SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 34-8310/ May 8, 1968

ADMINISTRATIVE PROCEEDING
File Nos. 3-1503

In the Matters of: THOMSON & MC KINNON and WALTER T. O'HARA

BROKER-DEALER PROCEEDINGS

Grounds for Remedial Action

Interpositioning

Failure of Supervision

Where registered broker-dealer firm and partner in charge of its over-the-counter stock department, in execution of transactions for customers, interposed broker-dealers between registrant and best available market to detriment of customers, in willful violation of anti-fraud provisions of Securities Exchange Act of 1934, and failed to exercise reasonable supervision to prevent such violations, held, under all the circumstances, including previous sanctions imposed by registered securities association on basis of portion of interpositioning activities, and adoption of improved internal procedures to prevent recurrence, appropriate in public interest to accept offer of settlement providing for suspension of certain activities of broker-dealer's over-the-counter stock department and suspension of partner from association with any broker-dealer.

Arthur Goldman, Stanley Sporkin, and Lawrence Williams, for the Division of Trading and Markets of the Commission.

Donald E. Mc Nicol and James J. Marett, of Hall, Patterson, Taylor, Mc Nicol & Marett, for Thomson & McKinnon and Walter T. O'Hara.

FINDINGS, OPINION AND ORDER SUSPENDING BROKER-DEALER FROM PERFORMING CERTAIN ACTIVITIES AND INDIVIDUAL FROM ASSOCIATION WITH BROKER-DEALER

In these proceedings pursuant to Sections 15(b), 15A and 19(a)(3) of the Securities Exchange Act of 1934 ("Act"), an offer of settlement was submitted by Thomson & McKinnon ("registrant"), a partnership, which is registered as a broker and dealer and is a mamber of the National Association of Securities Dealers, Inc. ("NASD") and the New York Stock Exchange and other national securities exchanges, and by Walter T. O'Hara, a general partner of registrant. Under the terms of the offer respondents waived a hearing and post-hearing procedures. Solely for the purpose of settlement of these proceedings, and without admitting the allegations in the order for proceedings, respondents consented to such findings and conclusions as are warranted

by facts recited in a stipulation entered into by respondents and our Division of Trading and Markets, to findings of willful violations of the Act and of failure to exercise reasonable supervision to prevent such violations as alleged in the order for proceedings, and to the entry of an order suspending certain activities of registrant's over-the-counter stock department for up to seven business days, and suspending O'Hara from being associated with any broker or dealer for up to 35 calendar days.

After due consideration of the offer of settlement and upon the recommendation of our staff, we have determined to accept such offer. On the basis of the order for proceedings, the offer of settlement, and the stipulation, we make the findings set forth below.

Interpositioning

Registrant, together with or aided and abetted by O'Hara, willfully violated Sections 10(b) and 15(c)(1) of the Act and Rules 17 CFR 240.10b-5 and 15c1-2 thereunder, and failed reasonably to supervise the operations of registrant's over-the-counter stock department with a view to preventing such violations.

Between April 1959 and February 1963 registrant, in connection with its execution of customers' orders for stocks in the over-the-counter market,[1] regularly interposed seven broker-dealers, none of whom either made a market in or was otherwise a traditional source of the stocks traded, between itself and the best available market. On eight randomly selected trading days during the period, registrant effected an aggregate of 685 over-the-counter transactions, of which 175 or 25.5% were effected with the interposed broker-dealers. In substantially all cases, those firms effected same-day offset transactions at a profit with broker-dealers who made a market in or were traditional sources of the security (hereinafter referred to as "market makers"). During a representative period of about eight months, such offset transactions produced a profit for the interposed dealers which ranged from 1/8 to 3/8 per share and most frequently amounted to about $25 per 100-share transaction. That added transaction cost was borne by registrant's customers.[2]

The NASD on June 30, 1964, determined that respondents, in violation of the NASD's Rules of Fair Practice, interpositioned one of the interposed firms involved in the instant proceedings. Under the terms of the offer of settlement, we may consider in making our findings the NASD findings that during representative periods totalling about three months between April 1959 and December 1962, the interposed firm effected 316 transactions with registrant in a wide variety of securities, consisting of 237 effected as principal and 79 as agent. The NASD further found that in 218 of the principal transactions, the interposed firm realized an average profit of $40.37 per transaction, with the price spread generally ranging from 2 on a stock selling at 20 per share to $50 on a stock selling at $1,800 per share; that the dollar profit on individual transactions ranged from $6.25 on a 100-share trade with a 1/16 point spread to $250 on a 1,000-share trade with a

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1. Registrant usually acted as agent in executing customers' orders in the over-the-counter market and charged a commission based upon New York Stock Exchange minimum commission rates.
2. Moreover, the commission that registrant charged the customers on such purchases was larger than it would have been if registrant had acquired the stock directly from a market maker and avoided the interposed dealer's profit which was included in the price charged to the customer. See H.C. Keister & Company, Securities Exchange Act Release No. 7988, p. 5 (November 1, 1966).

1/4 point spread; that only about 54 of the principal transactions involved less than 100 shares; and that, on an over-all basis, the prevailing spread was 1/8 or 1/4. With respect to the agency transactions, computable commissions charged by the interposed firm were comparable in amount. They ranged from $7.50 to $75 per transaction, averaging $25.36, with only five of the transactions involving less than 100 shares. The NASD fined registrant and O'Hara $2,000 each, and suspended O'Hara's registration as a registered representative for a period of 30 days.

Registrant, a large retail firm,[3] was in a position in substantially all cases to have dealt directly with the market makers on as favorable a basis as that accorded by such market makers to the interposed broker-dealers. Indeed, in many instances registrant dealt on a regular basis with and had direct wire connections to the market makers used by those firms. Nevertheless, without regard to the interests of its customers and to their detriment, registrant engaged in a systematic practice over a prolonged period of placing the interposed broker-dealers between itself and the market makers. Registrant's primary purpose for doing this was to reciprocate for listed business referred to it by such broker-dealers and to reward them for furnishing services - principally the collection of quotations - to its over-the-counter order department. On the basis of the sampling the amount of the entirely unnecessary costs and charges to registrant's customers imposed by the interposed firms was substantial.

Although it was registrant's stated policy to obtain three quotations prior to execution of customers' orders for stocks in the over-the-counter market and execute such orders at the most favorable prices to customers, it failed to establish an adequate system of internal control to insure compliance with such policy. The order tickets generally did not record the markets checked, and the execution tickets were not reviewed or initialed by supervisory personnel. O'Hara, who was the partner in charge of the over-the-counter order department, reviewed its daily recapitulation sheet which identified the security involved and the broker-dealer with whom the transaction was effected, and recited the price at which the security was bought or sold. His review of prices, however, was limited primarily to a spot-check comparison of such prices with those quoted in the sheets, and he made no review to determine whether the broker-dealer involved in the transaction was a market maker. He had approved the direct wire connections of the interposed firms to registrant's over-the-counter stock department, and he knew or should have known that as a result of the regular execution of transactions with those firms, the prices paid or received by registrant's customers on purchases were higher and on sales lower than the prices that would have obtained had registrant dealt directly with the market makers.[4] Two of those broker-dealers were interposed as a result of an understanding between O'Hara and a mutual fund salesman.[5] As part of such understanding, the salesman directed a portion of the fund's listed portfolio business to registrant, and O'Hara permitted the two broker-dealers, selected by the salesman, to engage on a regular basis in transactions with registrant's

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[3] Registrant has 58 general and limited partners, 39 branch offices, and over 1,100 employees.

[4] According to the NASD decision discussed above, O'Hara approved the installation of the wire connection with the interposed firm there involved after receiving certain basic data respecting the firm, its personnel and financial condition, and the nature of its business. The NASD concluded that it was "most difficult" for it "to perceive how O'Hara with knowledge of the limited capital" of that firm, could have been satisfied that it was "a primary market maker in the very extensive list of securities which the record shows to have been traded."

[5] One of the broker-dealers was regularly interposed until about October 1960, and the other for the remainder of the period.

over-the-counter department. O'Hara knew that those two firms were not market makers in the diverse number of stocks involved.

We have on numerous occasions stressed the importance of the broker's fiduciary obligation to get the best price for his customers.[6] That obligation is basic and vital to the broker-customer relationship. However, notwithstanding that obligation, and in disregard of registrant's own stated policy of executing customers' orders at the best of three price quotations and of O'Hara's duty as the supervising partner to enforce that policy, respondents engaged in the practice, over an extended period, of interposing a number of broker-dealers between their customers and the best market. It is evident that respondents subverted the interests of their customers to obtain profitable business in listed securities and valuable services from the interposed dealers, thus enriching themselves at the expense of their customers. In view of the obligation of a broker to obtain the most favorable price for his customer, where he interposes another broker-dealer between himself and a third broker-dealer, he prima facie has not met that obligation and he has the burden of showing that the customer's total cost or proceeds of the transaction is the most favorable obtainable under the circumstances. Respondents, by making a practice of such interpositioning, obviously could not sustain such burden, and it is clear that their conduct constituted a fraud upon their customers.[7]

Public Interest

In determining to accept the offer of settlement submitted by respondents, despite their serious and extensive violations, we gave consideration to the facts that O'Hara has been associated with registrant for 46 years without having been the subject of disciplinary proceedings prior to the interpositioning activities, that sanctions were previously imposed upon respondents by the NASD on the basis of a portion of such activities, that the violations took place more than 5 years ago and since then supervision of registrant's over-the-counter stock department has been assigned to other partners, and that registrant has adopted improved internal procedures to prevent a recurrence of the violations found. Those procedures require that over-the-counter transactions be effected only with broker-dealers who quote the security involved in the daily pink sheets published by the National Quotation Bureau, Inc., with exceptions permitted only with the specific approval of a partner; that three quotations be obtained from firms in the pink sheets before any transaction in an over-the-counter security is effected and that all order tickets note such quotations and the sources thereof; and that the partner in charge review order tickets at the end of each day, check the execution price against the quotations given,[8] and on the following day spot check the quotations against those in the pink sheets for the firms involved. In

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6 See *W.K. Archer & Company, 11 S.E.C. 635, 642 (1942),* aff'd *133 F.2d 795* (C.A. 8, 1943); *Investment Service Co., 41 S.E.C. 188, 198 (1962); Arleen W. Hughes, 27 S.E.C. 629, 636 (1948),* aff'd *174 F.2d 969* (C.A. D.C., 1949); H.C. Keister & Company, supra, at p. 5 of cited release; Thomas Brown III, Securities Exchange Act Release No. 8032 (February 8, 1967); Delaware Management Company, Inc., Securities Exchange Act Release No. 8128, pp. 5-6 (July 19, 1967). See also S.E.C.'s Special Study of Securities Markets, H. Doc. No. 95, 88th Cong., 1st Sess., Pt. 2, pp. 620-24 (1963).

7 Wholly apart from the foregoing, it may be noted that respondents failed to disclose in the confirmation or otherwise to the customer the extent to which the customer paid more or received less than he would have if there had been no interpositioning and he had received the best execution. This is not to imply, however, that disclosure of the interpositioning practice would have obviated its fraudulent character.

8 Of course, we presume such procedure would also include a review of the source of the quotations and of the securities bought or sold as additional means of detecting interpositioning practices.

addition, registrant reaffirmed its policy that no over-the-counter business be exchanged for listed business, and it increased the number of persons executing orders for its over-the-counter stock department from one to seven so that it no longer uses other broker-dealers to obtain quotations for its customers. We also considered the fact that these proceedings were being decided upon the basis of an offer of settlement containing admissions and consents, and that our staff had recommended acceptance of the offer.

Under all the circumstances, we conclude that it is appropriate in the public interest and for the protection of investors to dispose of the proceedings in accordance with such offer and on the basis of the maximum sanctions specified in the offer.[9] During the seven business day suspension of registrant's over-the-counter stock department, as provided in the offer, registrant shall not solicit any over-the-counter trades in stocks or the purchase of mutual fund securities, may execute unsolicited orders for over-the-counter trades in stocks but only for existing customers and without any commissions, markups and markdowns on such trades, and shall not participate as underwriter, dealer or selling group member in underwritings except that it may accept unsolicited orders, from existing customers only, for securities of mutual funds and retain its portion of the sales load on such trades. During O'Hara's 35-day suspension, as provided in the offer, he shall not receive, directly or indirectly, any salary, commission, bonus or other compensation from registrant, and shall forego his proportionate share of all profits of registrant that would otherwise have accrued to him during such suspension period, but he may receive interest on his capital contribution in registrant.

Accordingly, IT IS ORDERED that commencing with the opening of business on June 6, 1968, the operations of the over-the-counter stock department of Thomson & McKinnon be, and they hereby are, suspended for a period of seven business days, and Walter T. O'Hara be, and he hereby is, suspended from being associated with any broker or dealer for a period of 35 calendar days, subject to the terms and conditions described herein.

By the Commission (Chairman COHEN and Commissioners OWENS, BUDGE, WHEAT and SMITH).

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[9] O'Hara has requested that his 35-day suspension period be divided into two periods of three weeks and two weeks, respectively, with an intervening two weeks "of grace," on the ground that a protracted period away from the office and the attendant publicity would impair his ability to supervise his customers' investment portfolios. After due consideration, we have determined to deny this request.