 (1966), where representations to customers that the salesman "anticipated a rise in the price of the stock to about 50 cents - 80 cents" and that the stock "had a chance of going up to $1 or $1.50 by the end of the year" were found to be fraudulent.

While the scripts allegation is couched in terms of "predictions of unfounded specific gains," I do not consider the ranges of predicted gains included in the scripts, which represent a prediction of a specific gain of at least the low end of the range, to be outside the allegation.

a short time. Padgett and Graff's further argument that predictions and scripts similar to those at issue here are standard in the securities industry is without merit. The predictions to which they point relate to the securities of well-established and substantial corporations not comparable to the speculative securities sold by Stuart-James, and they appear to be based on specific research. The scripts to which they point are simply not comparable to those in the Stuart-James Training Manual.

Sales Agents' Use of Scripts

As previously noted, the mere existence of deceptive scripts does not of itself provide a basis for finding antifraud violations. To warrant such a finding, it must further be found that the sales agents actually used the scripts in the Training Manual, or scripts "closely and substantially derived from such scripts," in connection with the offer or sale of securities.64/ It is of course probable that, since the scripts were presented to the sales agents to be used, they were in fact used. But that general conclusion does not enable findings to be made concerning

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64/ Surprisingly, respondents have not focused on that issue. Padgett and Graff's emphasis is on the question whether the scripts were inherently fraudulent, although they do cite customer testimony to the effect that sales agents discussed with the customers the specific merits of the particular security under consideration and the absence of any such testimony regarding generic use of scripts. Stuart-James simply asserts that the Division produced no evidence that the scripts were fraudulently used by sales agents in connection with any actual transaction during the relevant period. (Brief at 97). In fact, the Division produced extensive evidence on the subject. Whether that evidence supports its position is the subject of my findings in the text.

the manner in which they were used or the portions that were used. 65/ Moreover, it is not sufficient for the Division to show simply that agents, with or without using scripts of their own, made price predictions to customers, even predictions using numbers similar to those in the Manual. A link to the Manual must be shown. The Division could simply have alleged that Stuart-James sales agents made unfounded price predictions in violation of the antifraud provisions. It chose instead to limit the allegation, and therefore findings based on the allegation, to representations included in the scripts. On the other hand, if other terminology was taken from a script in or derived from the Manual, the fact that different figures may have been used would not take the representation outside the allegation.

Several former sales agents testified that they used scripts in the sale of securities. Some of their testimony related to use of scripts that was not shown to have occurred during the period of the alleged violations or to scripts that were not in the Manual or shown to have been derived from scripts in the Manual. 66/ The

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65/ Many of the Division's proposed findings on the scripts allegation relate to allegedly improper sales practices that do not fall within that allegation. I have given no consideration to them in making my findings.

66/ For example, Snook, who began working for Stuart-James in February 1986, testified to using certain scripts given to sales agents by Lasek and that those scripts were exactly the same as scripts in the Training Manual. However, she received these scripts in March 1986, and the record does not indicate whether she used them during the relevant period. She also testified to preparing a script for Sutton's approval at the outset of her employment (Div. Exs. 52 and 35), based on lectures by Sutton, Gibbs and John Roylance, a sales trainer,
(continued...)

testimony of certain agents, however, supports the Division's position. Daniel Ibanez, who worked at the downtown Colorado Springs office from January to October 1987, testified that he prepared scripts based on the scripts in the Manual. In particular, a script that he prepared and used, Div. Ex. 213, includes almost verbatim the "A" and "B" parts of the "A.B.C. Close." As noted, in the "B" part (which stood for "Benefit to Client") the prospect was told that taking a position of 50,000 shares "gives you the opportunity to take a 50% short-term gain on 1/2 of your holdings and keep the rest of the stock for long-term performance."

Mary Kim, a sales agent in the same office from June 1986 to January 1987, testified that she used parts of different scripts in the Manual and other scripts circulating in the office to generate her own scripts. She further testified that she prepared about five scripts, using essentially the same selling points for every security. She identified portions of scripts in the Manual that she used. Among these were the following: that the prospect

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66/(...continued)
and using it in her solicitation of customers. Although several passages in the script are substantially similar to scripts that were in the Manual, and while Snook testified that she used the script many times, the record does not show whether she still used it during the relevant period, when she was a relatively experienced agent.

Blair, who at various times was a sales trainer and assistant manager, testified that beginning in 1985 Roylance and another sales trainer included scripts in their training that were similar to or in some instances identical to scripts that came to be in the Manual, and that she trained sales agents to use those scripts, observed agents using them and used them herself. The record does not indicate, however, whether such use occurred within the period of the allegation.

had the "potential of seeing a return of 25-100% within 6 to 12 months" (Div. Ex. 188, Telemarketing at 39); that Stuart-James specialized in underwriting emerging growth companies " with the potential of explosive growth of 20% to 50%" (Id. at 49); and that "you can make 50, 100, 500, even 1000% on your money" in penny stocks." (Id. at 55). 67/

David Bethany, a sales agent in the Pompano Beach office from September 1986 to January 1987, testified that Czaja, his manager, and some of the "producers" in the office advised him to prepare his own scripts based on the scripts in the Training Manual. (Tr. 4812-13). 68/ He further testified that most of the agents in his office used scripts, and that those scripts consisted of "pieces of the [Manual] scripts that were put together," rather than

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67/ I reject Padgett and Graff's unsupported contention that the above testimony by Kim was biased and therefore not credible.

Nassir Midani, who was employed in the Colorado Springs downtown office from October 1986 to October 1987, testified that he used parts of page 47 of the Telemarketing chapter in developing his sales presentation. When asked whether he used a specific return, like the "possibility of getting a 30% return" referred to on that page, he answered: "A range of return, yes, I used that." (Tr. 9051). His further answers indicate that he was referring to material citing the Stuart-James "track record" showing appreciation of other securities underwritten by Stuart-James over the IPO price. Hence, his testimony does not support the allegation.

68/ Respondents assert that Bethany was not a reliable witness, citing, among other things, his admitted desire, at the time he left Stuart-James, to assist in "bring[ing] the firm down" because he considered its business methods to be dishonest (tr. 4964), and a tendency toward exaggeration in his testimony. It is clear that Bethany was antagonistic toward respondents, and it is true that his testimony frequently tended to be exaggerated or glib. Nevertheless, I consider his testimony on the scripts issue to have been straightforward and believable.

scripts taken verbatim from the Manual. (Tr. 4813). Bethany testified that he did not like working from scripts. His testimony is based essentially on his observation of the use of scripts by his fellow agents. Among segments of the Manual scripts that he testified were substantially similar to portions of the scripts being used in his office were the following (page references are to pages of the Telemarketing section): "I am currently following a company that I believe looks excellent" (20); "the reason I called was to tell you that there are several stocks that I like very much and am watching very closely" (28); "you have the potential of seeing a return of 25-100% within 6 to 12 months" (39); "if an opportunity came along that I felt would give you a return of 30%, 40%, even 50% on your investment, would you be interested?" (48) (but the scripts that were used referred to substantially higher percentages); and (in response to a hypothetical prospect's objection that a penny stock investment was too risky) "That's what penny stocks are all about. That's why you can make 50, 100, 500, even 1000% on your money." (55).

The record thus supports a finding that sales agents, in the offer or sale of securities, used scripts in the Manual, or scripts closely and substantially derived from such scripts, and that the scripts were materially misleading in predicting specific gains from investment in the securities being promoted by the Stuart-James agents. 69/

69/ With respect to the generic use allegation, Padgett and Graff assert that the scripts were mostly used in the first two (continued...)

Culpability of Padgett, Graff and the Firm

As noted, the Division asserts that, notwithstanding their denials, Padgett and Graff knew that the Manual contained the misleading scripts at the time it was distributed. Alternatively, it contends, they were reckless in distributing the Manual without knowledge of its contents. Respondents, on the other hand, claim that it was only in September or October 1987 that they became aware of the scripts in question and that then they immediately ordered their removal from the Manual. They deny that they acted recklessly. I turn now to an examination of the pertinent evidence. 70/

When it was decided to develop a Training Manual, Stuart-

69/(...continued)
calls, wher the agent ordinarily did not attempt to sell a security, and that the third-call scripts presupposed a detailed, non-generic presentation concerning the specific security being recommended. Actually, the price predictions, including those used by sales agents, came from the third call and "Handling Objections" segments of the Manual. It is not clear from the record, however, whether those predictions were used generically or whether other material representations concerning particular securities, based on the Manual scripts, were made in a generic way.

Padgett and Graff correctly note that the scripts allegation did not charge that the use of the three-call method as such was inherently fraudulent.

70/ Padgett and Graff contend that there is no basis for finding a primary violation by them, since neither one of them made any misrepresentation or failed to speak when there was an affirmative disclosure obligation. As I pointed out in dealing with a similar argument on the markups issue, the principal officers of a broker-dealer can be found to be primary violators of antifraud provisions regardless of the absence of direct contact with customers, where they are responsible for policies or practices that lead to violations. Here Padgett and Graff are charged with responsibility for distributing, and encouraging the use of, the scripts that were used by sales agents in a violative manner.

James retained a Dr. Paul Guglielmino, a professor of business and economics, to prepare it. With the assistance of various Stuart-James personnel, he did so. According to Padgett, at a regional vice-presidents' meeting those present reviewed a draft of the Manual. It was suggested that the Telemarketing section should include scripts that were currently being used in the branch offices. Guglielmino was asked to work with R. J. Renneker, a regional vice-president, to compile a sampling of those scripts. The record indicates that the scripts that ended up in the Manual came from materials kept in the branch offices, including materials that had been brought there by sales trainers. Thus, Geman testified that the materials in the Telemarketing section were "no different than the materials that were on the shelves in the branch managers' offices contained in telemarketing textbooks and in the telemarketing tapes." (Tr. 12698). And Blair was able to relate scripts pages in the Manual, including pages containing misleading material, to her notes of lectures that had been given in her office by sales trainers.

Graff and Padgett both testified that they did not see the scripts section before the Manual in its final form was distributed to the branch offices. Padgett testified that he read and reviewed the final draft in its entirety before distribution, including the Telemarketing section, but that at the review meeting it was suggested that "some additions be made to the script portion." (Tr. 362). He then identified the entire scripts section as material

that he did not see before distribution. In explaining why he did not do a further review, Padgett testified that

> [w]e had been working on the manual for a number of months. We kept telling people it was coming. Particularly the branch managers wanted a version and copy of it so we did tell Paul Guglielmino once he got that section together to get it out to the branches as quick as he could.

(Tr. 367). Graff testified that he "skimmed" most of the Manual, did not read any of it thoroughly and did not read the Telemarketing section. (Tr. 676). He further testified that he expected Renneker to clear the Manual with the compliance department, but later learned that this was not done. Padgett testified that the scripts in the Manual should have been reviewed by that department. Geman, who was responsible for compliance, testified that while he saw portions of the Manual, he did not see the scripts section before it was distributed. He attributed this to the fact that an "outside source" (Guglielmino) was involved in the process. (Tr. 12692).

Padgett and Graff testified that they first saw the scripts section of the Manual at a regional managers' meeting in about September 1987. According to their testimony and that of Geman, one or two of the managers expressed the view that certain scripts were inappropriate. Padgett, Graff, Geman and others thereupon reviewed the material indicated and agreed that those pages brought to their attention should be removed. Graff directed Peter Gadkowski, the senior vice-president of compliance, to call the branch offices to have those pages removed from the Manual. A memorandum of October 2, 1987 from Gadkowski to regional vice-

presidents and branch managers stated that he was confirming the previous day's oral instructions to remove nine specified pages from the Telemarketing section of the Manual. Among pages that were not removed was the page containing the "A.B.C. Close" and its 50% price increase prediction.

Considering Padgett's and Graff's hands-on approach and the facts that they were very much on top of what was going on throughout the firm, were closely involved in the process of creating the Manual and considered it an important tool for training sales agents, and that telemarketing was a critical aspect of the firm's business, their testimony that they did not know of the fraudulent scripts at the time the Training Manual was distributed or for more than a year after that puts some strain on my credulity. I do not conclude, however, that this circumstantial evidence and certain other factors cited by the Division are sufficient to warrant the conclusion that their testimony was false and that in fact they did know. 71/ In this connection, the fact that most of the offending pages were removed from the Manual in 1987 supports respondents' version of the events at issue.

71/ The Division asserted that since the scripts were to be drawn from material existing in the branch offices, Padgett and Graff were familiar with them. While admitting familiarity with sales training materials in the branch offices, Graff testified that to the best of his knowledge, the pages that were removed from the Manual in October 1987 were not derived from materials in the branch office libraries. Although, as noted, those were not the only pages containing misleading material, the record is simply not clear as to the scripts with which Padgett and Graff were familiar.

I am also not persuaded that their conduct was reckless, so as to provide the scienter component for a finding that they, and the firm, violated Section 10(b) of the Exchange Act, Rule 10b-5 thereunder and Section 17(a)(1) of the Securities Act. In asserting that Padgett and Graff were reckless, the Division points to their failure to review the entire Manual before it was distributed or to insure that at least the compliance department did so. It also points, among other things, to their failure to review the presentations of sales trainers in the various branch offices or the materials left there by the trainers. As noted, the evidence indicates that scripts in the Manual, including some I have found misleading, originated with the trainers. In my judgment, Padgett and Graff were clearly negligent in not assuring that the entire Manual was reviewed by Geman or compliance personnel subject to his supervision before it was sent out for use by the branch offices, particularly in light of the fact that they failed to monitor or provide for review of the sales trainers' presentations. While it is a close question whether their conduct crossed the line to recklessness, I find that it did not. 72/ However, based on their negligent conduct, I find that Stuart-James, Padgett and Graff willfully violated Sections 17(a)(2) and (3) of the Securities Act.

72/ Recklessness has been defined as "[i]nvolving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care. . . " Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1045 (7th Cir.), cert. denied, 434 U.S. 875 (1977).

IV. NO NET SELLING

The Allegation and Its Interpretation

Each of the branch manager respondents, as well as Ward who was a regional vice-president, is charged by the Division with violating the antifraud provisions by establishing "a policy or practice whereby, without disclosure to customers, for various periods of time and as to various securities, a market was established in which customers were not permitted to sell selected securities previously underwritten by [Stuart-James] and for which [Stuart-James] was a market maker unless and until that customer's sales agent, or another sales agent in that office or region," found a customer to buy those securities. According to the allegation, this policy or practice was known as "no net selling." The firm, Padgett, Graff and Nye are charged with failing reasonably to supervise the above individuals (in Nye's case, of course, only those branch managers within his region) with a view to preventing the violations.

In a More Definite Statement, the Division specified the branch offices where and the time periods when the policy or practice was allegedly in effect. As further clarified during the hearings (tr. 2814-17), it took the position that at certain times the alleged policy or practice extended to all securities for which the firm was a market maker, while at other times it extended only to particular, specified securities. Unlike the evidence presented on the markup and tie-in issues, the evidence presented by the

Division on this issue relates principally to events and transactions subsequent to the first day of aftermarket trading.

At the outset, the Division's briefs and respondents' responses present a basic question regarding the meaning and scope of the allegation. Taking the words in their ordinary meaning, the alleged policy or practice involved a flat prohibition of net sales, i.e., sales to the firm's trading account. This view of the allegation was confirmed in the More Definite Statement which referred to net selling in specified securities being "prohibited" in the specified offices during the specified periods. It was further confirmed at the prehearing conference where Division counsel, when asked to state the Division's legal theory, stated: "[I]t's our position that it's a material nondisclosure not to tell a customer when they're buying securities that they may not be able to sell those securities or will not be able to sell those securities unless and until another customer and (sic) that same agent can find a buyer." (Tr. 19). Similarly, in response to my order requiring a "clear and definitive statement" regarding the scope of this and other allegations (Further Order Regarding Delineation of Issues, June 29, 1989), the Division stated that in the offices and during the times in question, "a general pattern and practice was implemented to obstruct the rights of customers to freely sell securities . . . customers were unaware that they were generally not allowed to sell securities underwritten by Stuart-James unless and until another customer agreed to purchase

those securities." (Division's Summary of Allegations and Evidence, July 7, 1989, at 3-4).

In his opening statement at the hearings, Division counsel referred to "customers who wanted to sell their Stuart-James stocks [being unable] to do so unless a customer could be found to buy those stocks, a no-net selling policy" (tr. 138), and to "a policy where customers who wanted to sell stock couldn't do it unless another customer could be found to buy the stock." (Tr. 145). Foreshadowing an effort to broaden the allegation, counsel also stated, however, that customers were exposed to an undisclosed market risk that their orders would not be "promptly executed," that the evidence would show that in the offices and at the times in question, net selling stock was the "absolute last resort," and that the "goal" was to sell to another customer in order to maximize commissions. (Ibid.)

In its brief, the Division stated a revised version of the allegation: That the market established by the respondent managers and Ward was one in which customers were not permitted "to promptly sell unless and until efforts were made to find another customer to purchase the securities." (Div. Brief at 75 (emphasis added)). According to the brief, "[t]his was known as no net selling." The brief goes on to state that the evidence showed that each of the charged respondents "routinely encouraged or required the sales agents to delay prompt execution of customer sell orders in order to find buyers for the securities." (Ibid.). The brief also introduced an additional legal theory, namely, that it is

fraudulent not to disclose to a <u>seller</u> that his or her order will not or may not be promptly executed.

Various respondents urge that the position taken in the Division's brief represents a new theory that was not alleged, and that it therefore cannot be the basis for findings against them. 73/ Beaird, Gibbs, Sullivan and Sutton ("Beaird et al."), and Padgett and Graff characterize the original theory as a "workout market" theory and the theory put forth in the brief as involving a delay of execution or a failure to provide best execution. 74/ In its reply brief, the Division denies that it changed its theory. It states that its opening brief is "nothing more than an explanation of why the charged and proven violations constitute a material non-disclosure and therefore a fraudulent practice." (Reply Brief at 46). The Division contends that its opening statement clearly stated what it would prove, and that the manner in which respondents tried the case demonstrated that there was no surprise.

The reply brief, however, fails to explain the apparent discrepancy between the allegation in the order for proceedings and the way in which it is restated in the Division's opening brief.

73/ Against the contingency that I would disagree with them, respondents address the bulk of their arguments to the Division's "new theory."

74/ As described by these respondents, a "workout market" is one in which a broker-dealer accepts customer sell orders for a security only if it can find matching customer buy orders.

Beaird et al. and Nye also contend that the Division's new theory does not state a violation of the antifraud provisions. While I disagree with that contention, under my view of the allegation it is not necessary to reach it.

As there restated, the allegation would be changed from a policy or practice prohibiting net sales to one simply requiring some effort by a sales agent to find a matching buyer for a sell order, with some resultant delay. I agree with respondents that this would represent a material departure from the allegation. After essentially adhering to the terms of the allegation in written and oral prehearing submissions, the Division for the first time suggested a broader position in its opening statement. What its counsel there stated, however, did not go nearly as far as the way in which the Division expressed the allegation in its brief. Moreover, it is not clear that, as the Division claims, respondents' conduct during the hearings demonstrated their understanding that the Division was taking a broader view of the allegation. In any event, however, the terms of the allegation could not be superseded or expanded (as distinguished from clarified) by an opening statement or by the manner in which the issues were tried.75/ The proper and only way to do that was by amendment of the order for proceedings.76/ No such amendment was sought by the Division.

75/ An earlier version of the Rules of Practice that was in effect many years ago included a provision that findings could be made with regard to any issues that were tried by express or implied consent of the parties, even if they were not raised in the order for proceedings. (See Earl J. Knudson & Co., 40 S.E.C. 599, 600 n.4 (1961)). There is no such provision in the current Rules of Practice.

76/ It was also not appropriate for the Division to introduce a new legal theory in its brief.

Having said that, I nevertheless consider that it would be unduly technical to construe the allegation as not encompassing a scenario where a manager announced a policy that there was to be no net selling and implemented that policy by requiring extended efforts at finding a matching buyer, even though after extended delay (of more than a day) he ultimately permitted net sales to occur. Such a policy may reasonably be viewed as tantamount to a prohibition of net sales, as alleged. That is not true, however, for the situation contemplated in the Division's brief where agents were required merely to make some effort to find a matching buyer and, if unsuccessful in that endeavor, were able to net sell after a relatively brief delay in execution. I realize that the line between the two situations is not clear-cut, but it appears reasonable to draw it in that fashion.

Findings and Conclusions

The Evidence, Generally

As has been previously noted, under Stuart-James' compensation policies it was advantageous for sales agents and for their managers to cross transactions rather than to net sell. Customers could also benefit, particularly under the new pricing policy instituted in the fall of 1986, which required a 5% break for both seller and buyer in a cross transaction involving customers of the same agent. The record shows that each of the respondents charged with no net selling violations strongly encouraged the agents under him to cross sell orders within their own "books," or at least with customers of other agents in the same office, and discouraged them

from net selling the securities. In some cases, the managers were satisfied if the sale was matched with the reinvestment of the proceeds through purchase of another security by the selling customer. With respect to unsolicited sales, managers also instructed agents to try to talk customers out of selling.77/ At various times and places, explicit orders were given that there be "no net selling" with respect to particular securities, or generally. Where agents could not or did not want to sell securities to their own customers, procedures were used to facilitate buying by other agents, such as posting sell orders on office blackboards. Agents were encouraged to "build [their] books" and to "support the stocks [for which Stuart-James was a market maker]." While Padgett and Graff assert that these concepts (and, for that matter, the encouragement of agents to cross stock) had nothing to do with forbidding customers from selling, it is true that they tended to encourage crossing rather than net selling. However, even in the context where "no net selling" directives had been given, the record shows that in most instances sell orders were executed by the end of the day, even where a buyer could not be found. Of course, even relatively brief delays in the execution of sell orders created risks of a price decline for sellers. But,

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77/ That approach, of course, does not fit the Division's contention that conduct in the various offices was driven only by the goal of maximizing commissions. Even a net sale produced more commission than no sale. The discouragement of sales rather suggests a desire to maintain the price level of securities.

as stated above, that is not enough to bring such practices or conduct within the scope of the allegation.

The discussion that follows, after a brief detour to consider certain statistical evidence relied upon by respondents, includes findings based on the parties' contentions and the evidence regarding each of the respondents charged with no net selling violations. In light of the possibility that the Commission, on review, may take a broader view than mine of the allegation, that discussion is fuller than it would otherwise be.

Statistical Evidence

Stuart-James and Padgett and Graff claim that certain statistical evidence disproves the allegation that sales agents were required to cross rather than net sell. They interpret that evidence (particularly SJ Exs. 71(a) and (b)) as demonstrating that net sells were freely permitted. Although, as noted, it is the Division's position that at times, in the specified offices, the no net selling policy or practice extended to all securities for which Stuart-James was a market maker, the exhibits are limited to the specific securities identified by the Division. Exhibit 71(a) and the first part of 71(b) track trading activity in those securities for every agent in the specified offices during the specified periods. Exhibit 71(a) shows, for each of the 234 agents in these offices at the relevant times, by security and for each day on which there was activity, total customer buys and sells. Where there is a difference between the two figures, it is treated either as a net buy or net sell day. Where the figures are the

same, the assumption is that the securities were crossed. Exhibit 71(b) totals the number of days on which each agent engaged in transactions in the specified securities, the number of those days on which he or she was neither a net buyer or net seller, and the percentages that the second number represent of the first. Under respondents' analysis, the exhibit indicates that virtually none of the agents routinely crossed their securities, with the median agent doing so on less than 12% of the days he or she traded.

The second part of Exhibit 71(b) tracks each of the specified securities on a branch-wide basis for each of the charged offices. Respondents point out that this analysis reflects as crosses not only those within an agent's own book, but crosses with other agents in the same office. The exhibit shows that on virtually every business day each office had a net change in position and that only on very few days, ranging from 4.6% to 29.2% for different offices, were all of the specified securities crossed within the office. Each office was often a net seller. The last two parts of exhibit 71(b) show that the firm's overall inventory in the designated securities was constantly changing. Respondents interpret this as demonstrating that transactions were not all being crossed.

The Division asserts that respondents' analysis is misleading in counting trades as crosses only where the daily totals of buys and sales exactly match. It points out that on days where there were both buys and sales, but in different quantities, it is likely that the sales were crossed to the extent of the buys. This

approach, of course, yields a far higher percentage of crossed sales transactions.78/ Even under it there were a great many net sales. In any event, these exhibits are simply not dispositive of the issues.

Equally inconclusive are commission runs of individual sales agents that were introduced as exhibits by various respondents to demonstrate that net selling occurred on a large scale. The Division correctly points out that these exhibits only reflect transactions by customers of a particular agent and do not reflect instances where sell orders were crossed with customers of other agents. In addition, they do not indicate the extent of the delay, if any, in the execution of sell orders.

Beaird

During the relevant period (May 1985 through October 1987), Beaird was manager of the Houston Post Oak office. When a second Houston office opened in the summer of 1986, Beaird became area manager for both offices. The Division contends that the testimony of former sales agents who worked in the Post Oak office is consistent that there was a general prohibition against net selling. As indicated in the following summary of that testimony, however, the record does not support that contention.

Richard Evans worked in the Post Oak office from September 1985 to July 1986 and then in the second Houston office until

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78/ The Division also asserts that Exhibits 71(a) and (b) have significant errors that greatly reduce their reliability. Since I do not rely on the exhibits in reaching my conclusions, there is no need to address that assertion.

December 1986. He testified that, particularly subsequent to the UMBE offering, Beaird "highly discouraged" net selling, but that there was not an "absolute prohibition." (Tr. 7471). Elaborating, he testified that agents were encouraged to find a buyer either in their own book or through another agent, and that in some cases sell tickets were posted in the office in an effort to find a matching buyer before the end of the day or before the net sell was made. According to Evans, he was concerned that failure to abide by the policy would affect his new issue allotment, and that accordingly he made efforts to cross sell orders. Occasionally, he would ask customers to give him a little time to see if he could find a buyer and explained that he might thereby possibly secure a better price for them. Evans further testified that Beaird explained as a basis for his policy that it was necessary "to support the stock" in order to avoid the price going down. (Tr. 7470). On cross-examination, Evans reiterated that Beaird, while discouraging net sales, let him net sell for his customers when a cross could not be lined up.

Frances Dollen, an agent in the Post Oak office from February or March 1986 to January 1987, testified as follows on direct examination: While net selling was never "appreciated" during her tenure, beginning in the second half of 1986, Beaird used the phrase "no net selling," and "you could not net sell." (Tr. 7077). When a customer wanted to sell, the agent would either cross or try to talk the customer out of it. She recalled an incident where the brother of a former agent wanted to sell stock, and Beaird would

not let him do it. More than once, she saw Beaird tear up a sales ticket. She could not recall any specifics, however. On cross-examination, she testified as follows: With respect to the agent's brother, Beaird ultimately directed that the stock in question be delivered to the customer. In investigative testimony, she testified that if an agent could not talk a customer out of selling, "they" called the regional vice-president who would let the transaction go through as a net sale. No net selling was "said to be prohibited. . . . Generally it was very discouraged." (Tr. 7249).

Roger Hubbard, who was an agent in the Post Oak office for about three months beginning in November 1986, testified that it was frequently stated by the assistant manager and others that there was no net selling, and that in one instance he observed another agent being upset because a net sell ticket had been rejected. He further testified that it was the office's goal to get all stock crossed. Hubbard himself never wrote a sell ticket. He testified that if a customer wanted to sell, the agent was to try and talk him or her out of it or to cross it. He acknowledged that he knew no specifics about the sell ticket that was rejected and could not say whether it was rejected because it was a net sell or for other reasons.

Beaird himself denied that he, or anyone in his presence, told agents in his office that he did not want net selling, to try to talk customers out of selling or that net selling was a last resort. He also denied telling agents that net selling of a

particular security was not allowed, or discouraging such net selling. He acknowledged that he urged them to "build their books" and to "support the stocks," which could be done only by customers buying.

The Dollen and Hubbard testimony regarding incidents where net sell tickets were assertedly rejected is not specific enough to warrant a finding that net sales were prohibited within the scope of the allegation. The testimony of Evans, whom I consider among the most reliable witnesses, establishes the contrary.

Sutton

Sutton was manager of the Colorado Springs downtown office from April 1985 to June 1986 and then became manager of the new Colorado Springs North Creek office. At about the time he opened that office, he also became area manager for Colorado Springs and Albuquerque. The no net selling allegations as to him cover the period from July 1985 to October 1987 and are limited to his service as branch manager.

The Division's contentions regarding Sutton may be summarized as follows: He admittedly encouraged sales agents to cross their sell orders, and he refused to sign sell tickets unless and until all efforts to cross had failed. Whenever a sales agent could not cross a sell order in his or her own book, it was posted in the office and other sales agents were encouraged to have their customers buy the securities. Sell orders were routinely delayed in order to attempt to locate buyers. On specified occasions, Sutton told sales agents in December 1985 that there would be no

net selling and that every pink (sell) ticket should be accompanied by a blue (buy) ticket; told the Albuquerque agents that there would be no net selling of Find;79/ and told his sales agents that there would be no net selling without legitimate reasons. In addition, before new issues traded, he told the sales agents to get "new money for new issue," prohibited net selling and told the agents they were not allowed to net sell any stock to finance the purchase of new issue.

Although the proposed findings cited by the Division in support of its contentions reflect only snippets of testimony, some of which are out of context, it appears that the record as a whole supports those contentions. However, with the possible exception of the first two of the specified incidents and the asserted prohibition before new issues traded, they do not add up to a prohibition of net selling, as alleged in the order for proceedings. The instructions to the Albuquerque sales agents refer to testimony by Snook that such a statement was made _either_ by Sutton or Nye; it therefore cannot be the basis of a finding against either one. With respect to the December 1985 incident, the Division cites Proposed Finding 2349, which states, citing certain testimony by Brasley (at that time a sales agent), that at a due diligence meeting in December 1985, Sutton advised the Colorado Springs sales agents that there would be no net selling

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79/ It is the Division's position that Sutton's activities encouraging no net selling in offices that he did not manage, in his capacity as area manager, make it more likely that he engaged in similar conduct in his own offices. Evidence of this nature was received on that basis.

allowed, that every pink ticket should be accompanied by a blue ticket, and that the agents should raise new money for new issue. The cited testimony is that prior to a due diligence meeting with Padgett, the agents had a meeting with Sutton in which "[b]asically, we went over the no net selling policy and the new money for new issue, bring me a pink ticket with a blue ticket (sic), support your stock." (Tr. 9344). In other testimony, Brasley stated that Sutton used the phrases "no net selling" and "bring me a blue ticket with that pink ticket," and that Sutton did not accept a sell ticket unless the agent had made "quite an effort" to cross it, but that he did eventually accept and process net sell tickets, after delays ranging from 15 minutes to several hours. (Tr. 9289-90). At another point Brasley testified that sell tickets were always executed at least by the end of the day.

For its argument regarding no net selling directives before new issues traded, the Division relies principally on the testimony of former sales agent Rada. He testified that Sutton usually used the phrase "no net selling" prior to an IPO. According to Rada, Sutton wanted the agents to get "new money for new issue," in that he did not want them to sell a security in a client's account to raise capital for a new issue. However, the "new money for new issue" concept did not involve the maximizing of commission income, the asserted rationale for a no net selling policy, since it was just as applicable to sales that were crossed as to net sales. Rada also testified that there were periods of time when the agents were not permitted to net sell on the opening day of trading of IPOs.

However, Rada also testified that these directives came from Nye (or even higher levels of management) rather than being established by Sutton.

In his own testimony, Sutton denied that he ever restricted net selling or that he told the sales agents or managers under him of any such restriction. He acknowledged that to the extent agents were "buyers," he encouraged them to cross sell orders, and that he did not want sell orders to go to the trading department if there were buyers in the office.

While Sutton clearly discouraged net sales, the record does not support a finding that he prohibited them as alleged.

<u>Sullivan</u>

Sullivan succeeded Sutton as manager of the Colorado Springs downtown office in July 1986 and continued as such until January 1987. The Division's contentions regarding him may be summarized as follows: His admissions combined with the testimony of sales agents establish that he encouraged and taught no net selling. He allowed net sales only after agents had exhausted all efforts to find customers to buy the securities. He admitted, and agents testified, that he taught crossing instead of net selling because it produced more commissions. He taught general trading philosophies, such as "build your book" and "new money for new issue," that were designed to result in no net selling. In December 1986, he announced that there would be no net selling of a particular security (Comverse), and he berated a sales agent for not crossing a Comverse sell order and tore up sell tickets. In at

least one case, this resulted in a three-day delay in executing a sell order. It was general office practice not to tell customers that sell orders were being delayed in order to find buyers.

As with Sutton, the Division's contentions, with the possible exception of the Comverse situation, do not add up to a prohibition of net selling as alleged in the order for proceedings. The Comverse situation involved a sales agent by the name of Mary Kim. She testified that in December 1986 or January 1987 she had a problem selling Comverse stock held by a Mr. I. at a time when the customer was out of the country and had given her authority to engage in transactions in his account. According to her testimony, Sullivan announced to the office that Nye had directed that there be no net selling of Comverse stock. Thereafter she wrote a ticket to sell Mr. I.'s Comverse stock. Sullivan referred to Nye's directive, pointed out that if every agent attempted to sell the stock it would adversely affect the market for Comverse and "indicated" that she should try to cross the sale. (Tr. 9879). She further testified that she made some effort to cross, but was not successful. When she took the ticket back to Sullivan, he told her that if she "proceeded to sell," he would no longer give her any new issue and again urged her to try and cross the order. (Tr. 9882). Subsequently, she insisted that Sullivan sign the ticket, and he did. She testified that the process took two to three days. On cross-examination, however, she acknowledged that she could not recall the extent of the delay.

Alice de la Torre, who as noted was a sales agent in the Colorado Springs downtown office from February 1986 to October 1987, testified that Kim told her that Sullivan had refused to let her net sell, and that she recalled other agents also being unable to net sell about that time. She further testified that later that day Sullivan announced that agents who wanted to net sell Comverse should do so, because "trading needed the stock"; but after a short time they could not net sell any more. (Tr. 10965). According to de la Torre, Sullivan never announced that there was "no net selling." In the Comverse situation, after the short period when selling was allowed, he would not sign net sell tickets. Aside from this, while Sullivan strongly encouraged crossing, she could not recall his ever refusing any net sell ticket.

When called by the Division, Sullivan denied that he encouraged crossing, that he ever told his agents that they could not have net sell tickets executed, or that he ever told an agent who had a sell ticket to find a buyer. In his defense case, Sullivan denied making an announcement as to no net selling in Comverse or requiring Kim to find a matching buyer. He acknowledged having a disagreement with her about the Comverse sale, but gave the following, different explanation: At the time she brought the sell order to him, the stock had "downticked" from a higher level that it had reached shortly after trading began. (Tr. 13218). He questioned her about the basis of her decision to sell at the lower price and attempted to contact the customer to see if he had

authorized the transaction. Having failed to reach the customer, he permitted the sale to be executed.

While I credit the Kim and de la Torre testimony as against that of Sullivan, their testimony is simply not specific or clear enough to warrant a conclusion that Sullivan established a no net selling policy or practice within the meaning of the allegation.

Meinders 80/

Meinders succeeded Sullivan as manager of the Colorado Springs downtown office in January 1987 and remained as such until August

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80/ Even though the proceedings with respect to Meinders were settled, it is still necessary to make findings as to whether he committed violations as charged, because Stuart-James, Padgett, Graff and Nye are charged with failing reasonably to supervise him. Those findings, of course, are made solely for the purpose of the issues pertaining to those respondents and are not binding as to Meinders.

Padgett and Graff, noting that the charges against Meinders were dismissed, contend that there can be no findings of supervisory failure where "the primary violations have been conclusively found not to have occurred." (Padgett and Graff Brief at 122 n.230). I disagree with this view of the Meinders order. That order was based on undertakings contained in Meinders' settlement offer and did not include findings respecting the allegations against him. In its Order denying motions to dismiss filed by various respondents following and on the basis of the dismissal of the proceedings against Meinders, the Commission noted that the Meinders order "simply dismissed the proceedings against Meinders. No findings were made; thus, there were no determinations that could possibly have a preclusive effect on other parties." (The Stuart-James Co., Inc., Securities Exchange Act Release No. 28810 (January 23, 1991), 48 SEC Docket 19, 23 n.12). Even had the order included findings with respect to Meinders, however, they would have been binding only on Meinders. Clearly, had adverse findings been made against Meinders, respondents would contend, and correctly so, that such findings were not binding against them. The result must be the same in the case of favorable findings. I note that when I ruled on this issue during the hearings, to the same effect as the ruling herein, counsel for Padgett and Graff stated that he agreed with my analysis. (Tr. 8822).

1987. The Division maintains that he routinely encouraged or required sales agents to cross sell orders instead of net selling them. Its most serious charge is that following an August 1987 meeting of Western region managers and sales agents in Denver where Graff assertedly instructed the assemblage that there should be no pink ticket without a blue ticket, Meinders prohibited all net selling.

Meinders testified as follows: Sell orders were delayed so as to provide an opportunity for crossing. He encouraged agents to cross in their own books; if they were unable to do so, he tried to have other agents find a buyer. Under the pricing policy in effect at the time he was manager, if the agent who had a sell order found a buyer and crossed the trade, both seller and buyer got a 5% price break. The emphasis was not on avoiding net selling, but on crossing, which was advantageous to the agents and the office. Nevertheless, net sell tickets <u>were</u> executed. At the August 1987 meeting, Graff said that if an agent was going to "net sell a security or sell a security," he should have a very good reason, and, if at all possible, he would like every pink ticket accompanied by a blue ticket. (Tr. 11871). Meinders testified that following the general meeting, Graff told the managers to find a reason to fire any agent who was continually net selling. Meinders was not asked whether he instituted a different policy in his

office thereafter, during the brief time that he remained as manager.81/

Nassir Midani, a sales agent in the Colorado Springs downtown office from October 1986 to October 1987, testified that in two instances in July 1987 he had problems net selling. In one instance Meinders initially refused a sell ticket and told Midani to try and cross. When he brought the ticket back the next day and told Meinders (falsely) that he had tried to cross, Meinders accepted the ticket. In the other case, when he brought the ticket to Meinders on the second day following an initial rejection, Meinders put the sell order on display for the whole office, and another agent found a buyer. According to Midani, at the August 1987 meeting Graff said that he did not want any net selling and did not want to see a sell ticket without a buy ticket, because they had to support the Stuart-James stocks. Midani testified that a few days later Sutton, the area manager, came to his office and reiterated Graff's directive, and that net selling was not allowed subsequent to Graff's statement. However, soon after the meeting Meinders ceased being the office manager.

Daniel Ibanez, who was employed in the same office from January to October 1987, testified to an incident where he took a sell ticket relating to Microphonics stock to Meinders; the latter told him to cross it; and he did so. He acknowledged that he made

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81/ The Division asserts that Meinders admitted that as a result of the Graff directive, he prohibited all net selling under any circumstances. In fact, Meinders did not so testify, and the proposed findings cited by the Division in support of its assertion do not support it.

several net sales of Microphonics thereafter. Ibanez testified that at the Denver meeting Graff said that there would no net selling and that he had instructed managers not to sign a pink ticket unless there was a blue ticket to go along with it. According to Ibanez, on the following day Meinders reiterated that there would be no net selling, and as a result the agents could not even "bring up the question" of net selling. (Tr. 10693).

De la Torre testified that Meinders did not address the sales agents regarding net selling versus crossing, and that under his administration they could net sell one particular security, "the older companies," and in situations where the proceeds were reinvested. (Tr. 11174). However, she further testified that Meinders also permitted net sell tickets not fitting those categories to be put through. She could not recall Meinders ever refusing to process any net sell ticket. De la Torre had a slightly different recollection of what Graff said at the Denver meeting: according to her, he stated, in substance, that if an agent brought a pink ticket to his manager by itself, he "better have a damn good reason." (Tr. 11183). She testified that, although Graff did not specifically say so, this meant to her that an agent "better have a pink ticket and a blue ticket, not just a pink ticket by itself." (Tr. 11604).

The record thus shows that on occasion Meinders initially refused to sign a net sell ticket, and that the agents involved thereafter managed to find a buyer, or, if not, that Meinders then signed the sell ticket. This episodic evidence does not, however,

prove that Meinders established a no net selling policy or practice. While Ibanez's testimony, which I credit, shows that such a policy or practice came into being following the August 1987 meeting, it was attributable to Graff's directive at that meeting, at least as it was understood by Meinders, Ibanez and others. Accordingly, I make no adverse findings against Meinders on this issue.

Gibbs

Gibbs was manager of the Albuquerque office from September 1985 to about May 1986. 82/ According to the Division, under Gibbs it was the routine practice in that office to look to cross sell orders as opposed to net selling, thereby causing delays in the execution of sell orders. It contends that Gibbs discouraged net selling in the strongest terms, and that it was a last resort. 83/ However, the testimony of the sales agents who served under Gibbs

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82/ When he left the Albuquerque office, Gibbs became assistant manager of the Colorado Springs North Creek office under Sutton. While I denied a motion by Gibbs during the hearings to limit the case against him to the period when he was manager in Albuquerque, the Division's brief on the no net selling and tie-in issues bases Gibbs' asserted culpability wholly on that period.

83/ As Nye points out, however, one of the Division's proposed findings (2499), citing Cordova's testimony, is that under Gibbs, the Albuquerque office had a policy of attempting to cross any sell order, but if the cross had not been accomplished by the end of the day, then the sale was generally allowed to be executed.

does not support a conclusion that he established a no net selling policy or practice as defined in the allegation. 84/

Snook testified that there was no problem with net selling during the time Gibbs was manager of the Albuquerque office. 85/ Similarly, Cordova testified that Gibbs required agents to "make some kind of effort" to cross either in their own books or within the office before he would put a net sell order through (tr. 3577), but that there were "not really" any problems with net selling under Gibbs. (Tr. 3802). McFadden testified to an incident in January 1986, where Gibbs yelled at an agent who had brought him a sell ticket and "threw it back at him" with directions either to talk the customer out of selling or to find a matching buyer. (Tr. 6403). She further testified that Gibbs told agents that they were not to "dump the stock back on trading," because trading didn't want it. (Tr.6456). McFadden also testified that "there was some net selling when Gibbs was there, but it was not something that was done as a matter of course." (Tr. 6550). Further, according to her, Gibbs would periodically announce that there would be no net

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84/ See also the next section, dealing with Lasek, including references to testimony contrasting Gibbs' and Lasek's conduct.

85/ The Division claims that Snook testified that Gibbs had a no net selling policy. (Reply Brief at 50 and Proposed Finding 2296: "Stuart-James' Albuquerque office had a policy of no net sells while Gibbs was manager."). However, the portions of Snook's testimony cited do not support that statement. Two of those portions relate to the period when Gibbs was no longer manager, and the third is unclear on the point.

selling and/or that he did not want any more pink tickets. 86/ On cross-examination concerning the January 1986 incident, McFadden acknowledged that she was unaware of the particular circumstances of the transaction in question.

Gibbs testified that in line with the concept of "building your book" and keeping securities and money under management instead of liquidating, he discouraged agents from net selling and encouraged them to cross sell orders. He further testified that if a customer wanted to sell stock immediately, "those trades were run right away," although the agent would first seek permission to "work" the order for the rest of the day (or even overnight in case of a large block) and see if he could get a better price. (Tr.6310).

Lasek

Lasek succeeded Gibbs as manager of the Albuquerque office in May or June 1986. The Division contends that he encouraged agents to cross sell orders rather than net sell, and that, as a result, it was routine practice in the office to cross, resulting in delay in the execution of sell orders. Further, according to the Division, he admittedly told the agents that henceforth there would only be crossing and no net selling of Find; and sales agents testified that he regularly used the phrase "no net selling" and strictly enforced this as office policy.

86/ The directive concerning pink tickets suggests that there were to be no sales, not merely no net sales.

Lasek denied that he generally discouraged or even prohibited net sales, but acknowledged that in some instances he discouraged them. He testified that he had a goal of keeping stock as much as possible from being sold to trading, because seller and buyer would get a better price, the agent would keep the stock in his or her book and the commission would be larger. According to his testimony, where an agent wanted to find a buyer because he liked the security, there could be a delay in execution, but the selling customer had to give his or her informed consent. He testified that he had no problem with executing unsolicited net sells, but he did encourage agents to cross and thereby produce a better price for the customer and more commission for the agent. Lasek denied that he ever prohibited net selling of Find. He acknowledged that he said words to the effect that there would only be crossing and no net selling of Find. He explained what was meant was that the consensus of the office was to be a net buyer because he and the agents liked the company, and that as a result there would be buyers for any sellers and thus no need to net sell.

The testimony of sales agents who served under Lasek places his conduct in a less benign light. Snook testified that there was a no net selling policy throughout Lasek's managership; that he announced many times that there would be no net selling in the office; and that she observed him rejecting sell orders on many occasions. She further testified that at an office meeting on November 19, 1986, Lasek announced that there would only be crossing and no net selling in Find. In her direct examination,

Snook stated that the no net selling policy began in June 1986. On cross-examination, she testified that while net selling was a problem even before November 19, it became a policy and "set in stone" at that point. (Tr. 2314) It may well be that Snook, who admittedly had problems with recollection, erred in her recollection, which was based on cryptic notes, of Lasek's November 19 statement concerning Find, and that Lasek's explanation, as noted above, is accurate. She was perfectly clear and consistent, however, regarding the fact that under Lasek there was a no net selling policy.

Snook further testified that she had problems when she did not like a security and therefore did not want to cross. Sell tickets that she gave to Lasek were not run and were returned to her two or three days later. With respect to one customer it took her several weeks to get Itelco stock sold because Lasek wanted her to cross it. The scenario was similar with respect to another customer who wanted to sell Univation warrants. She eventually crossed these in her book. While she was ultimately able to net sell, "it was like pulling teeth." (Tr. 1787). She also observed problems another agent (Gutierrez) had in trying to sell a client's portfolio as a result of Lasek's refusal to net sell the securities, including his tearing up sell tickets and telling the agent to cross the securities. Another agent (Kessler) told her that he had been trying to sell stock for a week and that Lasek refused to "run" the ticket.

Under cross-examination, Snook acknowledged that even after November 19 customers of hers were "probably" permitted to net sell, but added that this was "not necessarily in a timely manner." (Tr. 2315). As Nye points out, 87/ Snook's monthly commission reports reflect a number of sales without matching buys. As the Division counters, however, those records do not reveal whether transactions were crossed with another agent in the office nor do they indicate whether or not the execution of the order was delayed.

McFadden testified that Lasek told the agents that "there was to be flat, no net selling." (Tr. 6407) When a customer wanted to sell, the agent was first to try to talk him or her out of it, and, if that was not successful, to tell the customer the agent would try to get a better price which might take a little while. Lasek told the agents that in the latter situation, the agent could cross in his or her own book or with another agent in the office. McFadden testified that she actually followed this approach. She further testified that Lasek routinely posted sell orders on a board so that any agent in the office could buy the securities in question for a customer, and that these orders sometimes remained there for an extended period before a buyer was found. McFadden testified at length concerning her experience with a customer who needed to liquidate his position. She could not find a buyer. Lasek stated that the stock was to be put on the board; "it was dribbled

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87/ As noted at the outset of this decision, Lasek himself made no post-hearing submission.

away by people buying it in the office" over the course of four or five days. (Tr. 6429). McFadden testified that the amount involved was so large that if she "had hit the bid," the bid would have dropped. She could not recall whether the price dropped during the time the stock was being sold. She further testified that Gibbs and Lasek had the same policies, but that Gibbs, unlike Lasek, did not enforce them "across the board." (Tr. 6648). While testifying that she did not know whether there was never an instance where stock sold by one of her customers went back to trading, she denied that Lasek would allow a net sell to proceed as long as the agent had tried to cross the securities.

Similarly, Cordova testified that Lasek was stricter than Gibbs with respect to net selling. 88/ According to her, whereas under Gibbs the stock was generally net sold by the end of the day if a buyer could not be found, under Lasek "the broker had to try a lot harder and the ticket would sit longer." (Tr. 3578). Cordova further testified that Lasek frequently told the agents that net selling was not allowed. She also testified to an occasion where Lasek, rather than executing a sell order, put the stock "on the board" to display it to the other agents, and that it remained there about a week. Cordova testified that Lasek did permit some net sell tickets to go through, provided the agent had tried to cross it for a substantial amount of time or if it was a small

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88/ The Padgett and Graff assertion that McFadden's and Cordova's testimony do not corroborate one another, because they met and coordinated their testimony is discussed, and rejected, in note 36, supra.

order. She acknowledged that she had no problem effecting a number of net sales, but stated that these all involved small positions.

Aaron Appel, a sales agent in the Albuquerque office from June to September 1986, testified that in office meetings, Lasek stated that "we" did not want to sell stock to the trading department, but rather to keep it in the office. At another point, he testified that Lasek's words were "No net selling. Every pink ticket must have a blue ticket with it." (Tr. 2908). According to Appel, he had a customer who wanted to sell; he tried without success to sell the securities to other of his customers and through other agents; and he then took the sell ticket to Lasek, who said "there is no net selling" and told Appel to find a buyer. (Tr. 2850). Appel testified that, after a couple of days of trying to find a buyer, he eventually sold the securities to his mother.

The evidence warrants a finding that Lasek established a no net selling policy and practice as defined in the allegation. It is evident that no disclosure of that policy and practice was made to persons buying securities through agents of the Albuquerque office during the time that Lasek was manager. This was a material nondisclosure, and Lasek was at least reckless in not requiring that appropriate disclosure be made. Accordingly, I find that Lasek willfully violated the antifraud provisions. 89/

89/ Nye contends that the Division has not cited any evidence that a customer sustained a loss as a result of delay in the execution of a sale transaction. It is well established, however, that in enforcement actions by the Commission, as distinguished from private actions, no showing of harm or injury to customers is required. (See, e.g., SEC v. Blavin, (continued...)

Ward and Czaja

Ward became regional vice-president of Stuart-James' southeast region in late 1984 or early 1985 and remained in that position until he left Stuart-James in 1988. 90/ Among the offices subject to his supervision were the Boca Raton ("Boca") and Pompano Beach ("Pompano") offices, both in Florida. Ward is charged with establishing no net selling policies or practices in Boca during the period from January 1985 to November 1986 and in the Pompano office from November 1986 to April 1987. Czaja, who was manager of the latter office from April 1986 to April 1987, is charged with establishing such a policy or practice in that office during the November 1986-April 1987 period. 91/

The Division asserts that, based on Ward's admissions and their corroboration by managers and sales agents, Ward directed that sell orders in the two offices be crossed instead of net sold and that, as a result of his instructions and pressure that he put on the managers under him, they routinely directed sales agents to

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89/ (...continued)
760 F.2d 706, 711 (6th Cir. 1985); Berko v. SEC, 316 F.2d 137, 143 (2d Cir. 1963); Shaw, Hooker and Co., 46 S.E.C. 1361, 1366 (1977)).

90/ The Division alleged that at other relevant times Ward was a manager of certain branch offices. However, based on time periods specified in the Division's More Definite Statement, the issue with respect to Ward relates to a time when he had already been promoted to regional vice-president.

91/ The Division's brief is in error in stating that the no net selling allegation against Czaja covers the period April 1986 to April 1987. Both its More Definite Statement and its Summary of Allegations and Evidence specify the November 1986 to April 1987 period for the Pompano office.

cross. It further asserts that on at least two occasions in 1986, Ward, at office meetings, directed agents in the two offices to "support the stocks" by "stopping the net selling." With respect to Czaja, the Division maintains that the record shows that, pursuant to Czaja's instructions, the routine practice in the Pompano office was to cross sell orders and that net selling was a last resort. It asserts that as a result sell orders were routinely delayed for days. According to the Division, Czaja used intimidating methods to keep agents from net selling and taught trading philosophies such as "support the stocks" and "build your book" that encouraged no net selling.

Ward maintains that none of the witnesses presented by the Division presented credible evidence supporting the allegation against him. He asserts that some did not implicate him at all, while others (Bethany and Joyce) were not credible for various reasons. He points out that his defense witnesses all testified that there were no restrictions on net selling in the Boca and Pompano offices. He points to the fact that no customer witnesses testified against him. And he asserts that the only credible evidence implicating him was his own testimony to the effect that on a few occasions, he transmitted instructions from his superiors to limit customer selling, but he denies that he established a no net selling policy.

Czaja denies that he established any unlawful sales practices, contending that any such practices that may have existed in the Pompano office were a reflection of the firm's overall practices.

Similarly to Ward's arguments, Czaja asserts that certain of the witnesses against him did not implicate him, while the testimony of others is not credible. Like Ward, he points to the absence of customer witnesses against him and to the favorable testimony of defense witnesses. He asserts that he truthfully testified that, while agents sought to cross customer sell orders for the benefit of both customers and agents, there were no restrictions on net selling. Regarding his further testimony that on a few occasions he was instructed to limit customer sales, he asserts that he assumed the instructions to be based on legitimate grounds and did no more than pass on instructions, and that even in those situations, securities could be and were net sold.

Pertinent testimony was given by Ward and Czaja and by former sales agents who had worked in the Boca and/or Pompano offices. Ward's direct testimony, as a Division witness, was as follows: He used the phrase "build your book" and expected managers to teach agents to keep stock in their books. About a month after UMBE began trading in March 1986, and pursuant to Graff's instructions, he told the branch managers in his region to "stop the selling" in UMBE. (Tr. 4451). Graff made no distinction between all sales and net sales, but Ward interpreted the command as being limited to net sales. On a few subsequent occasions, Graff gave similar instructions as to particular securities. Ward regularly explained to managers in his region that higher commissions could be earned through crossing than by net selling. He did not recall any occasion where Graff stated that net selling of Find should be

discouraged. He instructed managers that agents who only sold without buying were depleting their books, and with respect to particular securities he told them to try to get their agents to cross any sales. He denied telling the agents in the Boca office in the fall of 1986 "we must support our stocks, there will be no net selling." (Tr. 4500).

On cross-examination Ward testified that the firm never had a no net sell policy; that Graff's "stop the selling" instruction regarding UMBE remained in effect for only one day and similar instructions in other instances for one to two days; and that sell orders received at those times were executed by the end of the trading day. On redirect examination, Ward testified that on 15-20 occasions, managers called him for permission to execute a net sell order, and that in each instance the sale was executed. 92/

Czaja acknowledged that it was a general goal in the office to try to cross stock before net selling it, and that he occasionally told the sales agents that net selling should be avoided because it caused the price of the securities to go down. He further testified that during some months he asked Ward's permission two to four times to run a net sale, and that he did so when Ward had told him he wanted to "control the selling or ease up on selling" with respect to particular securities. (Tr.4578). Czaja testified that those instructions referred to net selling and that they remained in effect anywhere from a few hours to a couple

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92/ The Division translated this testimony into a proposed finding that branch managers "generally" called Ward for permission to run a net sell order. (P.F. 2208)

of days. He testified that when he received such instructions he told the agents that Ward had called and wanted them to stop soliciting sells in the particular securities. Czaja denied that Ward's instructions about controlling selling also applied to unsolicited sales. On those, according to Czaja, they first tried to cross, but if unsuccessful, net sold. Czaja insisted that every sell order was executed by the end of the day on which it was given.

Paul Joyce, who as noted was an agent in the Boca office from January 1985 to November 1986, gave the following testimony: Although there was not a "set policy at all times" of no net selling, from time to time there was no net selling as to particular securities. (Tr. 5713). Sometimes his manager said that trading was long and was not taking any sells. While those directives were in effect, securities had to be crossed. Shortly after UMBE started trading, Ward came to the office and said "no net selling," covering all securities. Joyce could not recall how long this directive was in effect. On a second occasion, in the fall of 1986, Ward again announced that there would be no net selling. On cross-examination, Joyce further testified as follows: As to Ward's first directive, he may not have used the words "no net selling"; the substance of what he said was "no selling any stocks until they are supported." (Tr. 5785). He did not know the duration of that directive; it could have lasted only a day. The second Ward directive lasted longer; it was still in effect when he left the firm. Since he was able to dissuade customers from

selling or to cross sell orders, he never had to test Ward's directives. When no net selling instructions were in effect, he did not disclose that to buying customers. 93/

Andy Vuksic, who was a sales agent in the Pompano office from October 1986 to April or May 1987 and later became manager of that office, testified as follows: It was understood that it was beneficial not to have "assets leaving your book" as a result of a net sale, as well as that crossing in the agent's book provided more commission than net selling and could also benefit the customers. (Tr. 5683). If an agent could not cross in his or her own book, the agent would try to cross with another agent in the office. Crossing would take hours or "in some unfortunate circumstances" even days. (Tr. 5686). Czaja never said that Vuksic was not to submit a net sell order. Vuksic could not recall Ward ever addressing the agents on the subject of no net selling or controlling selling.

Bethany, who as noted was a sales agent in the Pompano office from September 1986 to January 1987, testified as follows: In late November or early December, Ward came to the office and announced that, because the firm wanted to support the stocks traded by the firm and pursuant to orders "from Denver" and on a firm-wide basis, there would be no net selling until further notice. (Tr. 4878). Agents were to attempt to dissuade customers from selling; if that

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93/ Relying in substantial part on asserted inconsistencies between Joyce's hearing and investigative testimony, Padgett and Graff, as well as Ward, assert that his hearing testimony is not credible. On close analysis, however, his testimony on the two occasions was essentially consistent.

failed, the sales had to be crossed. The witness interpreted the order as applying to the firm's "favored stocks," i.e., those that the firm wanted to support. (Ibid.). The directive remained in effect until the witness left the firm. Following Ward's announcement, Czaja on several occasions used the phrase 'no net selling." When the witness took a sell ticket for Find shares to Czaja, the latter said he could not sign it because Find was a company that was being supported by Stuart-James. He was able to cross part of the shares with other brokers and was able to net sell the balance on a day when Czaja was absent. 94/ There was a delay of several weeks between the time he took the ticket to Czaja and the final sale.

On cross-examination, it was brought out that in his investigative testimony Bethany attributed the rejection of the Find sell ticket to Harvey Nelson, who was either officially or de facto assistant manager of the office, rather than to Czaja. Bethany testified at the hearing that while it was Nelson who rejected the ticket, the incident occurred in Czaja's presence. He acknowledged that he could recall only two occasions when Czaja used the phrase "no net selling" or a phrase that was the same in substance. One of those was in connection with the rejection of the Find ticket; he could not recall anything concerning the second

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94/ When asked how he was able to net sell the shares if there was a firm-wide no net selling policy, Bethany testified that he wondered at the time whether "the action truly c[a]me from Denver or was it being controlled by Doug Ward and Mike Czaja. Because I was able to sell those." (Tr. 4974-75).

occasion except that it involved another agent. He could not recall having any other sell ticket refused.

The remaining Division witness on the no net selling charges against Ward and Czaja was Susan King. Unlike the other non-respondent witnesses, King had not been a Stuart-James sales agent. 95/ Rather, prior to their divorce in 1989 she was the wife of Jeffrey Parker, who was an agent in the Pompano office from June 1986 through January 1987. 96/ During most of that period, King spent 20 to 30 hours a week at the Pompano office doing secretarial work for Parker, but not as an employee of the firm. When she was in the office, she had the opportunity to hear statements made by the manager and others; she was present during most of the regular morning and afternoon office meetings, at least until December when she spent less time at the office. King testified that from about November on, Czaja stated about two or three times a week at regular office meetings, as well as in between when an agent attempted to execute a net sell, that he did not approve of net selling and that customer sell orders were to be crossed. According to her testimony, Czaja's directive applied to all stocks in which the firm made a market, encompassed both solicited and unsolicited sales and was not limited in duration. His explanation was that the

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95/ King had been licensed as a securities sales agent with two other firms.

96/ Czaja asserts that the failure of the Division to call Parker casts serious doubt on the credibility of King's "second-hand version of events."(Czaja Submission at 4). However, her testimony as to what she heard and observed in the office while she was present is not "second-hand."

only way to make money was to keep assets in the agents' books. She testified that Czaja indicated that Ward felt even more strongly about net selling. King testified that in six or seven instances Parker had problems net selling. She further testified that after a delay of "sometimes a day or two" and much "shouting and pushing" between the agent and Czaja, and after Czaja had directed the agent to try to dissuade the customer from selling and, if that was unavailing, to attempt to cross the transaction, he permitted a net sale to go through. (Tr. 5335).

On cross-examination, King testified that Czaja talked about no net selling already in June 1986 when Parker began working for Stuart-James. She acknowledged that Parker was always able ultimately to net sell. She also acknowledged that since she was not a sales agent, she was not interested in what Czaja had to say, but added that she certainly listened to him. With respect to Parker's net selling problems, she was unable to recall any particulars. She testified that Parker tried to dissuade customers from selling and then tried to cross, and that these efforts took at least a day and sometimes two days, and that sometimes Czaja urged Parker to continue his efforts for a second day.

Three defense witnesses called by Ward and Czaja, all of whom had been sales agents in the Pompano office and one of whom had also worked in the Boca office, testified to the absence of a no net selling policy or of any restriction on net selling. One of the witnesses, Ronald Pentaude, who worked in the Pompano office from April to November 1986 and thus was not there during most of the

relevant period, testified that the emphasis was on crossing, since it was advantageous for both agents and customers, but that crossing was not required and that net selling was not prohibited, either generally or with respect to particular securities.

While the record is far from clear, there is a preponderance of evidence that at certain times Ward established and implemented no net selling policies. Ward admitted that on certain occasions he directed branch managers under him to stop net selling of particular securities. In light of that admission, the testimony of the defense witnesses that there were no such restrictions loses most of its force. The case against Czaja rests mostly on the testimony of Bethany and King. The former was strongly antagonistic to respondents and his testimony was in part exaggerated and glib. The latter was in the office only on a part-time basis. I cannot properly make findings against Czaja based essentially on their testimony.

As the Division points out, it is not a defense that Ward was carrying out instructions received from his superiors. 97/ And there is no doubt that no disclosure was made to buying customers at the time the no net selling policies were in effect. Ward was at the least reckless in not requiring such disclosure.

97/ The allegation, by its terms, extends only to respondents who "established" a no net selling policy or practice. It could be argued that a respondent who simply carried out the instructions of his superiors to adopt such a policy or practice did not establish it. That, however, would be an overly technical construction of the allegation.

Accordingly, I find that he willfully violated the antifraud provisions.

V. TIE-INS

The Allegation and Its Interpretation

As I found in an earlier part of this decision, IPO purchasers were widely encouraged to sell when trading began, in order to provide sales agents with a supply of securities for crossing with aftermarket purchase orders. The Division alleged that more than simple encouragement was involved. In the so-called "tie-in" allegation, it charged each of the branch manager respondents with further willful violations of the antifraud provisions by establishing a policy or practice "whereby sales agents were encouraged or required to allow a customer to purchase securities in an initial public offering underwritten by [Stuart-James] only if the customer agreed either to purchase additional securities when aftermarket trading started, or sell securities bought in the underwriting at the opening of trading." According to the allegation, "[s]uch 'tie-in' arrangements were not disclosed to other market participants." As with the no net selling allegation, the firm, Padgett, Graff and Nye are charged with supervisory failure.

In its More Definite Statement and its Summary of Allegations and Evidence, the Division specified the branch offices where and the time periods when the policy or practice was allegedly in effect. It stated that the policy applied to all new issues underwritten by the firm during those periods. It also specified

that Meinders was the only respondent who allegedly required new issue customers to agree to buy additional securities and specified the particular securities issue involved. 98/ According to its brief, the purpose of the tie-in condition was to create a supply of securities at a fixed cost that could be crossed in pre-arranged aftermarket trades and thereby to maximize commissions.

The nature of the allegation is a subject of considerable dispute, and its terms have been misstated by the parties at various times. As I parse the allegation, its elements are that (1) each respondent branch manager established a policy or practice "encouraging or requiring" sales agents (2) to allow customers to buy IPO securities underwritten by Stuart-James only if they agreed to sell "securities bought in the underwriting" or to buy additional securities at the opening of trading and (3) these arrangements were not disclosed to other market participants.

Nye contends that in its subsequent prehearing submissions and statements, the Division in effect abandoned the "encouraging" part of the allegation. The argument is not without substance, as a result of the imprecise way in which the Division paraphrased the allegation. For example, in its More Definite Statement, the policy was variously described as one requiring customers, in order to obtain new issue, to sell their securities (or, in one instance,

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98/ In its Summary of Allegations and Evidence, the Division identified that security as Immucell. In an amendment, it stated that the security involved was not Immucell, but Celerity Computing. However, the evidence showed that the security in question was Immucell after all, and in its brief the Division so stated.

to buy more) on the first day of trading, or, at another point, to agree to sell their securities on the first day. (More Definite Statement at 4). At the prehearing conference, Division counsel, in explaining the tie-in allegation, stated that "people were not allowed to buy new issue unless they agreed to sell that new issue [on the] first day of trading." (Tr. 24). The Summary of Allegations and Evidence, which I had directed the Division to submit as a "clear and definitive statement . . . regarding the scope of the [allegation]" (Further Order Regarding Delineation of Issues, June 29, 1989), stated that "[o]nly customers who agreed to sell their new issue on the first day of trading were allowed to actually purchase that new issue." (Summary of Allegations and Evidence at 4). 99/

Both the More Definite Statement and the Summary also referred to various mechanisms designed to enforce the alleged tie-in agreement policies, such as intimidation of sales agents and punishment of agents for not complying with tie-in agreement policies. Enforcement mechanisms such as these are more consistent with requirements imposed on sales agents and by them on customers than with mere encouragement of agents to require tie-in agreements. Again, in his opening statement, Division counsel referred to a policy under which "if you wanted new issue, you had to sell the first day. It was required. Registered reps whose

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99/ Division counsel used similar terminology at the prehearing conference in explaining the legal theory underlying the tie-in allegation.

customers didn't play ball found that their customers or they lost their new issue or were penalized in other ways." (Tr. 146).

The Division contends, however, that it has never wavered from the position that the tie-in agreements were "encouraged or required" and that it should not be required to restate the exact words of an allegation "each time the issue of the scope of the charges is articulated." (Reply Brief at 73-74). I note, in this connection, that both the More Definite Statement and the Summary of Allegations and Evidence referred back to the allegation itself, and that in the latter document the Division also referred to customers being "required or strongly encouraged" to agree to sell their new issue the first day of trading. Although the "encouraged or required" terminology of the allegation refers to sales agents and not to customers, the Division's reference to that type of terminology indicated that it was not abandoning the "encouraging" part of the allegation. In the course of the hearings, the Division specifically disclaimed any such abandonment. While a more definite statement frequently not only clarifies but narrows the scope of an allegation, it seems to me that only in a clear case should it (or other prehearing statements by the Division) be interpreted as an abandonment of a part of the allegation. This is not such a case. Moreover, the issues surrounding the alleged tie-ins were tried exhaustively. There is thus no basis for contending that respondents were misled into trying the case on narrower grounds.

Certain other aspects of the allegation require further clarification. For example, the Division, as noted, has made shorthand statements such as that "in order to obtain new issue[,] customers were required to either sell new issue the first day of trading or buy more." (More Definite Statement at 4). That statement fails to reflect the fact, subsequently stressed by the Division itself, that the allegation refers to an agreement by the customer to sell or buy rather than to an actual sale. Thus, on the one hand, the allegation covers an unconsummated agreement to sell. On the other hand, a mere showing that customers sold IPO securities (or bought more of the same securities) at the opening of trading would not be sufficient, absent a further showing that they had agreed to do so at the time of the IPO purchase. This particular formulation is also inaccurate in stating that customers had to agree to sell on "the first day of trading," when the allegation specifies "the opening of trading."

Respondents have also misstated elements of the allegation. For example, Padgett and Graff state that the Division's "original theory in the Order for Proceedings was that Stuart-James IPO customers were required to sell out their IPO allocations on the first day of aftermarket trading." (PG Brief at 108). The argument is that the Division had alleged that a total liquidation was required so that if, as was the case with most IPOs, they were offerings of units consisting of common stock and warrants, all the stock and all the warrants had to be sold. Padgett and Graff then seize on the conceded fact that not all IPO customers dealing with

the specified offices sold their entire allocations on the first day of trading to argue that the Division has conceded that the allegation is false. Other respondents make similar arguments. Of course, the Division has made no such concession. For one thing, it points out that the allegation speaks in terms of an agreement by the customer to sell (or buy), as distinguished from an actual sale (or buy). Moreover, the argument overlooks the encouragement aspect of the allegation. A showing that a manager had a policy or practice of encouraging agents to require tie-in agreements would come within the terms of the allegation. 100/ In addition, the allegation does not refer to an agreement to sell "the securities" bought in the underwriting, but only to an agreement to sell "securities" so bought. Thus, whether or not the Division so intended in framing the allegation, 101/ the terms of the allegation support its argument that the required agreement relates to "all or part" of customers' IPO allocations. (See, e.g., Division Reply to Stuart-James Proposed Findings 169-174).

The foregoing discussion, of course, relates only to the proper interpretation of the allegation. Whether a particular

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100/ Whether such a policy or practice is fraudulent within the meaning of the antifraud provisions is discussed in the last part of this section of the decision.

101/ Cf. the famous United Nations Security Council Resolution 242, adopted following the 1967 war between Israel and various Arab states, which among other things and under specified circumstances provided for Israel's withdrawal from territories occupied in the war. By referring to "territories" rather than "the territories," the Resolution deliberately left the extent of the withdrawal vague.

factual situation would constitute a violation of the antifraud provisions is left for later consideration.

Findings of Fact

Statistical Evidence

Whereas the Division relies principally on the testimony of former sales agents, respondents emphasize statistical evidence they introduced showing the extent to which IPO securities were sold or not sold on the first day of trading. Pointing to statistical evidence (SJ Exhibits 31-60) demonstrating that customers who bought IPO securities did not all sell out on the first day of aftermarket trading, Stuart-James contends that that evidence refutes the tie-in allegation. Similarly, Padgett and Graff, as well as Beaird et al., urge that that evidence conclusively demonstrates that no policy existed requiring IPO customers to liquidate their IPO purchases on the first day of aftermarket trading. As noted above, however, these arguments rest on a misconstruction of the allegation, which refers to customers' agreement to sell and not to actual sales. Moreover, some of the evidence on which respondents rely is of a firm-wide nature, whereas the allegation pertains only to a few branch offices and not to the firm. 102/

102/ For example, Padgett and Graff point out that in UMBE, less than 39% of the IPO purchasers sold their entire allotment on the first day of trading. About 56% of the common stock and about 44% of the warrants were sold. In Find, the corresponding percentages were 47%, 70% and 60%, respectively. In other offerings, the percentages were much lower.

(continued...)

The above exhibits also contain detailed data covering every branch office, including the designated offices. In addressing these data, Padgett and Graff stress not only the percentages of units, stock or warrants that were not sold by IPO purchasers of the various offerings on the first day of trading, but wide variations among different branches in the same securities issue and among different issues in the same branch. These, they urge, are inconsistent with a tie-in policy or practice as charged. Beaird et al., also contending that there is no pattern consistent with a tie-in theory, point out that some customers held stock and sold warrants, some sold stock and held warrants, some sold both and some held both.

The Division, in response, maintains that what is alleged is that IPO customers were required to agree to sell (or in one case buy) at the opening of trading, not that they were actually required to sell (or buy). In line with this approach, it addresses the statistical evidence as follows: Contrary to respondents' claims, that evidence

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102/(...continued)
Exhibits introduced as background for the testimony of Padgett and Graff's expert witness, Professor Fischel, show, among other things, the percentage of purchasers in the Stuart-James IPOs during the relevant period who did not sell any part of their IPO on the first day of trading, as well as the percentages of UMBE and Find IPO purchasers who did not sell on the first day and who received allocations in subsequent IPOs. (PG Exhibits 115-117). Professor Fischel interpreted these as negating the tie-in allegation. However, because these are firm-wide statistics, his conclusion rests on a misunderstanding of the allegation. Moreover, as noted, respondents are charged with exacting illegal agreements rather than requiring actual sales.

> does not conclusively prove the existence or non-existence of soliciting an illegal agreement from customers to trade as a condition for obtaining IPO. Nonetheless, where significant percentages of customers in the charged offices did trade all or part of their new issue on the first day of trading, this fact supports the Division's allegations.

(Reply Brief at 69). The Division does not specify what it deems to be a "significant percentage." Focussing on the branch offices involved in the allegation, the Division extracted statistics from SJ Exhibits 31-60 regarding first-day sales of common stock and warrants by IPO purchasers in offerings that were on a unit basis. 103/ It asserts that for each office, in some securities, extremely high percentages of customers sold at least some of their new issue on the first day of trading, and that this is persuasive evidence of the existence of tie-in agreements as charged. Actually, the above exhibits do not show percentages of customers who sold part of their new issue on the first day. Rather, they show the percentages of common stock and warrants (where the IPO consisted of units) that were sold on the first day.

It appears to me that where there is other evidence that agents were encouraged or required to obtain tie-in agreements, a high percentage of sales on the first day of trading provides corroborating evidence. At the same time, it must be recognized that other factors may account, at least partially, for those

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103/ The Division included statistics relating to the Houston West or Downtown office. That office, however, was not included among the offices specified in the More Definite Statement or the Summary of Allegations and Evidence. None of my findings relates to transactions in that office. In addition, a few of the statistics cited in the Reply Brief are inaccurate. My findings reflect the corrected statistics.

sales. Where IPO purchasers were able to realize substantial profits by selling at the opening of trading, as was the case with most Stuart-James IPOs, large numbers of customers would be inclined to sell of their own volition. In addition, Professor Fischel's expert testimony and supporting exhibit (PG Exhibit 114) attest to the fact that in IPOs generally, the volume of sales tends to be much higher on the first day of trading than on subsequent days. 104/ Moreover, agents who were at all perceptive quickly realized, without the need for prodding by their managers, that it was to their advantage to set up matching sell and buy orders for the opening of trading.

Where the percentages of first-day sales in particular securities and in a particular branch office were on the low side, it is at least some evidence of the absence of tie-in agreements. Here, too, however, the figures are not conclusive. The Division indicates, with some supporting evidence, that on occasion customers simply reneged on their agreements. Most prominent among factors pointed to by the Division that it asserts could account for a failure of IPO purchasers to sell on the first day of trading even if they had agreed to sell is the situation in which aftermarket buyers were not available and, because net sales were frowned upon, agents did not call on their IPO customers to sell. In keeping with this concept, the Division expresses the agreement

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104/ It should be noted, however, that the exhibit, which is based on statistics concerning 118 IPOs in 1985, shows, in contrast to the much higher figures referred to below, that on average about 28% of the shares that constituted the offering were traded on the first day of trading.

that was allegedly obtained from new issue customers as an agreement to sell _if_ their shares of stock (or warrants) were needed to fill aftermarket orders. Another factor cited by the Division is that in some instances the bid prices at which trading began were less than had been predicted.

I turn now to consideration of the evidence pertaining to each of the respondent managers, including pertinent statistics regarding first-day sales in their offices.

Beaird

The tie-in allegation with respect to Beaird, who as noted was manager of the Houston Post Oak office, covers the period from December 1985 to March 1987. In addition to the testimony of sales agents Evans and Dollen and Beaird's own testimony, the Division relies on testimony by Blair regarding a training talk given by Beaird to her office prior to the time he became manager of the Houston office. 105/ It sees that testimony as bearing on his conduct when he became a manager. In essence, Blair testified that Beaird taught a system that involved giving new issue only to customers who agreed to sell when trading began. She acknowledged that the system was not presented as mandatory, but as strongly encouraged. Beaird, while admitting that he taught the agents in Houston the same matters that he had taught in Atlanta, denied that he discussed the above subject and insisted that he only taught

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105/ The Division also cites testimony of Roger Hubbard, another sales agent in the Houston Post Oak office. However, he was not endorsed as a witness on the tie-ins issue, and I base no findings on his testimony.

crossing techniques. Beaird denied that he encouraged agents to encourage their customers to sell new issue stock on the first day of trading. He further denied that he ever lowered an agent's allocation or otherwise disciplined him or her because his or her customers had not sold their new issue the first day of trading. In investigative testimony, however, Beaird had noted that crossing on the first day of the aftermarket provided "a big commission advantage" to the agents, so that getting agents to have their IPO customers sell in cross trades "took care of itself." (Tr. 7022).

Evans testified that Beaird frequently discussed the strategy of crossing from IPO buyers to aftermarket buyers as a way of maximizing commissions. He further testified that in connection with the UMBE offering, he (Evans) told IPO purchasers that they would most likely make money in selling out the first day of trading. He testified that he told them "they had to give up that stock" or that "we needed to trade out of that." (Tr. 7432). The record shows that his UMBE IPO purchasers sold all of their stock and warrants on the first day of trading, with the exception of one purchaser who retained his warrants and bought additional warrants. On cross-examination, Evans testified that if he chose to do so, he could sell IPO to a customer who took the position that he or she would not sell on the first day of trading, but that he ((Evans) "would be penalized for that kind of thing." (Tr. 7542). However, he explained his reference to a penalty to mean that the resultant lesser production would affect subsequent allocations of IPO securities, because they were based on production.

Dollen testified that Beaird directed the agents to have IPO customers sell at the opening of trading and cross to aftermarket purchasers. She testified that in that connection she heard Beaird use the phrase "control your client," and that Beaird also threatened agents with loss of the next IPO allocation if their customers did not sell at the opening of trading. She could not, however, recall any occasion where that happened. 106/

The above testimony supports the conclusion that Beaird at least encouraged the agents in the Post Oak office to sell IPO securities only to customers who agreed to sell at the opening of trading. Further support is provided by the fact that in all but one IPO during the relevant period the percentage of common stock sold on the first dav of trading was at least 63% and in five of the seven IPOs for which data were available was at least 75%. 107/ On the other hand, the testimony of Evans and Blair demonstrates

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106/ Beaird points to portions of Dollen's testimony where she assertedly admitted that Beaird did not instruct agents to have their customers sell in the aftermarket and that she never engaged in tie-in arrangements with her customers. The cited testimony is far from clear, however. I deem the summary of her pertinent testimony in the text to be accurate. On the other hand, I have not given much weight to her testimony. For one thing, she did little business in the securities underwritten by Stuart-James, concentrating instead on listed securities. For another, she acknowledged testifying adversely to Beaird in the investigation without knowledge of the facts in question simply because of her dislike of Beaird.

107/ Without explanation, the Division excluded UMBE from its compilation. I included it in the text data.

Several former agents who had worked in various offices testified that, where the IPOs involved units consisting of common stock and warrants, their managers placed primary emphasis on selling the stock.

that Beaird's policy or practice did not rise to the level of a requirement.

Sutton

As noted, Sutton was manager of the Colorado Springs downtown office from April 1985 to June 1986 and then became manager of the new Colorado Springs North Creek office. The tie-in allegation as to him covers the period from November 1985 to October 1987. 108/

The Division's contentions regarding Sutton may be summarized as follows: Sutton stressed to the sales agents the economic benefits of having new issue customers sell out at the opening of trading and crossing the securities to aftermarket purchasers. He also stressed the importance of "controlling the customer" in the sense of inducing him or her to sell at the open. According to the agents' testimony, it was routine practice in the offices managed by Sutton to sell new issue to those customers who would sell when trading opened. Where new issue customers were not sold out at the opening of trading, it was primarily due to insufficient buying demand to absorb sales. Sutton and Nye, in addition to relying on the statistical evidence, contend that the agents' testimony does not support adverse findings against Sutton.

Sales agent Brasley testified as follows: Prior to the UMBE offering, Sutton told the agents in substance that they should control their clients in the sense of placing the new issue with people whom they knew they could "bring out" on the first day of

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108/ References by Nye to several offerings that preceded November 1985 are therefore not relevant.

trading. (Tr. 9252). On the UMBE offering and the other IPOs as well, he (Brasley) did not give IPO securities to customers who "would not allow [him] to take them out of the stock on the first day of trading." (Tr. 9256). He gave his entire UMBE allocation to one customer whom he knew he could "take out" on the first day. At the time he sold the UMBE units, he asked the customer whether, if he could show him a certain percentage profit, the customer would be willing to sell on the first day. The customer agreed and in fact sold both the stock and the warrants on the first day, although not at the opening of trading. Prior to Find, Sutton again instructed sales agents to place IPO securities with "people that you can take out on the first day" and to line up crosses with first-day buyers. (Tr. 9277). He (Brasley) again placed his allocation with customers who agreed to sell when trading opened if a certain percentage profit was achieved. The customers (in fact there was only one) in fact did sell. He did not give IPO securities to customers who did not agree to sell in the aftermarket.

According to Rada, who also served as a sales agent under Sutton, the latter consistently instructed agents to give IPO securities only "to people that were going to be willing to give it back so that you could generate the crosses." (Tr. 10235). He testified that Sutton used the phrase "control your client" in the sense of getting clients to sell when the agent wanted them to do so. On cross-examination, it was brought out that, according to the firm's commission records, out of eighteen IPOs in which the

witness had participated, in three the IPO purchasers sold out completely on the first day, in six they sold nothing and in the others they retained a substantial part. Rada responded that where the agents were unable to cross, "you are going to end up holding the stock," because they were not able to net sell. (Tr. 10538). He further testified that, with respect to IPO purchasers, the requirement was not so much to sell as to cross, so as to generate maximum commissions.

Sales agent de la Torre, who worked under Sutton for a few months, testified that he stated several times that sales agents should "establish and maintain control" over customers, explaining that "if you're going to give new issue to a customer, you better know that he's going to give up his stock on the first day of trading." (Tr. 10888-89). She testified that in Univation, the only IPO she participated in under Sutton, her IPO customers sold out on the first day of trading. On cross-examination, it appeared that the transactions took place on the second day.

Sutton denied telling agents that it was important for them to establish and maintain control over customers. He also denied that agents were to determine whether IPO buyers were interested in selling if a specified percentage gain could be achieved. He acknowledged that in Find, all but one of his IPO customers sold all of their common stock on the opening day of trading. However, he denied encouraging them to do so, testifying that they were happy to take a profit when the stock started to trade at a premium. None of them sold Find warrants on the first day.

Sullivan, who was assistant manager under Sutton in the Colorado Springs downtown office before succeeding him as manager in July 1986, testified as follows concerning the period when he was assistant manager: Sutton did not have a plan for first day trading of new issue; he only wanted to know what the sales agents planned to do. He (Sullivan) did not tell the agents that their IPO customers should get out on the first day of trading or encourage them to have their customers sell out when trading opened, and he did not observe Sutton teaching that. On UMBE, he did not know, until the stock traded, who would be selling or how much. He did have an idea which customers would be interested in selling. He acknowledged that most of his twenty-seven UMBE IPO customers sold all of their common stock and warrants on the first day of trading, but denied that he had caused the IPO customers to agree, prior to aftermarket trading, to sell out when trading began.

The statistics regarding first-day sales in the two offices managed by Sutton militate against a conclusion that it was his policy or practice to <u>require</u> agents to obtain customer tie-in agreements. In at least half the IPOs during the relevant period, less than 50% of the common stock was sold on the first day of trading. The maximum percentage of warrants sold on the first day in any offering was 53%.

Moreover, the percentage of IPO securities sold in different offerings varied widely, even between offerings fairly close in time. In UMBE, 66% of the stock and 43% of the warrants were sold

on the first day of trading. In Univation, two months later, only 17% of the stock and 15% of the warrants were sold. In Comverse, the figures were 61% and 13%, respectively. Two weeks later, in Disc Technology, the corresponding figures were 7% and 22%. There is some evidence that, as the Division suggests, in some cases aftermarket buyers were not available, although the fact that almost all the IPOs were hot issues makes this unlikely on a substantial scale. In some instances customers who had agreed to sell reneged on their agreements. However, even if it is assumed that all sales were effected pursuant to agreements to sell, these factors do not adequately explain the low and variable percentages of sales. Nevertheless, despite the denials by Sutton and Sullivan, I credit the consistent testimony of the sales agents that they were strongly encouraged to allocate IPO securities to persons who would be willing to sell when trading opened.

Sullivan

As noted, Sullivan succeeded Sutton as manager of the Colorado Springs downtown office in July 1986 and remained in that position until January 1987. The Division asserts that before each new issue Sullivan admittedly diagrammed the economic benefits to agents of crossing stock between new issue customers and aftermarket buyers, and that he routinely encouraged agents to give new issue only to customers who they knew would sell at the opening of trading. It further asserts that Sullivan monitored the agents to make sure they had crosses lined up, and that he stressed the importance of controlling IPO customers and requiring them to sell when trading

started as a condition for obtaining new issue. Sullivan and Nye contend that the evidence does not warrant adverse findings against Sullivan. I turn now to an examination of the relevant testimony.

De la Torre, who worked in the Colorado Springs downtown office throughout Sullivan's tenure as manager, 109/ testified as follows: Prior to the Find offering, Sullivan showed the agents "how to cross and make commissions," through what he called "the trickle theory." (Tr. 10925-26). That theory involved a whole series of transactions, but began with the IPO customer's securities being crossed to an aftermarket purchaser at the opening of trading. He encouraged the agents to use the theory "to help us make money." (Tr. 10929). He encouraged agents to conduct first day crosses of IPO stock. She sold her Find allocation to one customer, who agreed to and did buy more stock and warrants in the aftermarket. She did not suggest that he sell, because she liked Find. Sullivan criticized her for not crossing the customer's IPO securities. In Comverse, which she didn't like, four of her five IPO customers sold their positions on the first day. The stock sales were net sales; there were no repercussions to her from Sullivan. On Disc Technology and Disease Detection, in which her IPO purchasers did not sell on the first day of trading, Sullivan did not criticize her for not crossing. In one of these issues, the

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109/ Stuart-James and the Division stipulated that Sullivan became manager in July 1986. De la Torre testified that Sullivan was manager already when the ASA International offering became effective on June 25. In light of the stipulation, however, I proceed on the basis that Sullivan was not yet manager at that time.

IPO buyer bought more on the first day. Crossing in the immediate aftermarket was the norm; Sullivan monitored "how much is being crossed." (Tr. 10971). It was her general practice, when talking to IPO customers, to ask if they would be willing to sell if a certain percentage profit were achieved. On cross-examination, de la Torre acknowledged that in the IPOs that occurred while Sullivan was manager, she had the option, on the first day of trading, of doing nothing, buying more, net selling or crossing.

Agent Nassir Midani began working at the Colorado Springs downtown office in October 1986, in the middle of Sullivan's tenure as manager. According to his testimony, Sullivan repeatedly taught the agents that the IPO buyer, in order to get new issue, had to be willing to give it up on the first day of trading and to reinvest the proceeds in another Stuart-James security, and that the IPO securities should be crossed to an aftermarket buyer at the opening of trading. In this connection, Sullivan used a phrase such as "control your client." On the question whether the plan was mandatory or optional, Midani testified that "if you played the game, you got rewarded with a second new issue" and "[i]f you didn't play the game, you did not belong in the (sic) Stuart-James." (Tr. 8779). He also testified that the emphasis was on stock more than warrants. Midani further testified as follows: On Disc Technology, the first IPO in which he participated, he gave his IPO allocation to one customer, who was willing to go along with the above plan. When trading began, he sold the stock for her, crossing it to another customer, and she kept the warrants. On the

next issue, Disease Detection, the same customer again received Midani's total allocation and sold all or part on the first day. On cross-examination, Midani testified that Sullivan did not refer to his plan as mandatory, but that "[i]n context, it pretty much was." (Tr. 9234).

Sullivan denied telling sales agents that IPO customers should sell out on the first day of trading or even encouraging them to have their customers sell out. He acknowledged diagramming the way in which a cross worked and teaching the trickle theory, which he claimed, however, was not specifically related to the first day of trading. Sullivan also testified that he never disciplined an agent for not selling out IPO customers on the first day of trading and that IPO customers who did not sell out nevertheless were permitted to buy in subsequent IPOs. In Find, his own IPO customers sold out on the second day of trading.

The statistics regarding first-day sales under Sullivan make it doubtful that he established a policy or practice of requiring agents to obtain tie-in agreements. For example, in Disc Technology, only nine of the office's ninety-four IPO purchasers sold out their position on the first day. Only 18% of the stock and 22% of the warrants were sold that day. In the three other offerings for which figures are available, the percentage of common stock sold on the first day ranged from 41% to 69% and the percentage of warrants sold from 35% to 62%. However, I credit the agents' testimony that Sullivan, like Sutton, strongly encouraged the agents under him to sell their IPO allocations to customers who

would be willing to sell when trading opened.

Meinders

Meinders succeeded Sullivan as manager of the Colorado Springs downtown office in January 1987. According to the Division, in IPOs other than Immucell, and as demonstrated in memoranda issued by him, Meinders taught and encouraged agents to place new issue only with persons who would trade on opening day and reinvest the proceeds. The Division asserts that he admittedly threatened to take away new issue allocation to influence the behavior of the agents. In Immucell, the Division contends, he tried an alternative of having the agents require customers to buy more securities in the aftermarket as a condition for obtaining new issue.

I turn first to Meinders' own testimony and to the memoranda concerning upcoming IPOs that he distributed to the agents under him. Meinders testified as follows (summaries of the memoranda are my own rather than reflecting Meinders' testimony): Prior to the effective date of Immucell, the first IPO with which he was involved in the planning as manager, 110/ he distributed a memorandum to the agents that described "An Alternative New Issue Program." (Div. Ex. 99). The program contemplated IPO customers buying additional Immucell stock at the opening of trading rather than selling and crossing. Almost all of the agents "set up the trading the way it was presented in Exhibit 99." (Tr. 11796). He allocated additional IPO units to agents who obtained aftermarket

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110/ An earlier IPO, Concept 90 Marketing, became effective the day after Meinders arrived on the scene.

buy indications of interest of at least a certain amount, but did not reduce the allocation of agents who did not follow the plan. However, the plan failed because not nearly enough stock was available to fill the buy orders. He never attempted to use this strategy again. On the next offering, National Data Computer, he had no plan. In connection with the next IPO, International Microcomputer Software ("IMSF"), he distributed a memorandum entitled "Hoped for Guidelines" (Div. Ex. 98) advocating the crossing of the stock and warrants and setting forth crossing scenarios at different price levels. The office crossed 59% of the common stock and 64% of the warrants. (SJ Ex. 41(c) shows a figure of 67% for warrants sold). In the last IPO while he was manager, Celerity Computing, he distributed a memorandum (Div. Ex. 97) that referred to an office goal of doing riskless transactions (i.e., crosses within an agent's own book) on 100% of the office's allocation. It also directed agents to turn in their "prospect list" prior to final allocations, so as to "enable the office to monitor the trades." The memorandum also stated that if any agent did not like the offering and did not want to "participate in the group effort, this is fine, let me know early, the other brokers can have your allocations." According to Meinders, "nobody followed the guidelines on Exhibit 97" (tr. 12102), because there was no interest in the aftermarket. (SJ Ex. 46(c) shows that 9% of the stock and none of the warrants were sold on the first day of trading). In his investigative testimony, Meinders stated in effect that it was not mandatory for the agents to follow his plans; he

showed them the results if they did. He further stated that there were no consequences to agents who did not follow the plans.

According to de la Torre, customers who did not go along with the Immucell plan were not to get IPO securities, and those agents who wanted an IPO allocation were required to participate in the plan. On National Data, she identified a document entitled "Investment Proposal" (Div. Ex. 101), distributed by Meinders before the effective date and consisting of an illustration of a client selling out his or her IPO allocation at a substantial profit and reinvesting the proceeds. She testified that the plan contemplated crossing the stock when trading opened, but that when trading in fact opened, the bid price was below the price in Meinders' plan. She further testified that Meinders then told the agents to forget the crosses and instead to net buy. 111/ On IMSF, de la Torre testified that she sold out her IPO customers on the first day. On Celerity, she testified that Meinders did monitor the agents to make sure they had their crosses set up, and that she understood his memorandum to mean that she should not give IPO securities to customers unwilling to sell when trading opened. She testified that her IPO clients agreed that if they could realize a certain percentage of profit, they would sell when trading opened. She further testified that the opening bid price was not high enough, with the result that her IPO customers did not sell.

111/ SJ Ex. 33(c) shows that IPO customers of the Colorado Springs downtown office sold 26% of the stock and 8% of the warrants.

On cross-examination, de la Torre testified that Meinders did not require tie-ins on IPOs.

Midani testified as follows: Meinders, like Sullivan, taught the agents that, in order to be permitted to buy IPO securities, a customer had to be willing to give them up on the first day of trading and to reinvest the proceeds in another Stuart-James security. The Immucell plan was mandatory. Meinders told the agents that they had to be careful not to make it look like a tie-in and not to expressly tell customers that "if you buy in the aftermarket, I will give you new issue." (Tr. 8843). With National Data, they were to go back to "the original company plan, which is to cross on the first day of the new issue trades." (Tr. 8846). Likewise, on Celerity, they were instructed to "cross everything out at the open." (Tr. 8848). On cross-examination, Midani further testified as follows: The agents had to get the clients' commitment that they were willing to give up the stock on the first day of trading. "Of course," he never told a client that the latter could not buy IPO securities unless he agreed to sell out on the first day of trading, because they "had to be careful of how we worded it to the clients." (Tr. 9101). Meinders' "concern was what we said to the client, so that it doesn't come out explicit tie-in." (Tr. 9104). On National Data, none of his IPO clients sold out on the first day. The reason was that the price was not right. On IMSF, where he sold his IPO allocation to two customers, one of them sold the warrants and kept the common and the other sold both. On Celerity, none of his IPO customers sold on the first day. By that

point, he realized that first-day crossing was not in the interest of his IPO clients and he made no effort to do so.

The above testimony, combined with the Immucell memorandum, warrants a finding that the agents were required to obtain customer agreement to buy more shares in the aftermarket as a condition to permitting them to buy IPO units. Both de la Torre and Midani testified to the mandatory nature of Meinders' "Alternative New Issue Program," and Meinders himself, while denying that any of his plans were mandatory, acknowledged that almost all of the agents went along with the Immucell plan. With respect to the other offerings, the evidence supports a finding that Meinders encouraged the agents to sell IPO securities only to customers who agreed to sell at the opening of trading. The low percentages of actual first-day sales in National Data and Celerity were attributable to the fact that in both instances the opening bid prices were below the prices in Meinders' plans on which the agreements to sell had been solicited and obtained.

Gibbs

As noted, Gibbs was manager of the Albuquerque office from September 1985 to about May 1986. The Division's arguments with respect to him may be summarized as follows: 112/ He told agents

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112/ Nye asserts that the Division's brief relies on certain exhibits and testimony that were either not offered on the tie-in issue at all or not offered against him on that issue. In substantial part he is correct. For example, the record is clear that customer H.A. was a witness only on the markups issue and not on tie-ins. (See Tr. 6360-62). To the extent the Division's contentions rest on evidence not received on the tie-in issue, they are not cited here. And of course I do not base any of my findings on such evidence.

to establish and maintain control over their customers, explaining that new issue should only be given to those customers who would sell it back upon the agents' recommendation. He threatened agents with punishment, such as taking away new issue, if they failed to "tie-in" customers. An agent in the office explicitly told customer J.T. that in order to be permitted to buy IPO securities, he had to agree to sell at the open. Based on their interpretation of the statistical evidence and their analysis of the pertinent testimony, Gibbs and Nye contend that no violation has been proven.

According to Snook, Gibbs used the phrase "establish and maintain control," meaning, among other things, that "if you gave new issue to a client, it must be given back on opening day." (Tr. 1418). She testified that she observed this process happening in all IPOs in which she participated, and that the securities would be crossed to aftermarket buyers when trading opened. Snook further testified that while she never observed an agent or a customer losing IPO because the customer failed to give it up at the opening, she observed customers who were not given subsequent new issue because they had not sold new issue at the opening, and brokers that were punished for the same reason. She was not asked for specific instances. She testified that on UMBE, her IPO customers "came out" at the opening. On cross-examination, Snook testified that IPO purchasers had to commit "to give it back to me" on the first day of trading (tr. 2224), and that where clients decided or tried not to sell their IPO, her approach was to encourage them to buy more of the same in the aftermarket.

McFadden testified that on UMBE Gibbs did not want any IPO purchaser "to hold onto the stock" (tr. 6384), and that she told her IPO buyers that they were going to have to sell when trading opened. She further testified that when one UMBE IPO purchaser balked at selling, she told him that if he did not sell, neither he nor she would get any more IPO. According to her, this is what Gibbs had told the agents, explaining that selling out when trading opened was necessary to generate commissions. She testified that Gibbs monitored the agents to be sure they had crosses arranged before trading opened. On cross-examination, she testified that the recalcitrant customer did sell when she explained the situation to him, and that she could not recall any IPO customer of hers who did not sell her or his stock on the first day of trading.

Cordova testified as follows: Prior to the UMBE offering, Gibbs used the phrase "control your client" in instructing agents that they were to get their IPO clients to sell out on the first day of trading. He told them that if clients wanted to hold the IPO securities and did not want to buy more of the issue, they should not be given new issue thereafter. She overheard agents strongly recommending to UMBE IPO customers that they come out the first day, take their profit and reinvest the proceeds.

As stated previously, customer J.T. testified that, prior to UMBE, an agent in the Albuquerque office told him that if he wanted an IPO allocation, the "ground rule" was that he would have to follow the agent's directions as to when to sell, and that, on the weekend before trading began in the UMBE securities, the agent told

him that both stock and warrants would be sold when trading opened.

In his testimony, Gibbs denied that while he was manager, agents were instructed to teach new issue customers to sell on the first day of trading, or that it was his goal to have such customers either sell or buy more on the first day of trading, or that he instructed agents not to give new issue to customers who did not agree to sell or buy more that day. He further denied ever taking new issue away from an agent because in the previous new issue that agent's customers had not sold or bought more on the first day of trading, and denied even threatening such action. The record shows that during the time Gibbs was manager, there were at least three IPOs, CXR Telecom, First Stop Professional Services and UMBE. 113/ In CXR (a stock-only offering), 10% of the stock was sold on the first day of trading. In First Stop and UMBE, the stock percentages were 61% and 53%, respectively, and the warrant percentages 0% and 72%, respectively. I generally credit the former agents' testimony over that of Gibbs, to the effect that Gibbs encouraged agents to obtain sell-out commitments from IPO customers. Yet both Snook and Cordova pointed out that buying more of the same securities was an accepted alternative. And the above

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113/ The Division did not include CXR Telecom, an October 1985 common stock IPO, in its presentation regarding the statistical evidence, because it mistakenly listed Gibbs as manager of the Albuquerque office beginning in November 1985 rather than in September 1985. There was also an IPO in mid-September 1985 by the name of Itelco. The record does not show, however, whether Gibbs had assumed his duties by that time, and I make no findings concerning it.

figures are indicative that agreements to sell out at the opening were not required.

Lasek

Lasek became manager of the Albuquerque office in May or June 1986 and remained in that position until March 1987. According to the Division, under Lasek the customers of that office were allowed to participate in new issues only on the condition that they sell out at the open, in order to generate a supply of stock that the office could then sell in riskless principal trades to other customers. It asserts that in Find, it was admittedly Lasek's plan to "trade out" all of his new issue customers and that he encouraged the agents under him to follow the same strategy. It points out that 84% of the Find IPO customers sold their stock on the first day of trading, and that all of this stock was resold in matched trades on the same day. 114/ Additionally, the Division points to two incidents where Lasek assertedly tore up new issue order tickets of customers who refused to sell or to agree to sell at the opening of trading.

Snook testified that Lasek, like Gibbs, used the phrase "establish and maintain control," meaning, among other things, that "if you gave new issue to a client, it must be given back on opening day." (Tr. 1418). She testified that she observed this process happening in all IPOs in which she participated. Snook

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114/ The Division also refers to Lasek's own transactions in UMBE as demonstrating that he followed the instructions he gave his sales agents. However, at the time of UMBE the manager was Gibbs. Moreover, the exhibit showing Lasek's UMBE transactions was not offered against him.

further testified that whenever she sold new issue, she explained to the buyers that they had to be willing to give "it" up on the first day of trading, and the securities were crossed to aftermarket buyers when trading opened. According to Snook, tickets were prepared in advance and sometimes turned in in advance. She testified that while she never observed an agent or a customer losing IPO because the customer failed to give it up at the opening, she observed customers who were not given subsequent new issue because they had not sold new issue at the opening, and brokers that were punished for the same reason. In subsequent testimony, she stated that where IPO customers did not want to come out at the opening, their trades were sometimes cancelled or they would never receive new issue again, and the agent would be punished by a fine or loss of new issue allocation. She was not asked for specific instances. On cross-examination, Snook further testified as follows: She crossed her IPO allocation of Find on the first day of trading. IPO purchasers had to commit "to give it back to me" on the first day of trading; where customers decided or tried "to hang onto the IPO," her approach was to encourage them to buy more of the same in the aftermarket. (Tr. 2224). According to a Division analysis of transactions by Snook's IPO purchasers as reflected in her "commission runs" (Nye Ex. 1), first-day complete or partial sales in IPOs beginning with Univation were as follows: None of four customers; 4 of 4 (ASA International); 5 of

5 (Find); 115/ 4 of 6; none of 5; 7 of 8; and 4 of 4. (See Division Reply to Nye Proposed Findings 163-165).

McFadden testified that "you were not allowed to have [an IPO purchaser] hang onto the stock, period." (Tr. 6394). She testified that Lasek's instructions were to tell clients that they would be making a substantial profit and not to be greedy. According to her, he told the agents to "establish and maintain control" and that customers would not get IPO stock unless they agreed to sell out at the open. She further testified that Lasek monitored the agents to be sure they had crosses arranged before trading opened. On cross-examination, McFadden testified that she could not recall having any IPO customer who did not sell his or her stock on the first day of trading.

According to Cordova, Lasek regularly stated to the agents that clients should not be sold IPO securities unless they agreed to give it back on the first day of trading. He indicated that clients who did not so agree should not be given new issue again. Lasek used the phrase "pigs get fat, hogs get slaughtered" to indicate that customers "should sell out of their new issue, take their profit and move to something else." (Tr. 3573-74).On cross-examination, she acknowledged that one of her customers who bought IPO units in the Disc Technology offering and did not sell on the first day of trading nevertheless participated in the next IPO, that other customers also did not sell out at the opening of

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115/ The Division mistakenly cited the figures for Find as 1 of 1. See Division Reply to Nye Proposed Findings 163-65.

trading, and that there were no consequences to her in terms of future allocations.

Dirk Tinley, who was an agent in the Albuquerque office from May 1986 to January 1987, testified that, pursuant to Lasek's instructions, he required every IPO purchaser to "[have] the understanding that he was going to sell new issue on opening day." (Tr. 3810). He testified that Lasek used the phrase "control your client" in that connection. He further testified that on Find, prior to the effective date, he turned in his tickets for crossing the IPO stock. Tinley further testified that in Disease Detection, Lasek took away part of his IPO allocation because a customer who had agreed to sell on the first day of trading decided not to sell. According to Tinley, when he advised Lasek of the customer's decision, Lasek tore up the order ticket, took the customer's allocation away and did not permit Tinley to resell it to another customer. On cross-examination, Tinley, when confronted with his investigative testimony that the allocation was not taken from him, but that he had to find another buyer, indicated that he now believed, but was not certain, that it was taken away. He acknowledged that a number of his IPO customers did not sell all or part of their allocation on the first day of trading. The Division's computation of first-day complete or partial sells by Tinley's IPO customers, based on Tinley's "commission runs" (Nye Ex. 5), is as follows: 1 of 1 customer (Find); 1 of 5; none of 3; 2 of 3; and none of 3. (See Division Reply to Nye Proposed Findings 180-190). Tinley further acknowledged that his IPO allocations

(which were always in a minimum amount) were not taken away because of what his customers did or did not do in the aftermarket.

Aaron Appel, who was an agent in the Albuquerque office from June to September 1986, testified that in connection with ASA International, the only IPO during his tenure with Stuart-James, Lasek told the agents that new issue buyers had to sell when trading began. He further testified that he was allocated one unit; that he found a buyer; that he called the buyer back before the stock started trading and "asked him if he was satisfied with a 40 to 50 percent profit if we could sell the stock and move him into something else" (tr. 2844); and that the customer said that he was not interested in selling and wanted to hold onto the stock. According to Appel, when he told Lasek, the latter tore up the IPO ticket for that customer and said he would sell the unit to one of his own customers. On cross-examination, Appel reiterated that Lasek demanded that IPO customers sell out on the first day as a condition of getting new issue.

In his testimony Lasek denied that he had any problem with IPO customers who did not want to sell on the first day of trading or with agents whose customers did not want to sell. He testified that if a stock was up substantially from the offering price, he recommended selling it, and that the agents under him would likely follow his lead. He denied ever telling agents he would take new issue allocation away from them if their customers did not sell on the first day of trading and denied actually doing so. Lasek denied that he took Appel's ASA allocation from the latter's customer

because the customer declined to sell. He testified that he disapproved the sale to the customer because the customer had a reputation for causing compliance problems, and that he enabled Appel to sell the securities to one of his (Lasek's) customers.

The testimony with respect to Lasek is probably the strongest of that adduced with respect to any of the respondent managers. I credit the essentially consistent testimony of the sales agents over Lasek's denials. The fact that he actually tore up order tickets is compelling evidence of his determination to have IPO purchasers sell out when trading opened. The statistical evidence for two successive IPOs, ASA International and Find, supports a conclusion that at least during that time Lasek required the agents to obtain tie-in agreements as a condition for receiving IPO allocations. In ASA, 92% of the stock and 80% of the warrants were sold on opening day. Corresponding figures for Find were 84% and 71%.

Czaja

As noted, Czaja was manager of the Pompano office from April 1986 to April 1987. The Division contends, among other things, that he taught sales agents to sell new issue to persons willing to give it back when trading opened; that he threatened to and did take away new issue from customers who refused to trade at the open; and that he punished agents by reducing future allocation of new issue when they failed to tie-in new issue customers. Czaja, in turn, denies that he established any unlawful sales practices and specifically that there was a requirement that customers agree to

sell back new issue securities as a condition to the right to purchase such securities. He argues that to the extent that sales practices of the Pompano office were found to be questionable, they were a reflection of the overall practices of the firm. As with the no net selling allegation, Czaja asserts that certain of the witnesses against him did not implicate him, and that the testimony of others is not credible. He points to the absence of customer witnesses against him and to the favorable testimony of defense witnesses. Czaja also points to exhibits in the SJ Exhibits 31-60 series as supporting his position.

Former sales agent Vucsic testified as follows: He did not receive instructions from Czaja about placing IPO securities, but observed experienced agents generally placing IPO securities with clients "with the intention to sell it." (Tr. 5642). In some instances, he discussed selling out with customers at the time he sold the IPO securities to them. He heard the phrase "control the client" in the office in this context, but could not attribute it to Czaja. Since IPO allocation to agents was closely related to commissions generated on the previous IPO, agents had a strong incentive to maximize commissions on each IPO through crossing and reinvestment of proceeds. It was "generally understood" that a customer was "not worthy of IPO" unless he or she agreed to sell it when trading began. (Tr. 5656). He never observed an agent having his IPO trade "busted" or his allocation of IPO reduced or taken away because a customer would not agree to a tie-in, but he had "an understanding that that type of thing took place." (Ibid.).

According to Bethany, Czaja's new issue plan called for at least the stock portion of the IPO securities to be crossed as soon as trading opened, and Czaja "suggested" that a customer should not get new issue unless he or she agreed to give the stock back or buy more. (Tr. 4869). He testified that if a customer wanted to hold onto the stock, the allocation was taken away from the customer and the agent, but that it was acceptable for the customer to hold onto the IPO securities if he agreed to buy more. He named several agents who, according to him, lost allocations on this basis.

King (who, as noted, was the ex-wife of a former agent in the Pompano office and who spent considerable time in the office assisting him) testified as follows: Czaja regularly used the term "control your client" in the context of making customers understand that if they received an IPO allocation, they had to sell it on the first day of trading. Specifically, he wanted the agents to ask prospective purchasers if they would agree to sell if the price reached a certain level, to give an allocation only to those who agreed, and to write up sell tickets in advance. On cross-examination, she admitted that she could not cite a specific case where a customer did not get an IPO allocation because he did not agree to sell. She answered in the negative the question whether Czaja's statements were not just encouragement rather than requirements.

Czaja's three defense witnesses, all former agents in the Pompano office, denied that they were instructed to condition IPO purchases on the purchasers' agreement to resell at the opening of

trading and testified that they did not themselves impose such a condition and were not punished in instances where their customers did not sell at the opening of trading. They all testified that they made varying recommendations to their IPO customers regarding aftermarket strategy, including selling out in some circumstances.

Czaja himself testified that he did not impose any requirement on agents or customers that customers must agree to sell back new issue securities as a condition to the right to purchase such securities, and that IPO customers were free to do whatever they wanted in the aftermarket. He acknowledged that he told the agents in his office that the best way to make money with their new issue was to have the new issue customer sell out on the opening day of trading, cross the securities to an aftermarket buyer and have the new issue customer reinvest the proceeds.

The case that under Czaja sales agents were required to sell IPO securities only to customers who agreed to sell at the opening of trading rests largely on the testimony of Bethany and King. In the face of the unanimous testimony of the three defense witnesses and Czaja's own testimony that there was no such requirement, I am reluctant to make such a finding based on the testimony of one witness (Bethany) who was strongly antagonistic to respondents and another (King) who was in the office only on a part-time basis. 116/ On the other hand, the record, including the

116/ The Division claims that because Paul Frazzini, one of the defense witnesses, is a long-time friend of Czaja's, his "obvious bias" renders his testimony "not worthy of belief." (Reply Brief at 58). If I were to discredit automatically the (continued...)

statistical evidence regarding first-day sales, supports a finding that Czaja encouraged the practice of selling IPO securities only to customers who agreed to sell when trading opened. Throughout the period when Czaja was manager, the percentage of first day sales of IPO stock was, with only one exception, well above 50%.

Legal Discussion and Conclusion

The Division has advanced several legal theories as to why the conduct alleged in the order for proceedings involved a violation of the antifraud provisions. One theory is that the tie-in arrangements constituted a material alteration of the distribution plan for the various IPOs, and that the failure to disclose such alteration to the new issue customers, the immediate aftermarket buyers and IPO offerees who were not permitted to buy because of their unwillingness to accept the tie-in condition, defrauded persons in each of these categories. In addition, the Division contends that use of tie-in agreements artificially influenced and affected the entire trading market and breached respondents' duty of fair dealing. In this connection, it argues that tie-in agreements give a false impression of market activity that is induced as opposed to the natural result of a free market.

The Division's brief cites many cases in support of its arguments. As respondents stress, however, none of these deal with

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116/(...continued)
testimony of friends of the respondents, I would also have to discredit the testimony of many of the Division's witnesses who clearly had antagonistic feelings toward respondents. As indicated by my findings and discussion, I view this as an oversimplified approach.

the type of arrangement at issue here. 117/ The Division does refer to a 1984 statement by Commission officials to a House subcommittee regarding the hot issues market, which referred to illegal tie-in arrangements, whereby customers, in return for an opportunity to buy a hot issue stock, were required to either put in an aftermarket bid for additional shares at an increased price or purchase shares in another offering. These were characterized as devices designed to create a false impression of the market for a security. Respondents cite the lack of authority in support of the Division's position and urge that its legal analysis is not soundly based.

I am satisfied that where IPO customers sell securities because they have agreed to do so as a condition of being permitted to buy the IPO securities, it is a device which creates a false impression of the market in the form of a misleading appearance of activity for those securities and is fraudulent in the absence of full disclosure. Such arrangements are not legally distinguishable from the more common type of tie-in arrangement involving the purchase of securities in another offering as a condition of being permitted to participate in the first offering.

Presumably on the theory that the two situations are not legally distinguishable, the Division has not addressed separately the "encouraged" and "required" language of the allegation. I have

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117/ The only two cases it cites that involved tie-in arrangements involved requirements imposed on salesmen to "tie-in" customers' purchases of one security with the purchase of other securities. In both cases the Commission issued orders on the basis of settlement offers.

made separate findings because arguably there is a difference. Clearly, if the allegation were in terms of customers either being required or encouraged to agree to sell, a conclusion that the mere encouragement of customers to do so was fraudulent would be more difficult to sustain. However, whether sales agents were required or encouraged to obtain tie-in agreements does not appear to me to involve a legal distinction.

Accordingly, I conclude that Beaird, Sutton, Sullivan, Meinders, Gibbs, Lasek and Czaja, all of whom intentionally encouraged or required the tie-in arrangements, willfully violated the antifraud provisions.

VI. SUPERVISION

In view of my findings that Lasek and Ward violated the antifraud provisions by establishing no net selling policies or practices and that all respondent branch managers violated those provisions by establishing tie-in policies or practices, the next issue for determination is whether, under Sections 15(b)(4)(E) and 15(b)(6) of the Exchange Act, Stuart-James, Padgett and Graff failed to exercise reasonable supervision over those persons and whether Nye failed to exercise such supervision over the managers in his region (Gibbs, Lasek, Meinders, Sullivan and Sutton).

Section 15(b)(4)(E) provides that the Commission may sanction a broker-dealer if such broker-dealer "failed reasonably to supervise, with a view to preventing [securities] violations . . . another person who commits such a violation, if such person is subject to his supervision." Section 15(b)(6) makes the provisions

of Section 15(b)(4)(E) applicable to persons associated with a broker-dealer. In what all parties characterize as a "safe harbor" provision, Section 15(b)(4)(E) further provides that "for the purposes of this subparagraph (E)," no person shall be deemed "to have failed reasonably to supervise any other person" if (1) "there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by any other person," and (2) such person "reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system" and had no reasonable basis for believing that those procedures and system were not being followed.

The Commission has frequently addressed the standards of supervision required under the statutory provisions. In two of its most recent decisions, it has stressed that what the statute requires is reasonable supervision under the attendant circumstances. (Louis R. Trujillo, Securities Exchange Act Release No. 26635 (March 16, 1989), 43 SEC Docket 690, 694; Arthur James Huff, Securities Exchange Act Release No. 29017 (March 28, 1991), 48 SEC Docket 878). In defining the response that is required of supervisors when they are confronted with indications of irregularity (so-called "red flags"), the Commission recently stated that "those in authority [must] exercise particular vigilance when indications of irregularity reach their attention." (Louis R. Trujillo, 43 SEC Docket at 694 (quoting Wedbush Securities, 48 S.E.C. 963, 967 (1988)). As Padgett and Graff point

out, in the same decision the Commission stated that "a manager (of any stripe) 'must respond reasonably when confronted with indications of wrong-doing.'"(Id. at 695 (quoting William L. Viera, Securities Exchange Act Release No. 26576 (February 28, 1989), 42 SEC Docket 1815, 1821). 118/

The parties disagree on the way in which the safe harbor provisions of Section 15(b)(4)(E) should be treated. Respondents urge that the Division has the burden of proving the absence of the safe harbor, whereas the Division takes the position that those provisions are an affirmative defense as to which respondents bear the burden of proof. The statute is not clear on the point, and neither side is able to point to an authoritative judicial or administrative interpretation. The Division cites cases that deal with an entirely different issue. Respondents point to an initial decision that became final when no review was sought. However, that decision, Charles Schwab & Co., [1983-84 Trans. Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,469, at 86,498 (Dec. 28, 1983), does not in my judgment clearly address or resolve this issue. In any event, however, my findings herein do not depend on a resolution of the issue.

118/ Respondents urge, with justification, that this standard represents a considered departure from earlier, more stringent Commission pronouncements such as that in Paine, Webber, Jackson & Curtis,, 43 S.E.C. 1042, 1050 (1969) (quoting Reynolds & Co., 39 S.E.C. 902, 916 (1960)) that "in large organizations it is especially imperative . . . that those in authority exercise the utmost vigilance whenever even a remote indication of irregularity reaches their attention."

Padgett and Graff urge that there is no such offense as failing to supervise someone else's failure to supervise. While they state the principle correctly, it has no application here. In Arthur James Huff, Securities Exchange Act Release No. 29017 (March 28, 1991), 48 SEC Docket 878, the case on which respondents rely, Huff was charged, among other things, with failing to exercise reasonable supervision over a branch manager who himself was charged with deficient supervision of a salesman. The Commission pointed out that under the terms of Section 15(b)(4)(E) the supervisee must have committed a violation, and that deficient supervision by a subordinate is not a violation within the meaning of that section. Here, by contrast, Padgett and Graff are charged with failing to supervise branch managers and a regional vice-president who allegedly were (and have been found to be) direct violators of antifraud provisions.

Graff also argues that since he was not president of the firm, the Division never adequately explained how he "could even theoretically be liable for failure to supervise." (Padgett and Graff Brief at 124 n.233). Graff was chairman of the board. As the Division properly points out, he and Padgett exercised total joint control over the firm's day-to-day operations. There is no question that he was a supervisor of the branch managers and regional vice-presidents and as such, like any supervisor, comes within the reach of Section 15(b)(6). 119/

119/ See Arthur James Huff, 48 SEC Docket at 887, where the concurring opinion of Commissioners Lochner and Schapiro, in (continued...)

No Net Selling

As would be expected, the parties disagree as to whether the charged respondents exercised reasonable supervision. My analysis and conclusion, however, proceed along a different route. The Division contends that Stuart-James, Padgett and Graff created and fostered, and by certain of their acts encouraged, an environment conducive to no net selling and then failed to learn about or prevent the abuse, when any reasonable inquiry would have alerted them to the problem. But it further asserts, and offered extensive evidence in support, that Padgett and Graff, on various occasions and at various times, actually instructed agents and managers that net selling was prohibited. Thus, its position appears to partake both of supervisory failure and of affirmative encouragement of violative conduct. In Fox Securities Company, 45 S.E.C. 377, 383 (1973), the Commission, in discussing the distinction between aiding and abetting and failure of supervision and noting that the distinction was "somewhat shadowy," described aiding and abetting as "more of an active participation in or awareness of improprieties," while failure of supervision connoted "more an inattention to supervisory responsibilities when more diligent attention would have uncovered improprieties." 120/

119/(...continued) addressing the question of whether the respondent was a supervisor of the person who had committed the violations, stated that the alleged supervisor's power to control the violator's conduct was the most probative factor.

120/ In that case, the president of a broker-dealer was charged with aiding and abetting Exchange Act provisions which only (continued...)

At an early stage of these proceedings, I raised a question regarding the thrust of the allegations, in relation to a statement in the Division's More Definite Statement that Nye failed reasonably to supervise by, among other things, "encouraging" no net selling and tie-ins. In an order issued on May 19, 1989, I pointed out that that language suggested an active participation in the alleged practices rather than a failure to supervise, and that the Division would have to clarify the matter at the prehearing conference. When I raised the question again at the conference, Division counsel responded that the Division was only alleging failure to supervise. He stated that in his view "one can encourage without necessarily getting to the level of being a substantial enough participant to actually be a primary violator, and depending on the manner and method of encouragement, it could be a failure to supervisor (sic). For example, silence in the face of knowledge could be deemed encouraging." (Tr. 8). More than a year later, when the Division had almost completed its direct case, it filed a motion to amend the supervisory failure allegations by adding an alternative allegation, also based on Section 15(b)(4)(E), that Stuart-James, Padgett, Graff and Nye willfully "aided, abetted, counseled, commanded" the branch managers' alleged

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120/(...continued)
a broker-dealer can violate.

See also Anthony J. Amato, 45 S.E.C. 282, 286 (1973): "Failure of supervision . . . connotes an inattention to supervisory responsibilities, a failure to learn of improprieties when diligent application of supervisory procedures would have uncovered them."

antifraud violations. I denied the motion, on the ground that it would be unfair and prejudicial to respondents, "at this late stage in these enormous proceedings, to introduce a new allegation against them." (Order Denying Motion to Conform Pleadings to Evidence, July 31, 1990, at 6-7). 121/

Where, as here, the Division's arguments, and the evidence on which it relies, partake of both supervisory failure and active direction or participation, it appears to me illogical and inappropriate to make a finding of supervisory failure. 122/ Since this is true with respect to Stuart-James, Padgett and Graff, it would be incongruous to find that Nye, their subordinate, failed in his supervisory responsibilities.

Tie-Ins

As I have found, each of the respondent branch managers had a tie-in policy or practice, in that they encouraged or required sales agents to condition customers' purchases of IPO securities

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121/ In footnote 4 to that order, I dealt with the "spectre" raised by the Division that if I did not permit the amendment, respondents might defend by admitting that they counselled or commanded the violations and using those admissions as a defense to the failure to supervise allegation. I stated then that such a result would be intolerable, having in mind a situation where such admissions would not be consistent with the record. That is not the situation here, since respondents vigorously deny that they encouraged the violations or, *a fortiori*, that they counselled or directed them.

122/ *Cf.* Fox Securities Company, 45 S.E.C. 377, 383 (1973); R.A. Johnson & Company, 48 S.E.C. 943, 947 n.14 (1988). In these cases respondents were charged with both substantive violations or aiding and abetting and supervisory failure. There were findings of substantive violations. The Commission held that respondents could not also be held responsible for supervisory failure for the same conduct.

on the customers' agreement to sell securities bought in the underwriting at the opening of trading or, in one instance, to buy additional securities at that point.

Stuart-James, Padgett and Graff

The Division contends that Stuart-James, Padgett and Graff failed to exercise reasonable supervision over those managers, relying on the following arguments, among others: Padgett and Graff were particularly involved in the first-day trading of new issues. In advance of trading, they received accurate estimates of how many shares of stock each office expected to buy from IPO customers and at what prices. Yet there is no evidence of any action taken to determine if tie-in or other illegal practices were being used which would enable the offices to provide those estimates. The huge amount of fir t-day commissions and the practice of crossing new issue customers to aftermarket buyers were additional "red flags." The firm policy of rewarding cross trades required extra vigilance. The allocation process, through which managers rewarded agents who were big producers, encouraged tie-ins. Moreover, respondents delegated excessive supervisory responsibility to branch managers, who were not trained to detect or avoid sales practice abuses, and they hired young and inexperienced agents who were vulnerable to the managers' influence. Respondents' claim of an effective supervisory structure relies on the mere existence of an organizational chart, reports, manuals and the like. The record is devoid of evidence regarding the responsibilities of particular personnel or the manner in which reports and manuals were used.

Stuart-James, in response, contends that it designed and implemented a supervisory system that was reasonably designed, insofar as practicable, to detect violations that could be detected, and that its personnel reasonably discharged their duties under the system. It points, among other things, to the "chain of command," and it states that branch managers were required to make random calls to customers to check if there were problems; that regional vice-presidents were to check that the managers were doing what they were supposed to; that the branch offices were periodically audited; that the firm had a good compliance department and that, beginning in 1987, it developed a sophisticated automated management information system which aided compliance; and that the firm provided compliance manuals and videotapes for agents and manuals for managers. Stuart-James contends that the Division offered no proof as to what supervisory procedures would have detected or prevented tie-ins. Stuart-James denies that branch managers had excessive supervisory responsibilities, asserting that they were under constant supervision by those above them.

Like Stuart-James, Padgett and Graff point to the hierarchy of line supervisors and to the "successful and effective" compliance department (Padgett and Graff Brief at 125). They contend that they reasonably delegated supervisory authority to the line supervisors and to the compliance department, and they point out that the Commission has repeatedly held that a reasonable delegation relieves a supervisor of liability. They further contend

that there were no "red flags" that should have alerted them to the existence of tie-ins. In that connection, they assert that the statistical evidence demonstrates that even at the branch level, there was no pattern, such as consistently high first-day resales, that should have indicated to anyone that tie-ins were occurring.

Padgett and Graff acknowledge that even where the senior officers of a firm have reasonably delegated responsibility for compliance matters, they must respond reasonably when confronted with "red flags." As previously noted, however, in the Trujillo case from which that language is drawn, the Commission also used possibly stronger terms in stating that those in authority must exercise particular vigilance when indications of irregularity reach their attention.

I find that Padgett and Graff were confronted with red flags that, no matter which standard is applied, called for action on their part. They were deeply involved in the first-day trading of IPOs and in preparations for the opening of trading. They were, of course, aware of the Stuart-James commission structure which made crossing particularly advantageous for the sales agents and others up the line whose income was based on commissions. They must have been aware of the high percentage of IPO securities that were sold and crossed on the opening day of trading in many of the IPOs and of the very high commissions that were realized on opening days.

By contrast with Professor Fischel's exhibit — of average first-day trading volume for 118 IPOs, which showed a figure of about 28% (PG Ex. 114), first-day stock sales of many of the

Stuart-James IPOs were far higher. By way of illustration, on a firm-wide basis 55% of the UMBE common stock and 70% of the Find common stock were sold on the first day. 123/ In the branches under consideration, the figures were mostly even higher. Again by way of illustration, in the Houston Post Oak office the percentage of common stock sold on the first day of trading in five of the seven IPOs for which data were available was at least 75%. Of course, there were instances where the figures were much lower. And I am not suggesting that Padgett and Graff were aware of these precise percentages at the time of the IPOs. But they were aware that with many of the IPOs there was a very large number of transactions on opening day. This put them on notice that improper methods to stimulate transactions might be involved and required them to respond with appropriate steps to ascertain the facts and prevent further misconduct. 124/ Accordingly, I find that Stuart-James,

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123/ Padgett and Graff's citation of PG Exhibit 114 and Professor Fischel's testimony concerning it for the proposition that the 55% and 70% figures "are unexceptional volume figures for the first day of aftermarket trading of a NASDAQ security" is misleading. (PG Proposed Finding 256).

124/ The Division also contends that respondents had actual notice of tie-ins in April 1986, as a result of a suit filed that month by a customer alleging an unlawful tie-in. (Pelletier v. Stuart-James Co., 863 F. 2d 1550 (11th Cir. 1989)). I do not consider, however, that the Pelletier case further strengthens the Division's arguments. Pelletier sued in the United States District Court for the Northern District of Georgia under Sections 10(b) and 20 of the Exchange Act and Rule 10b-5. The defendants were a sales agent in the Atlanta office, his office manager and the firm. The plaintiff alleged that the agent entered into an agreement with him to sell him 10,000 IPO units of UMBE; that, as a condition for selling him the units, the agent required him to buy another security; that the agent subsequently informed him that he could only

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Padgett and Graff failed reasonably to supervise the respondent branch managers with a view to preventing their tie-in violations.

Nye

In contending that Nye failed reasonably to supervise the managers who were subject to his supervision, the Division presents the following arguments, among others: Nye was an active supervisor who was in constant touch with those managers, including the receipt of daily and weekly reports and regular visits to each of the offices. He himself taught sales agents to cross stock from new issue customers to aftermarket buyers, and he received reports from managers regarding anticipated purchases from new issue customers. He had actual notice of Meinders' tie-in plans, and in fact

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124/(...continued)
have 1,000 units and sought his permission to sell those units on the day of the public offering; and that the defendants refused to deliver the units because he rejected that condition. In October 1987, at the conclusion of the plaintiff's case, the court directed a verdict for the defendants. The court of appeals subsequently affirmed. The Division is correct in stating that the courts did not address the merits of the complaint; rather, the decisions were based on legal theories. However, Graff testified that when the suit was filed, Geman retained outside attorneys and investigated the merits of the complaint and that, based on the investigation, "we thought that the customer was dead wrong." (Tr. 12894). There is nothing further in the record bearing on this matter. Under the circumstances, it would be stretching things to find that further action was required as a consequence of the suit.

I also find no support for the Division's position that respondents failed in their supervisory responsibilities in the fact that in early 1988, subsequent to the relevant period, Padgett and Graff reappointed Meinders as Colorado Springs branch manager even though by that time they and Geman had learned of his IPO plans.

encouraged the ones after Immucell, but did nothing to monitor Meinders' trading strategies or prevent use of tie-ins. 125/

Nye, in response, contends that the Division, without justification, is seeking to impose on him an obligation to look for "red flags," regardless of any indication of wrongdoing. He further contends that there is no evidence of any customer or sales agent complaining or of records reflecting tie-in violations. With reference to the Division's reliance on crossing as a routine practice in Nye's region and his encouragement of crossing new issue securities, he argues that crossing is not illegal and in fact was accomplished to give customers a better price. With respect to Meinders, Nye asserts that he warned him against tie-ins; that Meinders' plans were nothing more than recommendations; and that no plan was ever implemented.

Notwithstanding Nye's denial, the record shows that he was confronted with red flags and did not act to detect or prevent the tie-in violations in the Colorado Springs and Albuquerque offices. In large measure, I base this finding on the same factors that I found with respect to Stuart-James, Padgett and Graff. If anything, Nye was in even closer and more constant touch with the branch offices under him than were his superiors. As such, he was aware of the huge amount of crossing that took place on the first trading

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125/ The Division also cites testimony regarding conduct in offices other than Colorado Springs and Albuquerque. As Nye points out, those other offices were not at issue with respect to the tie-in allegations, and the witnesses relied upon were not offered on the tie-in issue or against Nye. I have made no findings on that issue based on their testimony.

day of many IPOs. To a reasonable supervisor, this awareness should have prompted inquiry into methods being used by the branch managers and sales agents to encourage IPO purchasers to sell when trading opened and prompted him to seek to assure that no improper methods were being used.

With respect to the Meinders situation, the record shows the following: According to notes taken by Meinders at a managers' meeting in December 1986, when he was an assistant manager in Denver, Nye said words to the effect: "No Tie In Sales. Regulatory Problem." (Div. Ex. 328). Meinders testified that to him this meant that the managers should not have agents tie in the sale of the IPO then coming up with a sale by the customer. Thus, it appears that Nye was warning the managers against the very practice that is at issue here. As previously noted, in Immucell, Meinders' first IPO as manager of the Colorado Springs office, Meinders had an alternative plan that called for IPO customers to buy additional Immucell stock at the opening of trading. The plan failed, and Nye berated Meinders for his plan, telling him that if he wanted to fill buy orders he should cross the IPO stock. Meinders' weekly report dated May 1, 1987, the first day of trading for Immucell, and sent to Nye, Graff and Geman stated: "Plan 'A' didn't work due to lack of secondary stock. Screwed up. Didn't have plan 'B' ready in time. It won't happen again." (Div. Ex. 333(a)). On the same date Meinders wrote a memorandum summarizing the events surrounding the opening of Immucell, but kept it for himself. The memorandum indicated that Meinders believed his Immucell plan had been seen

and approved by his superiors, and it was essentially a defense of his strategy.

On the next three issues Meinders' written plans called for the new issue customers to be sold out at the opening of aftermarket trading. Meinders sent copies of the plans to Nye. And his weekly report after the first day of trading in International Microcomputer ("IMSF") stated: "The week went fairly close to plan[.] IMSF was close to what we targeted. I had hoped for 80% completion on the opening prices. We will get better." (Nye Ex. 28). Despite the warning signs, there is no evidence that Nye took any action after Immucell to monitor Meinders' trading strategies or prevent use of tie-ins which his earlier criticism of Meinders had encouraged.

Under all the circumstances, I find that Nye failed reasonably to supervise the managers who were subject to his supervision with a view to preventing the tie-in violations.

VII. PROCEDURAL ISSUES

Opportunity to Achieve Compliance

Padgett and Graff argue that under Section 9(b) of the Administrative Procedure Act ("APA"), 5 U.S.C. § 558(c), they must be given an opportunity to achieve compliance with the law before any restrictions are imposed on their right to work in the securities industry. Section 558(c) provides, in pertinent part, that such an opportunity must be accorded before an agency institutes proceedings for the suspension or revocation of a license, "[e]xcept in cases of willfulness or those in which public

health, interest, or safety requires otherwise." Thus, the Act speaks in terms of what must be done before proceedings are instituted and does not address a proceeding in the advanced stage of this one. These respondents nevertheless argue that they have not been given an opportunity to achieve compliance, and that the willfulness exception is to be interpreted more stringently than the Commission's willfulness standard under the Exchange Act. The argument is rejected.

The Commission has consistently held that proceedings such as these are within the willfulness and public interest exceptions. For example, in Sterling Securities Company, 37 S.E.C. 837, 839 (1957), a broker-dealer proceeding under the Exchange Act, the Commission said:

> In our opinion these proceedings are within the exceptions expressly provided in Section 9(b) of the Procedure Act. We can see no basis for interpreting the words "willfulness" and "public interest" in that Act more narrowly than in the Exchange Act. The Congress recognized that there must be latitude in an agency's determination of willfulness and the requirements of the public interest. Willfulness and public interest need not be proved prior to the institution of proceedings since these are issues to be determined on the basis of the record to be made at the hearings. It is sufficient that the order for proceedings involves these issues . . . . It is clear that the situation presented in this case, involving alleged fraud in the purchase and sale of securities, is of the type contemplated by the Procedure Act exceptions with respect to cases of willfulness or those where the public interest requires the prompt institution of proceedings. (Footnotes omitted).

See also Richard N. Cea, 44 S.E.C. 8, 21 (1969); Dlugash v. S.E.C., 373 F.2d 107, 110 (2d Cir. 1967).

Respondents point out that in Capitol Packing Company v. U.S., 350 F.2d 67, 78-79 (10th Cir. 1965), the court interpreted the

willfulness exception to apply only to "an intentional misdeed or such gross neglect of a known duty as to be the equivalent thereof." Respondents are not aided by this interpretation, however, in view of my finding that they acted with scienter in the markup situation.

Conclusion Within Reasonable Time

Beaird et al., joined by Padgett and Graff, urge that the proceedings should be dismissed because they have not been concluded within a reasonable time. The argument rests on a section of the APA, 5 U.S.C. § 555(b), which in pertinent part provides that "[w]ith due regard for the convenience and necessity of the parties or their representatives and within a reasonable time, each agency shall proceed to conclude a matter presented to it." Beaird et al. note that the investigation began in 1986, proceedings were instituted in 1989 and the hearings were concluded about two years later. They urge that the Division, through its investigation, was able to develop and memorialize favorable testimony; that its witnesses were able to refresh their recollections by reviewing their investigative testimony; that, where there was a failure of recollection, the Division was able to read the prior testimony into the record; and that respondents, who had no similar opportunity to memorialize favorable testimony, have been prejudiced because of the fading of recollections. They also allude to the fact that they have been stigmatized over an extended period

because they have been required to report the pendency of these proceedings on forms filed with the NASD. 126/

The Division responds that, given the complexity of the issues and the vigorous defense, there has been no violation of the APA's mandate. It argues that respondents' complaint concerning the Division's ability to use prior witness statements to refresh recollection is frivolous, since those statements were made available to and used extensively by all parties.

As pointed out by the court in a case cited by Padgett and Graff, "[t]here are no absolute standards by which it may be determined whether a proceeding is being advanced with reasonable dispatch." Deering Milliken, Inc. v. Johnston, 295 F.2d 856, 867 (4th Cir. 1961). 127/ In a more recent case, cited by the Division, the court held that before an agency action may be set aside for lack of punctuality, the aggrieved party must show that it was prejudiced by the delay. Panhandle Coop. Ass'n. v. E.P.A., 771 F. 2d 1149 (8th Cir. 1985).

126/ During a hiatus in the hearings resulting from Commission consideration of motions arising out of the Meinders settlement, Beaird et al. and various other respondents moved for dismissal of the proceedings on the basis of § 555(b). In orders dated November 28 and December 19, 1990, I deferred ruling on those motions, on the ground that the claimed prejudice from the passage of time could be evaluated only in the light of further developments at the hearings.

127/ At that time the APA provision read somewhat differently. It provided that "[e]very agency shall proceed with reasonable dispatch to conclude any matter presented to it except that due regard shall be had for the convenience and necessity of the parties or their representatives."

Of course, the instant proceedings have not yet been concluded. However, given their complexity and magnitude, it does not appear to me that the time elapsed to this point is unreasonable, regardless of the starting point from which that time is measured. The hearings extended over a very long period, but not an unreasonable one under the circumstances. In substantial part their length was attributable to the multitude of issues and to the fact that they were vigorously contested, including extended cross-examination by counsel for different respondents. It was also attributable in part to the fact that logistic and scheduling problems required that the hearings be conducted at intervals. The time that elapsed in the briefing and decisional stages was lengthy, but was commensurate with the enormous record and the complexity of the issues presented.

I also consider that respondents were not materially prejudiced. All sides were hindered to some extent by the recollection problems arising from the delay between the events under consideration and the witnesses' testimony. However, contrary to respondents' contention, they benefitted more than the Division from the transcripts of investigative testimony. Instances where the Division read investigative testimony into the record were relatively few, while all respondents read extensive portions of such testimony into the record as part of cross-examination. Those respondents whom the Division called as witnesses, and the defense witnesses called by Stuart-James and Padgett and Graff, did not have significant memory problems. Beaird et al. called no defense

witnesses. Finally, I do not consider that the reporting requirement, which is a collateral consequence of these proceedings, provides a basis for granting relief under § 555(b).

Miscellaneous Issues

Padgett and Graff reiterate several procedural arguments previously made by them and rejected by me. The matters in question are (1) the admission into evidence of the investigative transcript of Oliver Scarbro, who had died before the hearings began; (2) the Division's failure to provide more particulars relating to the no net selling and tie-in allegations; and (3) denial of respondents' request to amend their answer to assert the statute of limitations as an affirmative defense. Since respondents state that they are reiterating these arguments "for the purpose of ensuring that they are preserved for review," it does not appear that they are asking me to reconsider my rulings. In any event, I see no basis for modifying those rulings. With respect to the Scarbro transcript, I note that I have not used Scarbro's testimony in making my findings herein.

VIII. PUBLIC INTEREST

In view of my findings that each of the respondents either willfully violated antifraud provisions, failed reasonably to supervise others who did, or both, the remaining issue concerns the remedial sanctions to be imposed on respondents. As the Commission has recently reiterated (Donald T. Sheldon, Securities Exchange Act Release No. 31475 (November 18, 1992), 52 SEC Docket 3826, 3867-68), the factors to be considered in assessing sanctions

are those cited by the court in Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979), aff'd, 450 U.S. 91 (1981):

> [T]he egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations.

Padgett and Graff

The Division seeks an unqualified bar of Padgett and Graff from association with a broker or dealer. It emphasizes the markup violations, and characterizes them as a "horrendous fraud of literally monumental proportions," in which, according to its calculations, more than 6,000 customers were defrauded and millions of dollars of gross profits were realized by the firm and its personnel. (Brief at 144). The Division also contends, among other things, that Padgett and Graff designed a system which had the inevitable result of leading overzealous managers to adopt tie-in policies. It asserts that these respondents have shown no remorse or recognition of the wrongful nature of their conduct, and that Padgett has an extensive disciplinary history.

Padgett and Graff cite the Steadman case for the proposition that to justify exclusion from the securities industry, compelling reasons for such action must be specifically articulated. The court there went on, however, to list examples of types of situations that would seem to justify such action: "For example, the facts of a case might indicate a reasonable likelihood that a particular violator cannot ever operate in compliance with the law

. . . or might be so egregious that even if further violations of the law are unlikely, the nature of the conduct mandates permanent debarment as a deterrent to others in the industry . . . ." (603 F.2d at 1140). Here, the combination of egregious misconduct established in this proceeding and respondents' disciplinary history do not bode well for future compliance with applicable requirements.

The Division's characterization of the markup violations is not overstated. Padgett and Graff directed the scheme of pre-arranged trades which took advantage of uninformed customers and permitted the realization of huge profits by Stuart-James and its personnel. As experienced securities professionals, Padgett and Graff must have realized that under the circumstances they could not simply appropriate for the firm the enormous spreads they had created. In addition, they were remiss in permitting fraudulent scripts to be included in the Training Manual and in failing to exercise reasonable supervision with a view to preventing tie-ins. 128/ The pervasive emphasis on commissions and on crossing was a major contributing factor to the tie-in violations. Respondents' argument that the fact that Stuart-James is out of business decreases the need for sanctions against them lacks merit.

128/ As noted, I am dismissing the allegation of supervisory failure with respect to the no net selling violations, because the Division's contentions and the record show an active participation in the violations by Padgett and Graff. Even though that conduct was thus more serious than that alleged, it would not be appropriate, in light of the dismissal of the charge relating to such conduct, to rely on it in connection with the public interest issue.

I reject respondents' argument that I should not take into account prior disciplinary actions in which respondents consented to a settlement without admitting or denying any violations. As I pointed out in an interlocutory order, the Commission has routinely considered orders in settled proceedings as part of a respondent's disciplinary history. (Order on Motion to Admit Disciplinary Records, August 22, 1990 at 4). During the pendency of these proceedings, the NASD, under its consent procedure, and without respondents admitting or denying the allegations, found that in 1988 Stuart-James charged excessive markups in sales of four securities. With the firm's and their consent, it fined Stuart-James $1.9 million, Padgett $105,000 and Graff $25,000. Among numerous other provisions of the NASD's disposition of the matter, Padgett was restricted from acting in a principal or supervisory capacity with respect to the trading of low-priced securities for six months, and Graff was suspended from association with a member in a principal or supervisory capacity for sixty days. 129/ Padgett's history also includes sanctions imposed on him in two litigated proceedings. In one of these he was fined $1,000 by the NASD in 1981 for supervisory failure in connection

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129/ Graff points out that at the time of his consent, he had sold his interest in Stuart-James and no longer had a role in the day-to-day activities of the firm. He argues from these facts that the only inference to be drawn is that he settled because it was less burdensome and costly than to litigate. Undoubtedly, these are important elements in many settlements. However, I deem it neither possible nor appropriate to go behind settlements to speculate or delve into motives for settling or to base the weight to be attached to settlement sanctions on such considerations.

with free-riding and withholding violations. 130/ In the other, involving activities that occurred in 1977, the NASD suspended him as a principal for six months and fined him $5,000 for deficient supervision of a branch office whose personnel, among other things, dominated and controlled the market for a security and charged unfair prices. 131/

I cannot agree with respondents that the Division's proposed sanctions are not justified because they are not proportionate to sanctions imposed on large New York Stock Exchange members for similar conduct. As the Division points out, the Commission has consistently stated that the remedial action that is appropriate in the public interest depends on the facts of each case and cannot be determined by comparison with the action in other cases. In any event, the cases involving Exchange members that are cited by respondents are not comparable to the instant case. The two litigated cases involved misconduct in branch offices of the firms that was not orchestrated by top management. The third case, PaineWebber, Inc., Securities Exchange Act Release No. 25418 (March 4, 1988), 40 SEC Docket 693, was a settled proceeding involving excessive markups and markdowns in the sale and repurchase of stripped United States Treasury bond coupons. In addition to being censured, the firm undertook to make restitution to customers and to review its policies and procedures to prevent a recurrence.

130/ The NASD's action was affirmed on appeal. Blinder, Robinson & Co., 47 S.E.C. 812 (1982).

131/ On appeal, the Commission sustained the NASD's action. C. James Padgett, 48 S.E.C. 17 (1984).

The mitigating factors advanced by respondents, including the costs attendant upon these proceedings and the demise of Stuart-James as a consequence of the proceedings, do not overcome the serious nature of their misconduct. Respondents point to the extensive compliance structure they created at Stuart-James as being inconsistent with the behavior of habitual, intentional violators. But the existence of such a structure presents a misleading image where, as here, the people at the top set unlawful policies or create an atmosphere conducive to unlawful conduct.

Under all the circumstances, I conclude that it is in the public interest to bar Padgett and Graff from association with a broker or dealer.

Stuart-James

The Division urges that I revoke the firm's registration. Stuart-James, on the other hand, argues that at most only the mildest kind of sanction is called for. It contends, among other things, that the Commission's mark-up standards are nebulous and that the firm relied on experienced counsel to ascertain the applicable standards; that the few questionable scripts were removed from the Training Manual as soon as they as they were discovered; and that the no net selling and tie-in practices, if they existed at all, were unknown to management. Stuart-James also asserts that any violations covered only short periods of time. By way of example, it points out that the markup charges relate only to two trading dates for two securities.

The considerations cited with respect to Padgett and Graff apply with equal force to the firm that was essentially their creature. For reasons discussed in more detail in the previous section, I agree with the Division that the markup violations, even if limited to two days, involved a fraud of major proportions, that the pervasive emphasis on crossing as a way of maximizing commissions created an atmosphere conducive to tie-ins, and that the public interest requires revocation of the firm's registration and denial of effectiveness of its withdrawal notice. In reaching that conclusion, I have also considered the firm's disciplinary history. Over the years since 1986, the firm has been penalized by the NASD and state regulators on a number of occasions. Although some of the sanctions were of a relatively minor nature, the recent NASD action referred to above was clearly not of that character. In that action, which as noted was a consent proceeding, the NASD imposed a fine of $1.9 million on the firm for markup violations and required it to comply with various undertakings.

The Branch Managers

On the assumption that all branch manager respondents would be found to have violated the antifraud provisions with respect to both no net selling and tie-ins, the Division recommended the following sanctions: Czaja, Lasek and Sutton should be barred from association with a broker or dealer; and Beaird, Gibbs and Sullivan should be barred from acting in a supervisory, management or proprietary activity and should be suspended from all association

with a broker or dealer for nine months. In support of these proposed sanctions, the Division argued, among other things, that each of these respondents held a critical position of trust which he violated; that particularly with respect to no net selling, their customers were exposed to significant harm; and that none showed any recognition of the wrongful nature of his conduct or offered any other mitigating evidence. In at least partial explanation of the differences in the proposed sanctions, the Division characterized Czaja and Lasek as recidivists who had received significant previous sanctions and asserted that Sutton's conduct, in view of his position as area manager, was particularly egregious.

As noted, Lasek made no post-hearing submission. Beaird, Gibbs, Sullivan and Sutton urge that the Division has failed to demonstrate that sanctions are in the public interest. They assert that there were no specific rules or standards that could have put them on notice that their conduct violated the law; that they acted in accord with Stuart-James policies; that there is no evidence that customers were harmed or that confidence in the capital markets was impaired; and that none of them has any disciplinary history. Czaja, as already noted, contends that if there were unlawful sales practices in his office, they reflected the firm's overall practices. He also urges that the proposed sanction is disproportionate to those proposed as to other respondents. And he takes issue with the Division's characterization of him as a recidivist.

The fact that the managers other than Lasek were absolved of the no net selling charge of course puts a different light on the sanctions issue, although even those managers strongly discouraged net selling. As the Division indicates, from the point of view of customer and investor harm, a no net selling policy or practice is of a more serious nature than tie-in arrangements of the nature involved here. Nevertheless, the tie-in arrangements involved serious violations of the antifraud provisions, and respondents' conduct is not mitigated by their belief that they acted in accordance with firm policies. Moreover, I believe that these respondents were less than candid in their testimony. The remedial sanctions I have decided upon reflect the seriousness of the violation or violations found, the particular respondent's disciplinary history and, in the case of Sutton, his somewhat higher status.

Beaird, Czaja and Gibbs are to be suspended from any association with a broker or dealer for four months and suspended from such association in a supervisory or proprietary capacity for an additional eight months.132/

132/ In 1989, Czaja, at that time branch manager of another broker-dealer, was a party in an administrative proceeding in Florida in which he and others were charged with permitting an unregistered salesman to deal in securities and with failure to maintain certain records. The matter was resolved pursuant to a stipulation in which the respondents, without admitting or denying the allegations, agreed to comply with applicable Florida law. I do not consider that this matter warrants an increased sanction.

Sutton is to be suspended from any association with a broker or dealer for six months and suspended from such association in a supervisory or proprietary capacity for an additional six months.

Sullivan is to be suspended from any association with a broker or dealer for six months and barred from such association in a supervisory or proprietary capacity. This more substantial sanction reflects the fact that last year, after a hearing, the State of Idaho revoked Sullivan's registration as a securities salesman and fined him $5,000 based on findings, among others, that he engaged in unauthorized trading, churning and unsuitable recommendations.133/

Lasek is to be barred from association with a broker or dealer, with a right to apply after two years to become associated in a non-supervisory and non-proprietary capacity upon a satisfactory showing of adequate supervision. This sanction, while based principally on his violations of the antifraud provisions in connection with both no net selling and tie-ins, also reflects the fact that in 1990, an NASD District Business Conduct Committee, pursuant to an offer of settlement, censured Lasek and fined him $10,000 for unauthorized trading.

Ward

While regional vice-president, Ward established no net selling policies or practices in two offices under his jurisdiction. The

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133/ The Division attached a copy of the Idaho decision to its reply brief, and I take official notice of it. In the same action, Stuart-James' Idaho registration was suspended for six months and it was fined $10,000.

Division urges that he should be barred from association with any broker-dealer. It cites the fact that he was a top level executive and asserts, among other things, that the evidence against him is overwhelming and that his violations were flagrant and widespread. Ward admitted that on certain occasions he directed branch managers under him to stop net selling of particular securities. The record is not clear regarding the duration of these directives. Ward urges that he did no more than pass on instructions from his superior which he assumed to be based on legitimate grounds. He also states that if his conduct is found to have been unlawful, he apologizes for actions which he never intended to harm the public.

In his position, Ward should have been aware that the directives he was passing on were improper. On the other hand, he deserves some credit for his candor in admitting what he did. Upon consideration of all relevant factors, including the fact that Ward has not been subject to any prior disciplinary action, I conclude that it is in the public interest to suspend him from any association with a broker or dealer for six months and to suspend him from such association in a supervisory or proprietary capacity for an additional six months.

<u>Nye</u>

The Division contends that there were widespread, flagrant violations in the offices under Nye's supervision, that he presented no mitigating evidence and that he has shown himself unfit to be a supervisor. It recommends that he be barred from association with a broker or dealer, with a right to reapply in a

supervised, non-supervisory and non-proprietary capacity after eighteen months.

The allegation that Nye failed reasonably to supervise with a view to preventing no net selling violations is being dismissed. As discussed in the Supervision section, however, his conduct in connection with the tie-in violations of his subordinates was seriously deficient. In the face of numerous "red flags," he failed to take appropriate preventive action. Taking into account the fact that Nye has not been a subject of other disciplinary action, I conclude that he should be suspended from association with a broker or dealer for six months and barred from such association in a supervisory or proprietary capacity, provided that after eighteen months he may apply to become associated in such a capacity.

IX. ORDER

Based on the above findings and conclusions, 134/ IT IS ORDERED that:

1) The broker-dealer registration of The Stuart-James Co., Inc. is hereby revoked and its notice of withdrawal from registration is not to become effective.

2) C. James Padgett and Stuart Graff are hereby barred from being associated with a broker or dealer.

3) John M. Beaird, Michael C. Czaja and Robert E. Gibbs are hereby suspended from being associated with a broker or dealer for

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

four months and suspended from such association in a supervisory or proprietary capacity for an additional eight months.

4) Douglas P. Ward and John W. Sutton are hereby suspended from being associated with a broker or dealer for six months and suspended from such association in a supervisory or proprietary capacity for an additional six months.

5) Shaw P. Sullivan is hereby suspended from being associated with a broker or dealer for six months and barred from such association in a supervisory or proprietary capacity.

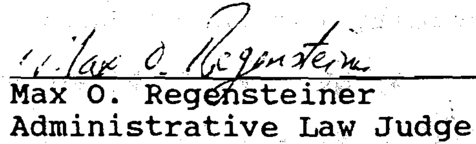
6) Ronald J. Lasek is hereby barred from being associated with a broker or dealer, provided that after two years he may apply to become so associated in a non-supervisory and non-proprietary capacity upon a satisfactory showing of adequate supervision.

7) Dirk Nye is hereby suspended from being associated with a broker or dealer for six months and barred from such association in a supervisory or proprietary capacity, provided that after eighteen months he may apply to become associated in such a capacity.

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

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

initiative to review that initial decision as to him. If a party timely files a petition for review, or the Commission takes action to review as to a party, the initial decision shall not become final with respect to that party.



Max O. Regensteiner
Administrative Law Judge

Washington, DC
March ~~18~~ 17, 1993