ADMINISTRATIVE PROCEEDING
FILE NO. 3-5086

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	:
G.C. GEORGE SECURITIES, INC., et al.	:
	:
(8-11682)	:

INITIAL DECISION

Washington, D.C.
June 30, 1981

Edward B. Wagner
Administrative Law Judge

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APPEARANCES: David J. King and George N. Prince, 3040 Federal Building, 915 Second Avenue, Seattle, Washington 98174; appearing on behalf of the Division of Enforcement, Securities and Exchange Commission.

Lawrence R. Small, Paine, Lowe, Coffin, Herman & O'Kelly, Washington Trust Bank Building, Spokane, Washington 99204; appearing on behalf of J.H. Dillon & Co., Inc., and Joe H. Dillon.

Thomas Malott, Malott, Southwell & O'Rourke, 415 Fidelity Building, Spokane, Washington 99201; appearing on behalf of G.C. George Securities, Inc., and Grover Cleveland George.

C. Dean Little, LeSourd, Patten, Fleming & Hartung, 1300 Seattle Tower, Seattle, Washington 98101; appearing on behalf of Jerry T. O'Brien, Inc., d/b/a Pennaluna Company, and Jerry T. O'Brien.

BEFORE: Edward B. Wagner, Administrative Law Judge

THE PROCEEDING

This public proceeding was instituted by order of the Commission on September 1, 1976 pursuant to sections of the Securities Exchange Act of 1934 (Exchange Act) against broker-dealer respondents, G. C. George Securities, Inc. and Jerry T. O'Brien, Inc., d/b/a Pennaluna & Company, and individual respondents, Grover Cleveland George and Jerry T. O'Brien.[1/]

The Commission's Order for Proceedings, insofar as pertinent here, contains charges by the Division of Enforcement (Division) that from January 1972 to about December 1974 the above respondents wilfully violated registration provisions of the Securities Act of 1933 (Securities Act)[2/] in respect to shares of 9 identified mining companies and that they wilfully violated antifraud provisions (Section 17(a) of the Securities Act and Section 10(b) and Rule 10b-5 of the Exchange Act) in that the stock of the 9 mining companies was sold at excessive markups.[3/]

1/ J.H. Dillon & Co., Inc. and Joe H. Dillon were also named as respondents in the Order for Proceedings. Their offer of settlement, which was submitted without admitting or denying the allegations made against them, was accepted by the Commission. SEA Rel. No. 14039 (October 11, 1977).

2/ Sections 5(a) and 5(c).

3/ In a More Definite Statement, dated November 9, 1976, the Division further particularized the charges against the George respondents by adding the names of 14 other mining companies to the improper markup charges.

In addition the George respondents were charged with violations of Section 15(c)(3) and Rule 15c3-3 of the Exchange Act in that they effected transactions in and attempted to induce transactions in securities while failing to maintain reserves in required amounts.

The Commission ordered a hearing to determine the truth of the Division's charges, to afford respondents an opportunity to establish any defense to the charges and to determine what, if any, remedial action is appropriate in the public interest.

A 6-day hearing was held in August, 1977 in Spokane, Washington.

In accordance with procedures established at the close of the hearing the Division and the parties made post-hearing filings.

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

Preponderance of the evidence is the standard of proof employed throughout. Steadman v. SEC, 49 U.S.L.W. 4174 (2-25-81).

Court Proceeding

The initial decision in this proceeding would have been issued in February of 1978 had it not been for the continuing injunction pending appeal issued by Judge Neill in SEC v. G.C. George Securities Inc. (No. C-75-28, U.S. D.C.E.D. Washington). That injunction

has now been modified to permit this initial decision to be mailed in a sealed envelope to the Clerk of the District Court in Spokane, Washington. It will be filed with the Commission only as ordered by the Court.

The Court proceeding and this proceeding have an issue in common, namely whether (as charged by the O'Brien respondents) the Commission in a settlement in the prior injunction action before Judge Neill struck a bargain with the respondents not to litigate the antifraud charges made here in an administrative proceeding. Since the District Court*/ may decide that respondents should exhaust their administrative remedies on that issue, and since a motion to strike the fraud charges based upon the alleged agreement has been made to me, I deal with the merits of the contention that there was a prior agreement.4/ If the District Court decides that question on the merits, that decision, if it becomes a final order, will take precedence over and supplant my determination on that question. A decision that there was such an agreement would eliminate any findings of fraud herein and would necessarily affect sanctions based upon any such findings.

PARTIES

George Respondents

G.C. George Securities, Inc. (George Securities) is a Washington corporation with its principal place of business

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*/ It is understood that Judge Neill is now deceased and that the case has been reassigned.

4/ A determination as to this question appears at pp. 6 through 10, infra.

at Spokane, Washington, which became registered with the Commission as a broker-dealer in securities pursuant to Section 15(b) of the Securities Exchange Act of 1934 on September 30, 1963, and is still so registered.

Grover Cleveland George (George), since the registration of George Securities with the Commission, has been and is president, a director, and owner of over 50% of the voting stock of George Securities. George is a member of the Spokane Stock Exchange, a national securities exchange registered with the Commission. He served as president of the Spokane Stock Exchange for a period of approximately ten years, from 1965 to 1975 and is 61 years of age. He served on the listing committee of the Spokane Stock Exchange during the years 1972, 1973 and 1974. The listing committee also approved applications for over-the-counter quotations.

O'Brien Respondents

Jerry T. O'Brien, Inc., d/b/a Pennaluna & Company (Pennaluna), is an Idaho corporation with its principal place of business at Wallace, Idaho, which became registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Securities Exchange Act of 1934 on July 30, 1970, and is still so registered.

Jerry T. O'Brien (O'Brien), since the registration on Pennaluna with the Commission, has been and is president, director, and sole owner of the voting stock of Pennaluna. O'Brien is also a member of the Spokane Stock Exchange. O'Brien is 71 years of age.

THE 9 MINING COMPANIES

The 9 mining companies involved in these proceedings were:

Caledonia Silver-Lead Mining Co.
Judith Gold Corporation
Lookout Mountain Mining & Milling Co.
Nancy Lee Mines, Inc.
New Era Mines, Inc.
Signal Silver Gold, Inc.
Silver Bowl, Inc.
United Mines, Inc.
Utah-Idaho Consolidated Uranium, Inc.

All of these companies are non-productive and had no significant income. 8/ Except for Judith Gold which was listed on the Spokane Stock Exchange over-the-counter list on December 1, 1972, the other 8 companies were on the over-the-counter list and traded for many years.

Dorothy Brainard (Brainard) served as corporate secretary for all of the above companies and of Gem State Silver Gold, Inc. (Gem State) which served as stock transfer agent and corporate agent for all of these companies. As transfer agent and corporate secretary, Brainard exercised effective control over the books, records, finances, stock records, bank accounts and all other corporate matters and records of the 9 mining companies. Many of the 9 companies owned stock of other companies in the group.

Carol Ann Goldsmith was the principal clerical employee of Gem State under Dorothy Brainard. Clayton E. Henley, now

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5/ During the 1972-74 period, only Judith Gold, Nancy Lee and Silver Bowl had working agreements for exploration with other companies.

deceased, a brother of Dorothy Brainard, was an officer of or director of most of the 9 mining companies and an employee of Gem State.

Dorothy Brainard's husband, Wendell Brainard, served as president or vice-president of all 9 mining companies.

PRELIMINARY MATTERS

Before discussing facts directly relating to the charged violations certain preliminary matters should be addressed.

Motion to Strike

The O'Brien respondents filed in this proceeding the same motion to strike which they filed in the Federal District Court.

The gist of the motion is that, prior to the institution of these proceedings, on February 12, 1975, the Commission filed a complaint for injunction in the Federal District Court against 11 broker-dealer members of the Spokane Stock Exchange, including the respondents in this proceeding, for violation of the same antifraud provisions involved here and based upon the same activity which is the subject matter of that aspect of this proceeding, that the injunctive action was settled and that the nature of the settlement precludes the Commission from raising the same issues in this proceeding.

The evidence underlying the injunctive complaint did involve allegedly unreasonable markups and markdowns in connection with the stock of the 9 mining companies (the Brainard companies)

for the same period involved here. However, the main object of the civil suit was directly to bring about changes in the over-the-counter quotation practices of the Spokane Stock Exchange. 6/

The respondent broker-dealer undertook to revise the system by which over-the-counter securities quotations were obtained and the medium in which they were to be published. It was required that all quotations for securities be representative of the prices at which purchasers and sellers may expect to effect transactions and that the quotations submitted be exclusive of retail markups, markdowns, or commissions. These results were achieved by the voluntary Stipulation, Undertaking to the Court, and Order of December 3, 1975.

No direct attempt to change general practices and procedures of the Exchanges is involved in this administrative proceeding. The injunctive action focused on the quotation system and used the underlying transactions as means of showing that this system reflects artificially inflated prices. The order for administrative proceedings on the other hand, focuses on the underlying transactions and charges that they were effected at unreasonable markups, irrespective of the prices appearing

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6/ The Commission contended that the quoted prices were artificially inflated and did not fairly reflect true and actual market. It stated that its evidence would establish that "When public investors or non-defendant broker-dealers are buying these securities, the price is more often than not within the published range of quotations, but when the defendants are buying, the prices are often strikingly below the published bid prices. The converse is usually true that, when the defendants are selling, the (continued)

in the quotation sheets. Respondents in the latter proceeding contend that their prices correspond to prices appearing on the quotation sheets and thus are not unreasonable. The Division alleges that contemporaneous actual transactions are the true basis upon which markups should be computed. Thus, while there are important differences between the two actions, the same very broad issue, the propriety of widely disparate "wholesale" and "retail" markets, appears to touch both.

Pertinent provisions appearing in the Stipulation and Undertaking are as follows:

> (Stipulations, agreements and representations of defendants were made):
>
> "...With the sole intention of disposing of said action without the need for an adjudication of the factual and legal contentions relevant thereto...for the purpose of settlement of this proceeding only." (p. 1)
>
> "This Stipulation is being entered into solely for the purpose of settlement of this proceeding and each stipulating defendant neither admits or denies the allegations contained in the Complaint." (p. 2)
>
> "This Stipulation and Undertaking and quotation system described herein have been proposed by the defendants voluntarily as an affirmative method for the purpose of disposing of the issues raised by the allegations of the Complaint and the Answers filed herein without further litigation." (p. 4)
>
> "Any Stipulation and Undertaking approved by this Court with respect to these provisions shall not be used as a basis for administrative action affecting any one of the undersigned defendants." (p. 4)

The O'Brien respondents argue that the settlement constituted a bargain by the Commission not to raise any of the

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6/ (Continued)
prices are within the quoted ranges and, when the public investors or non-defendant broker-dealers are selling, the prices again fall far below the published bid prices." ALJ Ex. 5, Plaintiffs Pre-Trial Status Report (injunctive proceeding) May 1, 1975, p. 3.

same issues again. They contend that considerable time and money was spent to settle the issues involved in the District Court action "without further litigation," and that now they are again forced to litigate these same issues in a different forum. They urge that the only reasonable conclusion is that the Commission breached its agreement.

However, the more reasonable interpretation of the settlement is, as the Division contends, that it was only to resolve the District Court Action. As it points out, no use is being made of the undertaking or stipulation in this proceeding in violation of the settlement.

Further, as the Division demonstrates, when the respondents, by letter dated September 9, 1975, sought a provision in the settlement barring the use of the "facts underlying the subject matter of the complaint" Mr. Jack N. Bookey, the Seattle Regional Administrator, declined to accept that language and stated in a letter dated October 3, 1975:

> "You are already aware that the facts underlying the complaint will not be used as the 'sole' basis for any administrative proceedings which may be contemplated. However, administrative proceedings could be initiated for some other irregular activities such as unreasonable markups or markdowns, for example. The deletion of any reference to the underlying facts will eliminate any confusion or questions of interpretation down the road and will preclude any speculation that we have not been candid in these negotiations or that we have acted contrary to the terms of the agreement." (ALJ Ex. 6).

In an affidavit submitted in this connection Mr. Bookey further states:

> "I participated in the extensive settlement discussions with counsel for all defendants, in addition to exchanging letters and talking to counsel by telephone. In the settlement discussions we made it very clear that the disposition of the

> civil case would not preclude the Securities and Exchange Commission from commencing administrative proceedings involving certain of the defendants based on transactions in unregistered stock of certain mining companies.... It was also made clear the administrative proceedings could also include allegations of unreasonable markups or markdowns in connection with the disposition of the unregistered stock by certain of these defendants. The possibility of criminal proceedings was also mentioned." (ALJ Ex. 6).

With these further facts in mind, it is absolutely clear that no bargain was struck not to use the underlying facts relating to markups in administrative proceedings. Accordingly, respondent's motion is denied.

Wilfulness

Counsel for the O'Brien respondents argues in connection with the alleged registration violations that wilful misconduct must be "intentional, knowing, purposeful" and that "even inexcusable. . . negligence is not enough" (O'Brien filing, p.15).

It is further argued specifically that in order to establish Section 5 violations it must be shown:

> "(1) That O'Brien knew the security was not properly registered; and
>
> (2) That with this knowledge in mind, he nevertheless intentionally engaged in the conduct of selling, or offering to sell or buy, unregistered securities." (Id. at 16)

This is not the law in the securities field.

As the Division points out, a finding of wilfulness does not require an intent to violate the law. Hughes v. SEC, 174 F.2d 969, 977 (D.C. Cir. 1949); Tager v. SEC, 344 F.2d 5, 8 F.2d Cir. 1965). It has been stated that all that is required

is that the person intended to do the act which resulted in the violation. Tager, supra at 8 n. 16; Thompson-Ross Securities Company, 6 S.E.C. 1111 (1940).

As contended by the Division, a showing that the facts were such that respondents should have known or should have made inquiry and did not is enough to fulfill the "wilfulness" requirement. Dlugash v. SEC, 373 F.2d 107, 109 (2d Cir. 1967).

In International Shareholders Services Corporation, SEA Rel. No. 12389A (April 29, 1976), 9 SEC Docket 802, 823, a case involving alleged registration violations and a "wilfulness" issue, the Commission stated:

> "...a broker-dealer participating in an unregistered distribution of securities purportedly made in reliance on exemption from the Securities Act's registration requirements must exercise reasonable care to see to it that the exemption is in fact available. This means that these are situations in which the totality of the circumstances necessitates inquiries and investigations with respect to the issuer's entire course of conduct."

Credibility of Dorothy Brainard

Dorothy Brainard testified in this proceeding. She had previously been convicted of income tax evasion in connection with the proceeds of stock sales involved here and had served a jail sentence (Tr. 130, 367). Brainard, through her attorneys, had received a promise by the United States Attorney of immunity from criminal prosecution for securities laws violations.[7/] Counsel for the George respondents argues that because of this

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7/ This was not a formal grant of immunity.

immunity her testimony (and that of Carol Goldsmith, who received a similar promise) should be looked at with "caution and skepticism" (George filing, p. 3). Counsel quotes testimony of Brainard from the transcript at p. 12 of his filing as follows:

> "Q. Did you know whether the agreement or the pledge was that they would not prosecute you if you testified against Mr. Dillon and Mr. George?
>
> A. That's my understanding.
>
> Q. You realize that pledge doesn't bind the Government? They might turn around and prosecute you.
>
> A. I don't think they would." (Tr. 109) 8/

He omits, however, a question and answer which appear immediately after the answer "That's my understanding" and before the second question. This testimony was:

> "Q. Were there any conditions upon that that your testimony had to [be] favorable?
>
> A. No." (Tr. 109) 9/ (Bracketed word added)

In my view Brainard testified honestly and without malice. Her testimony is generally credited, as is that of her chief clerical employee, Carol Goldsmith.

Registration Violations

It is not seriously disputed that the Brainard group was engaged in an illegal distribution of stock. 10/

There were no registration statements in effect with respect to any of the 9 mining companies during the application period.

8/ For a quote which seeks to create a similar misimpression, see p. 5 of the George filing.

9/ All these questions were propounded by counsel for the O'Brien respondents who do not attack the Brainard testimony.

10/ On June 25, 1975 Brainard, Gem State, Henley, Goldsmith and the 9 mining companies consented to the entry of a permanent injunction in the (Continued)

By virtue of their control of the transfer agent and of the mining companies Dorothy Brainard, Carol Goldsmith and Clayton Henry were able to and did effect the issuance of new issue shares for revenue purposes. Whenever Brainard needed money, she would call one of the brokers and sell them new issue stock. (Tr. 61, 70). Frequently the certificate which was delivered to the two brokerage firms was issued in the name of the purchasing firm so that nothing was shown as to the origin of the shares (Tr. 116; see Div. Ex. G 134).[11/] Sometimes the certificate delivered to the brokers bore fictitious names. On occasion, names of real persons who did not benefit were used (Tr. 68).

As O'Brien testified, she would say she needed the money for taxes or for the companies (Tr. 289, 290; 71). Stock was a regular part of the compensation received by Carol Goldsmith (Tr. 191). Stock was given to Brainard's mother because she baby-sat for Brainard's children (Tr. 65).

The prices at which shares were purchased from Brainard by George and O'Brien generally were substantially below the quotations in the Exchange over-the-counter list.

Brainard and her associates were in effect running a

10/ (Continued)
United States Court for the District of Idaho prohibiting the sale of unregistered stock and violation of the antifraud provisions in connection with the sales of any security. SEC v. Gem State Silver Gold, Inc., (Civ. No. 27432).

11/ In such instances the brokers never saw the certificate from which the shares were purportedly transferred. In fact, there was no such certificate. A few times Brainard stated to Goldsmith that shares would be transferred from prior certificates, which would be cancelled, but this was not done.

printing press for stock certificates.[12/]

During the approximately 2-year period beginning in 1972 George and his firm purchased and distributed unregistered new issue shares from the Brainard interests in the following amounts:

Company Name	Number of Shares
Judith Gold	834,500
Lookout Mountain	270,000
Nancy Lee Mines	488,600
New Era Mines	12,000
Signal Silver	520,000
Silver Bowl	245,000
United Mines	100,000
Total	2,470,000

Extended times the bid price at December 28, 1973, or about midway in the distribution, the total dollar figure for these shares is over $499,000 (Div. Ex. 187).

During the same period O'Brien and his firm purchased and distributed unregistered new issue shares from the Brainard interests in the following amounts:

Company Name	Number of Shares
Caledonia	378,000
Judith Gold	319,611
Lookout Mountain	195,000
Nancy Lee Mines	108,300
New Era Mines	89,250
Signal Silver	80,182
Silver Bowl	196,582
United Mines	82,000
Utah Idaho	122,000
Total	1,570,000

12/ Brainard said she would cause stock certificates to be issued "if I needed money . . . like we were trying to work some different deals for some of the companies or if I personally was broke, or we needed money for operating any of the stuff." (Tr. 61).

Extended on the same basis the dollar figure here is over $220,000 (Div. Ex. 187).

George and his son grossed over $100,000 on a purchase by George from Brainard of 400,000 unregistered new issue shares of Judith Gold in October, 1972, for 1/4 cent per share. Less than 2 months later, on December 1, 1972, George, as Chairman of the Listing Committee, approved Judith Gold for over-the-counter listing on the Spokane Exchange, and it began trading at 25 cents bid, 30 cents asked. Thereafter, George and his son distributed 300,000 shares of Judith Gold at prices ranging from 23 cents to 72 cents per share.

As demonstrated by exhibits which the Division has prepared and which were received in evidence (Div. Ex.'s G 127, G 129, G 132, G 134, G 136, G 138, G 140, G 141, P 144, P 146, P 148, P 150, P 152, P 156, P 158, P 159, P 162), purchases during the applicable period from the Brainard group effected by the George and O'Brien respondents occurred very frequently.

No claim is made by respondents that any exemption is available for the purchases and sales described above. 13/

13/ Although Rule 144 statements were furnished to respondents by Brainard after the effective date of that rule, April 15, 1972, it is clear that such rule was inapplicable variously for the following reasons:

(a) Dealer transactions do not qualify -- only unsolicited agency transactions in which the broker receives no more than the usual and customary broker's commission.

(b) The securities must be beneficially owned by the selling shareholder for at least 2 years before they are sold.

(c) A reasonable inquiry must be made by the broker including, if practicable, a physical inspection of the certificates to determine the length of time they have been held.

Respondents' defense is that they relied upon Brainard's representations that the stock was "free trading."

The Division contends that there were so many warning signals present here that respondents were obligated not to accept her representations at face value. Huge amounts of stock in dormant companies were emanating from the Brainard group at low prices. Both George and O'Brien knew Brainard controlled all of the mining companies and that therefore her stock and that of the controlling group could not be sold publicly by them absent an exemption. They further knew that she also controlled the transfer agent,[14/] and was thus in a particularly advantageous position to avoid the registration provisions. Brainard openly announced her continuing need for money to both brokers. They knew that she was issuing stock for services. Recent dates appeared on certificates in certain instances where certificates were delivered which were in the names of sellers.

In view of these facts the procedures employed by respondents were highly remiss. Although they regularly received certificates from Brainard made out in their names and the names of their firms, no demand was ever made to examine the certificates from which these shares were purportedly transferred. They did not question the recent dates appearing on some certificate Inquiry with respect to the identify of persons whose names

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14/ There was no registrar.

turned out to be fictitious or concerning persons who were merely being used as conduits could have been productive but is not shown.

Instead, respondents took no real precautions.[15/] They merely relied upon Brainard and her generalized statements, oral and written, that the stock was "free-trading."[16/]

Respondents argue that Brainard was the wife of a small-town newspaper publisher and that her reputation for honesty and integrity was good. O'Brien, in particular, argues that the rural area in which he and Brainard live -- Wallace and Kellogg, Idaho -- is an "enclosed society" as far "from an urban atmosphere as 1977 is from the nineteenth century" in which people trust their neighbors and where "to ask for a writing would be an affront." ("O'Brien filing, p. 11). The "small-town" argument cuts both ways, however. O'Brien acknowledges that he knew Brainard had started drinking. Further, Goldsmith testified that everyone in Brainard's office knew she was issuing original issue stock. (Tr. 207, 208).

In any event, the warning signals were so strong that these arguments are not convincing.

15/ O'Brien's conversation with an attorney for Brainard, apparently sometime in 1972, did not even mention the Securities Act nor the "free trading" concept and therefore is not regarded as an effective step.

16/ One of the written representations upon which George contends he relied (under date of Dec. 1, 1972) reads (George Ex. 4):

"All stock transactions of Dorothy P. Brainard of Kellogg, Idaho are free and tradeable stocks under SEC rules of the Act of 1933. If we can be of any further help, please fee free to contact us."

NANCY LEE MINES, INC.
D.P. Brainard"

It should be noted that neither George nor O'Brien is a stranger to Section 5. George Securities was enjoined in 1964 from the sale of unregistered stock of Mineral King Mining Company. O'Brien was similarly enjoined in 1943 with respect to the stock of Callahan Consolidated Mines, Inc.

The circumstances were such that respondents should have made diligent inquiry, and they did not. See International Shareholders Services Corporation, supra, p. 14; Hanley v. SEC, 415 F.2d 589 (2d Cir. 1969); As stated in SEC v. Mono-Kearsarge Consolidated Mining Co., 167 F. Supp. 248, 259 (D.C. Utah 1958), cited by the Division:

> "With all of these red flags warning the dealer to go slowly, he cannot with impunity ignore them and rush blindly on to reap a quick profit. He cannot close his eyes to obvious signals which if reasonably heeded would convince him of, or lead him to, the facts, and thereafter succeed on the claim that no express notice of those facts was served upon him."

There is no doubt that George and O'Brien acted as underwriters in purchasing stock from issuers and controlling persons with a view to distribution.

Based upon the foregoing, I conclude that both the George respondents and the O'Brien respondents wilfully violated the registration provisions of the Securities Act, as charged.

Antifraud Violations

The Division focuses on 17 George transactions,[17/] 9

17/ A transaction in North Star Uranium, Inc. involving a total spread of $20 has been ignored.

of which involve the Brainard companies, in which the difference between the purchase prices and the sales prices ranged from 11% to 76.4% (Div. Ex. G 185).[18/] These transactions cover a period of around 10 months. The average spread was 28% on these transactions and the average dollar spread was $94.

It focuses on 52 O'Brien transactions, all of which involve the Brainard companies, in which the difference between the purchase prices and the sales prices ranged from 12.5% to 100% (Div. Ex. P 167). These transactions span a period of slightly over 2 years. The average spread was 34% and the average dollar spread was $121.

Sales by both George and O'Brien were to public customers and to other brokers. There was never any disclosures of cost or source of the securities.

All of the George transactions except 3 reflect situations where the purchase and sale occurred on the same day. Only 5 of the O'Brien transactions did not occur on the same day. All of these exceptions are situations in which the purchases and sales were one day apart.

There is no dispute as to these facts.

It has long been held that it is a fraud for a broker-dealer to sell securities at prices which are not reasonably related to the market price in the absence of disclosure.

18/ This schedule and Division Ex. P 167, which sets forth the O'Brien transactions, were prepared to afford respondents with notice of the transactions which the Division would contend involved unreasonable markups (Tr. 706-709).

Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1934); Barnett v. U.S., 319 F.2d 340, 344 (8th Cir. 1963). The basic principle underlying these cases is that persons dealing with registered dealers must be treated honestly and fairly. United Securities Corp., 15 S.E.C. 719, 727 (1944).

No exceptions to these principles have been created for penny stocks,[19/] although it has been recognized by the National Association of Securities Dealers (NASD) in applying its markup rules that a somewhat higher percentage than its general rule of 5% sometimes be justified in respect to low-priced securities.[20/]

Respondents' contention in 1977 that scienter must be established in respect to fraud charges has now been proven correct insofar as §10(b) of the Exchange Act and §17(a)(1) of the Securities Act are concerned. Aaron v. SEC, 100 S. Ct. 1945 (1980). In my view scienter in markup situations such as these requires at most a knowledge of the disparity between the price paid for securities and the price charged to customers. Clearly respondents were aware of the prices they were paying and charging, and I, therefore, find scienter.[21/]

19/ Barnett v. U.S., supra.

20/ See Samuel B. Franklin v. SEC, 290 F.2d 719, 725 (9th Cir., 1961).

21/ Further, as the Commission stated in Crosby & Elkins, Inc., SEA Rel. No. 17709 (April 13, 1981) p. 6, George and O'Brien both with long experience in the securities business "could hardly have been oblivious" to the excessive nature of their markups.

In any event, a finding of scienter is not required with respect to violations of §17(a)(2) and (3).

Respondents have cited no cases impugning the legal principles applicable to markups as set forth above and generally merely disagree with them. 22/

They do argue that the spreads involved fall within the quotations published by the Spokane Exchange and were therefore proper. No showing, however, has been made that these quotations were binding upon anyone, and respondents obtained huge quantities of all 9 mining stocks at much lower prices. See Waldron & Co., SEC Release No. 12872 (Oct. 6, 1976), 10 SEC Docket 663, 664. Contemporaneous cost is obviously the measure of market value which should be applied in this case.

It is contended by counsel for O'Brien that the market in penny mining stocks, or "white chips," as he terms them, is "illogical," that there "are few consistent factors which predict general price movements of the market," that "general factors such as the silver-gold market and the economy have a bearing," and that "acquisition, existence or termination of a working agreement has been effected." 23/ (O'Brien filing, p. 13). The basic thrust of this argument is that these factors

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22/ Thus, the O'Brien respondents state concerning the fraud theory behind unreasonable markup violations:

> "The rationale for this theory make[s] little sense" (O'Brien filing, p. 38).

23/ As Brainard put it:

> "...if we'd put out a good story that we were doing something, like on Nancy Lee or Judith, or anyone we were trying to work a deal with, with a larger company or anything, they'd go up, naturally." (Tr. 71).

make such stocks speculative, extremely volatile, limited in their activity and subject to merely spasmodic public interest. Accordingly, the argument goes, a dealer must be rewarded with a larger markup because he is at substantial risk and performing a necessary economic function when he takes positions, either short or long.

While these arguments appear to have validity in a general sense, they have no application to this case. Here, the great majority of the illegal markups occurred in "same day" transactions and where pre-existing inventory positions do not appear significant.

Respondents argue that proving that transactions were "on the same day" and proving them "riskless" are two different things. (O'Brien filing, p. 49). I believe, however, that I am entitled to conclude that a substantial number of the "same day" transactions were truly "riskless," [24/] in the absence of any evidence to the contrary from respondents. See N. Sims Organ, 40 S.E.C. 573, 577 (1961), aff'd. 293 F.2d 78 (2d Cir. 1916), cert. denied 82 S. Ct. 440. In any event, no findings have been proposed by respondents that long-term positions, possibly justifying greater markups, were ever taken in the stocks of the 9 mining companies. Further, the Commission has indicated that markups in excess of 10% are unfair even in the sale of low-priced securities. J.A. Winston & Co., Inc., 42 S.E.C. 62, 69 (1964); Costello, Russoto & Co.,

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24/ Absence of "market risk" is the definition employed here.

42 S.E.C. 798, 802 (1965).

In this last connection, it is noted that the two Division schedules which set forth the markups in issue here, Div. Ex.'s G 185 and P 167, reflect 36 transactions for O'Brien and 10 for George in which the markups exceeded 20%.

It is concluded that it has been established that all transactions reflected on these two schedules involve excessive markups. Accordingly, all respondents are found to have wilfully committed violations of the antifraud provisions with which they were charged.

Section 15(c)(3)

The evidence is uncontroverted that George Securities, aided and abetted by George, was continuously doing business as a broker and dealer in securities during the months of June 1974 through November 1974, inclusive, when there were insufficient bank reserves to satisfy the requirements of subparagraph (e) of Rule 15c3-3 under Section 15(c)(3) of the Exchange Act. The shortages ranged from $8,896 to $19,018. The shortages in the reserves were due to failure to include bank overdrafts in the computation.

The George respondents appear to concede that violations took place but state without support in the record that they were inadvertent.

It is concluded that George Securities, wilfully aided and abetted by George, wilfully violated Section 15(c)(3) of the Exchange Act and Rule 15c3-3.

PUBLIC INTEREST

The Division recommends that the broker-dealer registrations of both firms be revoked and that both O'Brien and George be expelled from membership in the Spokane Stock Exchange and be barred from association with any broker-dealer. It is pointed out that the violations continued over a substantial period and appear to evidence contempt for the securities laws and for customers.

George argues that no sanctions at all are warranted. O'Brien argues that at most he was not as careful as he should have been, there were no customer complaints, and that the Division's proposed sanctions are too severe.

The registration violations occurred under such suspicious circumstances that it can only be concluded that respondents acted intentionally or with extreme recklessness. The markup violations, while not as numerous as those in some cases[25/] were nevertheless extensive and substantial.

The Commission has recently stated the factors to be taken into account in assessing sanctions in Lamb Brothers, Inc. SEA Rel. No. 14017 (October 3, 1977), 13 SEC Docket 265, 274:

> "Past misconduct is the essential predicate for liability. Once liability has been established, our concern is with the remedy. And there our orientation is to the future. Two questions are presented. The first is: What action is needed to protect investors from future harm at the particular respondent's hands? Pertinent to that inquiry is the fact

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25/ The schedules upon which they are based are limited to contemporaneous transactions in timely traded stocks (Tr. 693).

> that the statute is drawn on the premise that past misconduct gives rise to an inference of probably future misconduct.... The second question is: What effect will our action or inaction have on standards of conduct in the securities business generally? As the Court of Appeals for the Second Circuit has recently observed, 'The purpose of sanctions must be to demonstrate not only to petitioners but to others that the Commission will deal harshly with egregious cases.' Arthur Lipper Corporation v. S.E.C., 547 F.2d 171, 184 (C.A. 2, 1976)."

One Court of Appeals has informed the Commission that permanent exclusion from the business will not be upheld unless compelling reasons are articulated for such a sanction. Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979).

Bearing in mind the guidance afforded by the Lamb and Steadman cases, I find the violations involved here serious both from the standpoint of magnitude and nature, but not so egregious as to mandate "a permanent disbarment as a deterrant to others in the industry" (Steadman, supra at 1140). Further, insofar as preventing future harm at the hands of these particular respondents, there is a reduced need for such relief in the markup area in view of the settlement agreement in the District Court precluding the use of unrepresentative quotations. In differentiating between George and O'Brien it is noted that the latter did not violate Section 15(c)(3) and Rule 15c3-3 and that his testimony at the hearing was more open and more indicative of a willingness to cooperate in the regulatory process. While a 12-month period of suspension is believed necessary for the George respondents, only a 9-month suspension is imposed on the O'Brien respondents.

Accordingly, IT IS ORDERED:

1. The registration of George Securities as a broker-dealer is suspended for 12 months.

2. George is suspended from membership in the Spokane Stock Exchange for 12 months, and suspended from association with any broker-dealer for 12 months.

3. The registration of Pennaluna as a broker-dealer is suspended for 9 months.

4. O'Brien is suspended from membership in the Spokane Stock Exchange for 9 months, and suspended from association with any broker-dealer for 9 months.

This order shall become effective in accordance with and subject to Rule 17(f) as described below.

Pursuant to Rule 17(f), this initial decision shall become the final decision of the Commission as to each party who has not, within (15) days after service of this initial decision upon him, filed a petition for review of this initial decision pursuant to Rule 17(b), unless the Commission, pursuant to Rule 17(c) determines on its own 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. 26/

Edward B. Wagner
Edward B. Wagner
Administrative Law Judge

Washington, D.C.

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