ADMINISTRATIVE PROCEEDING
FILE NO. 3-6022

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of :

JAMES F. NOVAK :

:

INITIAL DECISION

January 14, 1982
Washington, D.C.

Ralph Hunter Tracy
Administrative Law Judge

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APPEARANCES: Joyce G. Lynch and Janice N. Skipper of the Chicago Regional Office for the Division of Enforcement.

Peter R. Sonderby of Chadwell, Kayser, Ruggles, McGee and Hastings for James F. Novak

BEFORE: Ralph Hunter Tracy, Administrative Law Judge

This public proceeding was instituted by Commission order (Order) dated May 11, 1981, pursuant to Sections 15(b) and 19(h) of the Securities Exchange Act of 1934 (Exchange Act) to determine whether the above-named respondent James F. Novak (Novak)[1/] had committed various charged violations of the Securities Act of 1933 (Securities Act) and the Exchange Act and rules thereunder as alleged by the Division of Enforcement (Division) and the remedial action, if any, that might be appropriate in the public interest.

The Order alleges, in substance, that during the period from October 8, 1979 to November 5, 1979, Novak directly and indirectly, willfully violated Section 17(a) of the Securities Act and Sections 10(b) and 14(e) of the Exchange Act and Rule 10b-5 thereunder; and that he willfully aided and abetted violations of Section 17(a) of the Exchange Act and Rule 17a-3(a)(6) thereunder.

The evidentiary hearing was held at Chicago, Illinois, from July 14 through July 16, 1981, with Novak being represented by counsel. Proposed findings of fact, conclusions of law, and supporting briefs were filed by the respondent and the Division. The findings and conclusions herein are based upon the preponderance of evidence as determined from the record and upon observation of the witnesses.

1/ The Order also named Merrill Lynch, Pierce, Fenner & Smith, Inc. (Merrill Lynch) as a respondent. However, Merrill Lynch submitted an offer of settlement which was accepted by the Commission. Exchange Act Release No. 17793/May 11, 1981, 22 SEC Docket 1028. Therefore, the findings herein are binding only on Novak.

The respondent, James F. Novak (Novak) is 31 years old and has been with Merrill Lynch since October 24, 1978, starting as a trainee and becoming an account executive in February 1979. Prior to joining Merrill Lynch he was employed as a consultant by the Blue Cross-Blue Shield.

This proceeding involves Novak's solicitation of customers to purchase shares of Harnischfeger Corporation stock while such shares were the object of a tender offer by Mannesmann A G (MAG), a West German corporation. Harnischfeger is a Delaware corporation located in Brookfield, Wisconsin, engaged in the manufacture of construction and mining equipment, and industrial and electrical products.

On July 13, 1979, MAG announced that it was offering, in the period August 9, 1979 to August 29, 1979, to purchase for cash any and all shares of common stock of Harnischfeger at 27 1/2 a share. On August 2, 1979 the Federal Trade Commission (FTC) authorized an investigation to determine possible violations of anti-trust provisions resulting from the tender offer. On the same day, at the request of the FTC, the offer was extended to September 7, 1979. On September 7 the offer was extended until September 27 and on that date MAG announced that it would not purchase any shares prior to October 5, 1979 and that it had extended the offer to that date. On September 28, 1979 the FTC filed a complaint in the U.S. District Court for the District of Columbia against MAG seeking a temporary restraining order and a preliminary injunction enjoining the

acquisition of Harnischfeger shares by MAG. On October 1, 1979 the offer was extended to October 12; on October 9 it was extended to October 23; and on October 25 it was extended to November 9, 1979. However, on November 5, 1979, MAG withdrew the offer.

The MAG announcement of September 7, 1979 and all subsequent announcements contained a contingency clause in bold type which stated that the FTC was conducting an investigation of the offer, and that if such investigation was still continuing at the expiration date of the offer MAG would be under no obligation to purchase shares pursuant to the offer.

Anti-Fraud Provisions

The Order alleges that during the period from October 8, 1979 to November 5, 1979 Novak willfully violated Section 17(a) of the Securities Act and Sections 10(b) and 14(e) of the Exchange Act and Rule 10b-5 2/ thereunder in that he induced customers to purchase Harnischfeger stock by making false and

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2/ Section 10(b) as here pertinent makes it unlawful for any person to use or employ in connection with the purchase or sale of a security any manipulative device or contrivance in contravention of rules and regulations of the Commission prescribed thereunder. Rule 10b-5 defines manipulative or deceptive devices by making it unlawful for any person in such connection: "(1) to employ any device, scheme, or artifice to defraud, (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading or (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person..." Section 17(a) contains analogous antifraud provisions. Section 14(e) was added to the Exchange Act in 1968 and is identical to Rule 10b-5 except that it prohibits deception "in connection with any tender offer."

misleading statements of material facts and omitting to state material facts concerning a tender offer of such securities, and that he misrepresented or failed to disclose to such customers the actual risks involved in purchasing Harnischfeger stock.

On October 8, 1979, Novak received a telephone call from a customer who asked him to purchase 4,000 shares of Harnischfeger for him at the market price, which was then 19 1/2. Although Novak testified that he had known of the tender offer prior to October 8, this was apparently the first transaction in Harnischfeger stock which he executed for a customer. Later the same day Novak solicited 4 other customers who purchased a total of 3,450 shares of Harnischfeger stock. Novak also purchased 200 shares for his own account.

Following these transactions on October 8, Novak sold 3,850 additional shares of Harnischfeger to customers. For the period from October 8 to October 29, 1979 he sold a total of 7,300 shares to 15 customers in 21 transactions.*/ Sixteen of these transactions for 6,400 shares were solicited by Novak while 5 transactions for 900 shares were unsolicited.

When Novak commenced the solicitation of his customers to purchase Harnischfeger stock on October 8, 1979, he made inquiry of Merrill Lynch's Research Department and was told that Harnischfeger was not on Merrill Lynch's list of approved securities. Therefore, under Merrill Lynch policy, with which

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*/ These 7,300 shares are in addition to the original 4,000 purchased at a customers' request.

he was familiar, he could not solicit customers to purchase the stock unless he (1) obtained prior approval of his branch manager who had to be satisfied that the information to be given to customers would be factual, complete and properly evaluated; (2) secured the approval of both Merrill Lynch's Research Division, and Compliance Department; and (3) insured that customers were advised that Merrill Lynch was not recommending the stock. Under Merrill Lynch policy this would be a "no opinion" stock and customers must be so informed.

Five investor witnesses testified as to their purchases of Harnischfeger stock on Novak's recommendation, as follows:

J.J. testified that he knew Novak over the telephone only, had never met him in person; that he had received a telephone call at work from Novak in the fall of 1979; that Novak described Harnischfeger and said that it was being acquired by a German firm and he (Novak) felt there was a good chance to make a short term profit; nothing was said about FTC opposition to the acquisition, or that there was a condition in the agreement which would allow the offer to be withdrawn. J.J. was not told about anti-trust problems or of any risk concerning the offer. He was not told about any opinion by Merrill Lynch and never received any material concerning Harnischfeger from either Novak or Merrill Lynch. He testified that if he had known about the FTC involvement it could very well have affected his investment decision: "I wish I would have known that." He bought 100 shares at 19.

W.A. testified that Novak called him and said that Harnischfeger was a "hot one" and guaranteed to go up. Novak did not tell him anything about the company, about a tender offer, about any FTC involvement, about any risk, about any opinion by Merrill Lynch. W.A. purchased 200 shares at 20 but had to sell some other stocks first. He also placed an order for his partner C.K. Harnischfeger did not go up and Novak told him to get rid of it, that it was supposed to be taken over but was not. This was the first W.A. had heard of any takeover.

C.K. first heard of Harnischfeger from his partner W.A. Subsequently, Novak called and said he guaranteed Harnischfeger would move up several points but did not tell him anything else; did not tell him about the company, about the FTC being involved, about any risk, or of any opinion by Merrill Lynch. C.K. stated that he never received any materials from Merrill Lynch or any other source describing the terms of the tender offer. He bought 200 shares at 19 7/8.

F.K. testified that Novak was his broker at Merrill Lynch when Novak called him in October 1979 and told him about Harnischfeger. This was the first he had heard of Harnischfeger. Novak said there was supposed to be a takeover but did not tell him the terms of the tender offer, the FTC involvement, any risk, or anything else specific. He was told nothing about any opinion by Merrill Lynch, and never received any material about Harnischfeger. F.K. bought 100 shares at 19 3/4. Later Novak

called and said the deal had fallen through.

S.E. had been in the Army Reserve with Novak and Novak had been his broker for about 3 years. He was solicited by Novak on the telephone. Novak said that Harnischfeger was a takeover situation by a European concern. Novak told him that Harnischfeger was trading at about 19 or 20 a share and that the takeover price was about 27 or 28. Novak recommended the stock strongly and said he could make several points quickly. Novak did not tell him about the terms of the offer, FTC involvement, risk, or Merrill Lynch's opinion, S.E. bought 450 shares of Harnischfeger in two transactions. Novak called him again to buy some more Harnischfeger and recommended that he sell other securities to buy it. S.E. had never received any material from Merrill Lynch. Novak called later and told him the offer did not go through and recommended that he sell and take his loss because it might go even lower.

It is clear from the foregoing testimony of the investors that Novak did not tell them anything about the FTC investigation of Harnischfeger nor of any condition in the tender offer that it could be terminated by MAG. In fact, at least one investor was not told about the tender offer. In addition, unsubstantiated promises were made concerning a rapid price rise in a short period of time, that it was a sure thing, and that there was no risk involved.

In his testimony Novak admitted that he had solicited some of his customers to purchase Harnischfeger stock and that on some occasions he had marked their order tickets unsolicited

when in fact he had solicited the purchase. Prior to soliciting the first customer he had not received any tender offer material. He knew that Harnischfeger was a stock about which Merrill Lynch had no opinion, and that Merrill Lynch rules did not allow him to solicit customers for a stock on which Merrill Lynch had no opinion unless he followed certain procedures. He said that he did follow procedures and told all customers that Merrill Lynch had no opinion on Harnischfeger. However, this is in direct contradiction of the testimony of the witnesses and is not supported by the record. Novak testified, on the other hand, that he did solicit certain customers and did not follow the appropriate procedures. Also, that he marked order tickets unsolicited when they were solicited. He then said that marking order tickets unsolicited when the transactions were solicited was an error. In November 1979 a customer of Novak's complained to the Branch Manager, who in turn verbally reprimanded Novak for soliciting customers for a stock for which Merrill Lynch had no opinion. On February 8, 1980 the Branch Manager issued a memo to all sales persons which was directed at halting the type of activity in which Novak was engaged. The memo stated in part:

> ... Solicitations of No Opinion Stock is strictly prohibited. by Merrill Lynch and will not be tolerated under any form within this office. Several people have on their production records No Opinion Stocks with an indication that they are not solicited. Except to the occassional (sic) mishap, future offenders of this company policy will not, REPEAT will not be paid commissions on 6-6 stocks that are not clearly unsolicited. 3/

3/ A 6-6 stock is identified in the Merrill Lynch Manual as a No Opinion Stock.

Respondent does not seriously dispute the facts as set forth above concerning his sales of Harnischfeger stock to customers. Instead he argues that the fact that he took a position in Harnischfeger stock demonstrates good faith on his part, that he sincerely believed the opportunity he presented to his customers was a good one, and that such action negates the requisite element of scienter and willfullness. Also, that while he did not follow the literal requirements of Merrill Lynch's rule regarding no opinion stock, he did not violate its spirit because he made a reasonable investigation of his own before recommending the stock. Additionally, he asserts that the mismarking of the order tickets does not demonstrate fraudulent intent since it was a result of errors and not an intent to mislead or defraud anybody.

The Commission has held that a salesman's responsibility to his customer is not lessened because he believed in the prospects of the recommended stock or was willing to speculate with his own funds, or because the customer may have previously known or done business with the salesman or knew that the stock was speculative.[4/]

The reason for Merrill Lynch's rule is simply that no stock is to be recommended until sufficient information has been gathered upon which to make a judgment as to whether or not to offer an opinion. The rule is for the protection of

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4/ Cortlandt Investing Corporation, et al., 44 S.E.C. 45, 51 (1969).

the firm and its salesmen. While ignoring a firm rule may not of itself be a violation of the securities laws, it certainly indicates a disregard for established broker-dealer practices. Moreover, there is no indication in the record that Novak ever made any investigation concerning Harnischgeger. In Hanley v. S.E.C., 414 F.2d 589 (1969) the court said, at 579:

> In summary, the standards by which the actions of each petitioner must be judged are strict. He cannot recommend a security unless there is an adequate and reasonable basis for such recommendation. He must disclose facts which he knows and those which are reasonably ascertainable. By his recommendation he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation. Where the salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information. (Citing SEA Rel. No. 6721, 2-2-62).

The mismarking of the order tickets constitutes a separate violation which is discussed in the following section.

On the basis of the record herein it is found that respondent Novak willfully violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

The same acts, or facts, as found above, are equally applicable to Section 14(e). Therefore, since the misrepresentation and omissions were also made "in connection with" a tender offer it is found that Novak willfully violated Section 14(e) of the Exchange Act.

While it has been held that the Commission needs only to prove negligence to support a violation of 17(a)(2) and (3)

of the Securities Act,[5] it is concluded that Novak acted with scienter. The record clearly indicates that he knowingly omitted material information[6] in his solicitation of customers to purchase Harnischfeger stock. Such "knowing . . . conduct" satisfies the scienter requirement.[7] At the very least, respondent was recklessly indifferent to the consequence of his actions.[8]

Section 17(a) of the Exchange Act and Rule 17a-3(a)(6) Thereunder

The Order charges that during the period from October 8, 1979 to November 5, 1979, Novak willfully aided and abetted violations of Section 17(a) of the Exchange Act and Rule 17a-3(a)(6) thereunder, by, among other things, falsifying order tickets to read unsolicited when, in fact, they were solicited orders.[9]

5/ Aaron v. Securities and Exchange Commission, 446 U.S. 680 (1980).

6/ A material fact is one substantially likely to have "assumed actual significance in the deliberations of the reasonable shareholder." TSC Industries, Inc. v. Northway, Inc., 426 U.S. 449 (1976).

7/ Aaron v. S.E.C., 446 U.S. 680, 690 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

8/ Recklessness also satisfies the scienter requirement. See e.g. G.S. Thompson & Co., Inc. v. Partridge, 636 F.2d 945, 961 (5th Cir. 1981); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1023-25 (6th Cir. 1979); Edward J. Mawod & Co. v. S.E.C., 591 F.2d 588, 595-97 (10th Cir. 1979); Nelson v. Serwold, 576 F.2d 1332, 1337-38 (9th Cir. 1978), cert. denied, 439 U.S. 970 (1978).

9/ Section 17(a) of the Exchange Act, as applicable here, requires registered brokers and dealers to keep such books and records as the Commission by rule or regulation may prescribe as necessary or appropriate in the public interest or for the protection of investors. Rule 17a-3(a)(6) specifies that a memorandum of each brokerage order be prepared and maintained.

Merrill Lynch's policy regarding stock for which the firm has no opinion has been set forth previously. (See pages 4 and 5, supra). In order to insure compliance with this policy Merrill Lynch has established certain procedures. One of these requires the wire operator who executes the order to segregate all purchase order tickets that are market solicited for which Merrill Lynch has no opinion. There is a place on the order ticket form where the account executive is to indicate whether the order was "solicited" or "unsolicited."

Novak circumvented this procedure and the aforementioned policy by marking most of the purchase orders for Harnischfeger "unsolicited" when they were, in fact, "solicited." Out of 16 transactions which were solicited (see page 4, supra), 12 of the order tickets were marked unsolicited by Novak.

Novak does not deny that he did not follow all of the Merrill Lynch guidelines regarding transactions in "no opinion" stock. In his post-hearing brief he asserts that time restraints imposed by the expiration date of the tender offer did not permit him to follow all of the steps. He, also, admits that the evidence shows that he incorrectly marked some of the order tickets that represented solicited orders to be "unsolicited." However, he argues that this was not demonstrated to have been willful or intentional or to have been done with the intent to mislead or defraud.

As a result of Novak's falsification of the order tickets, Merrill Lynch's records were inaccurate and in violation of Section 17(a) of the Exchange Act and Rule 17a-3(a)(6) thereunder. See Sinclair v. S.E.C., 444 F.2d 399, 401 (2d Cir. 1971); Haight & Company, Inc., 44 S.E.C. 481, 507 (1971).

The Commission has repeatedly stressed the importance in the regulatory scheme for strict compliance with the requirement that books and records be kept current in proper form.[10/] The requirement that records be kept embodies the requirement that such records be true and correct.[11/] Compliance with the rule relating to maintenance of books and records is regarded as an "unqualified statutory mandate" dictated by a broker-dealer's obligation to investors to conduct its securities business on a sound basis.[12/]

Novak is charged with willfully aiding and abetting violations of Section 17(a) of the Exchange Act and Rule 17a-3(a)(6) thereunder. In the context of the federal securities laws, one may be found to have aided and abetted a violation when (1) some other party has committed a securities law violation, (2) the aider and abettor was aware that his role was

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10/ Olds & Company, 37 S.E.C. 23, 26 (1956); Pennaluna & Company, Inc., 43 S.E.C. 298, 312 (1967).

11/ Lowell Neibuhr & Co., Inc., 18 S.E.C. 471, 475 (1945).

12/ Billings Associates, Inc., 43 S.E.C. 641, 649 (1967).

Niebuhr

part of an overall activity that was improper, and (3) the aider and abettor knowingly and substantially assisted the violation.[13/] All of these elements are clearly present in this case.

It is found that Novak willfully aided and abetted Merrill Lynch's violations of Section 17(a) of the Exchange Act and Rule 17a-3(a)(6) thereunder.[14/]

Public Interest

The remaining issue concerns the remedial action which is appropriate in the public interest with respect to the respondent, who has been found to have committed, or aided and abetted, the commission of certain violations of the federal securities laws as alleged in the Order. The Division proposes that Novak be suspended from association with any broker, dealer, investment company, or investment adviser, or affiliate thereof for a period of eight months.[15/]

13/ Woodward v. Metro Bank of Dallas, 522 F.2d 84, 94 (C.A. 5, 1975). See, also, In the Matter of William R. Carter and Charles J. Johnson, Jr., Exchange Act Release No. 74597/ February 28, 1981.

14/ Except for the anti-fraud provisions of the securities laws it is well established that a finding of willfulness does not require an intent to violate the law; it is sufficient that the person charged with the duty knows what he is doing. Billings Associates, Inc., 43 S.E.C. 641 649 (1967); Tager v. S.E.C., 344 F.2d 5, 8 (1965); Hughes v. S.E.C., 174 F.2d 969, 977 (1949).

15/ Inasmuch as the Order contained no allegations under either the Investment Company Act or the Investment Advisers Act no findings can be made or sanctions imposed under those acts.

Respondent states that the Division failed to prove that any of the alleged violations occurred; that the most that was shown were infractions of Merrill Lynch's rules and procedures. Accordingly, he requests that all charges be dismissed.

The violations found herein were serious and cannot be excused by a claim of a lack of knowledge of pertinent requirements. Indeed, respondent went to some lengths to keep his activities from being discovered.

In dealing with public interest requirements in a particular case weight must be given to the effect of the decision on the welfare of investors as a class and on standards of conduct in the securities business generally. If these proceedings are to be truly remedial, they must have a deterrent effect not only on the present respondent, but also on others who may be tempted to engage in similar misconduct.[16/]

Upon consideration of all the circumstances it is believed that the public interest requirement will be served by a six-month suspension from association with any broker-dealer.

Accordingly, IT IS ORDERED that James F. Novak be suspended from association with any broker or dealer for a

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16/ Thomas A. Sartain, Sr., Exchange Act Release No. 16561/ February 8, 1980; Arthur Lipper Corporation v. S.E.C., 574 F.2d 17, 184 (2d Cir., 1976), cert. denied, 343 U.S. 1009.

period of six months.

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

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

Ralph Hunter Tracy
Administrative Law Judge

January 14, 1982
Washington, D.C.

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