ADMINISTRATIVE PROCEEDING
FILE NO. 3-6370

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	:
RFG OPTIONS COMPANY (8-24148) EUGENE V. RINTELS ANDOR A. FLEISCHMAN DENNIS G. GUY	:
	:

INITIAL DECISION

Washington, D.C.
June 4, 1985

Administrative Law Judge
Ralph Hunter Tracy

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APPEARANCES: Peter B. Shaeffer and Joan M. Flemming for the Division of Enforcement.

Michael B. Roche, L. Andrew Brehm, David J. Shukovsky for the respondents.

BEFORE: Ralph Hunter Tracy, Administrative Law Judge

On May 30, 1984, the Commission instituted this proceeding against RFG Options Company (RFG or Registrant), Eugene V. Rintels (Rintels), Dennis G. Guy (Guy), and Andor A. Fleischman (Fleischman) by an order for public proceeding (Order) pursuant to Sections 15(b) and 19(h) of the Securities Exchange Act of 1934 (Exchange Act). The proceeding was instituted to determine whether there were any violations of securities law 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 RFG willfully violated and Rintels, Guy, and Fleischman willfully aided and abetted violations of Sections 7 and 8(a) [1/] of the Exchange Act, and Regulations T, U, and X, promulgated thereunder by the Federal Reserve Board. In addition, the Order alleges that RFG willfully violated and Rintels, Guy, and Fleischman willfully aided and abetted violations of Section 17(a) of the Exchange Act and Rules 17a-3 and 17a-4 thereunder.

The evidentiary hearing was held in Chicago, Illinois, from December 10 to 14, 1984, and all respondents were represented by counsel; proposed findings of fact, conclusions of law, and supporting briefs were filed on behalf of all parties.

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

1/ In its post hearing brief the Division did not seek any violation under Section 8(a).

Respondents

RFG is an Illinois partnership organized in August 1979 and is registered with the Commission as a broker-dealer and has been so registered at all times relevant to this proceeding. RFG is a member of the National Association of Securities Dealers (NASD), the Midwest (MSE) and American (AMEX) Stock Exchanges, the Chicago Board Options Exchange (CBOE), the Midwest Clearing Corporation (MCC), and the Depository Trust Company (DTC).

Rintels is a general partner of RFG, having contributed 56 percent of its capital. He has been registered with the Commission as a sole proprietor broker-dealer since 1975. He is the senior partner of RFG in charge of all operations, with overall supervisory responsibilities for the firm. Rintels is 42 years of age and has a BS/BA degree from the University of Denver. He has been in the securities business since 1969; he had earlier been a registered representative with the brokerage firms of Cole, Meyer & Co., and Reynolds & Co.

Guy is 42 years old, a general partner of RFG, and contributed 16 percent of its capital. He attended Boston College for two years and the University of Colorado for one year but did not obtain a degree. He has been registered with the Commission as a sole proprietor broker-dealer since July 6, 1979. He was formerly in the furniture business and was introduced to the securities business by Rintels from whom he learned the fundamentals.

He has supervisory responsibilities for all of RFG's day-to-day operations, including back office functions, the stock loan department, and proprietary trading.

Andor A. Fleischman is 57 years old and has a BS degree from New York University and a Master's degree in physics from the University of Rochester. He was an optical engineer at Bell & Howell and a consultant in optics prior to 1978, at which time he purchased a seat on the CBOE. He has been registered with the Commission as a sole proprietor broker-dealer since 1977. He is a general partner in RFG, contributing 28 percent of its capital. He trades for his own account and spends the day on the floor of the CBOE. He shares in the profits generated by RFG but is not active in the day-to-day management.

Dividend Reinvestment Plan

The charges in the Order stem from RFG's participation in various dividend reinvestment plans. All of the facts concerning the operation of such plans and the program engaged in by RFG have been stipulated to by the respondents and the Division.

In general, dividend reinvestment plans offer an issuer's shareholders of record the opportunity to reinvest cash dividends paid by the issuer in additional shares of the same issuer. In order to induce shareholders to participate in their dividend reinvestment plans some issuers provide that

the stock offered under the plan may be purchased at a price usually equal to 95-97 percent of the average price of the issuer's stock on a designated securities market as of a specified date or dates (the pricing date). In other words, such dividend reinvestment plans permit the issuer's shareholders to purchase stock at a discount of between 3-5 percent of the prevailing market; the purchase is made directly from the issuer with no brokerage commissions or charges being incurred.

For example, the dividend reinvestment plan of Commonwealth Edison Company provides that the price of the shares offered under the plan is 95 percent of the average of the high and low prices on the NYSE on the cash dividend payment date.

Another pricing formula is used by American Telephone and Telegraph Company (AT&T) whose dividend reinvestment plan provides that the price of the shares offered under the plan is 95 percent of the average of the daily high and low sale prices on the NYSE for the five trading days ending on the cash dividend payment date.

As an illustration of dividend reinvesting, assume that RFG received a $10,000 cash dividend from Company A, and that on the pricing date the market value was $10 per share. Through the dividend reinvestment program, using a discount of 5 percent, RFG would purchase $10,000 worth of stock at $9.50 per share, thereby receiving approximately 1,052 shares. RFG would then immediately sell the shares at $10 per share or a total of $10,520, thereby realizing a profit of $520, less interest and transaction costs.

During the period from July 1982 through May 1984, RFG participated in the dividend reinvestment plans of about 80 issuers involving between 700 and 810 transactions. This dividend reinvesting grew to comprise over 90 percent of RFG's total business.

RFG was only a token shareholder in the companies in whose programs it participated. Therefore, in order to participate in the dividend reinvestment plans of an issuer, RFG borrowed stock of that issuer, usually from a broker-dealer, using the facilities of the Depository Trust Company (DTC). DTC is a clearing agency registered with the Commission pursuant to Section 17(a) of the Exchange Act; it is an independent corporation owned by broker-dealers and banks; it holds on deposit (in the name of its nominee) securities owned by its user participants. DTC maintains a dividend reinvestment service department which services its members and issuers with respect to dividend reinvestment plans.

Because the borrowed stock was in RFG's account at DTC on the dividend record date, under applicable industry custom and practice RFG was treated as the record owner of the borrowed stock. Accordingly, RFG was then entitled to receive the cash dividend and was in a position to elect to reinvest the dividend in the issuer's program. However, RFG remained obligated to pay the cash dividend to the lending broker.

RFG deposited cash with the lending broker as collateral for the stock loan. The amount of this cash collateral was usually

equal to the fair market value of the stock, plus a premium of between one-half and two points per share over the stock's fair market value. If the value of the stock increased, RFG made additional deposits of cash collateral, commonly known as "mark-to-the-market" payments. After the borrowed stock was returned, RFG received from the lending broker a rebate or credit in the form of interest income on the cash collateral.

RFG obtained most of the cash necessary to collateralize its borrowed stock by borrowing funds from several major national banks. Each of these banks is a member of the Federal Reserve System. The banks would loan RFG cash equal to 75-90 percent of the fair market value of the stock being borrowed. The remaining 10-25 percent of the cash collateral was paid from RFG's own funds. RFG paid interest to the bank for this borrowing at a rate greater than the rate at which the lending broker's rebate was computed.

In order to secure its bank borrowing, RFG pledged the borrowed stock to the bank. This is accomplished through the requisite accounting entries at DTC and the execution of the bank's standard collateral deposit form.

On November 30, 1982, RFG's bank borrowings, made in order to establish its position on record date, totalled approximately $26 million. The value of the collateral was approximately $32 million. Its banks therefore had extended credit to the extent of approximately 80 percent of the current market value of the collateral. At December 31, 1982, RFG had bank loans of approxi-

mately $24 million, collateralized by securities having a market value of approximately $28 million. Its banks therefore had extended credit to the extent of approximately 85 percent of the current market value of the collateral. For each bank borrowing, RFG completed and executed a printed form, prepared by the bank, commonly known as a "purpose statement."

Within three days after the dividend record date, RFG provided DTC with written notice of its intention to participate in an issuer's dividend reinvestment plan, thus entitling RFG to participate in the plan. Shortly after the dividend record date, the borrowed stock would be returned to the lending broker. In turn, the lending broker returned the cash collateral to RFG. RFG would then immediately use the cash collateral to repay its bank borrowings. RFG's stock and bank loans remained outstanding for a period of less than one week. In most instances, such borrowings were outstanding for only a few days.

Violations

The Order alleges that RFG willfully violated Section 7(c) of the Exchange Act in that RFG, in its stock-borrowing activity, extended cash credit to the stock lender at a time when RFG was using the borrowed stock for a purpose other than one permitted by Section 6(h) of Regulation T (Section 16 after the November 21, 1983 amendment of Regulation T).[2/] The Order also alleges that Rintels, Fleischman, and Guy willfully aided and abetted

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2/ Regulation T. 12 C.F.R. 221, revised November 21, 1983.

those credit extension violations of RFG. The Order further alleges that RFG, Rintels, Fleischman, and Guy willfully aided and abetted violations by certain banks of Section 1(a) of Regulation U (Section 3[a] after the November 21, 1983 amendment of Regulation U) [3/] in that the banks extended "purpose" credit to RFG in an amount which exceeded the maximum loan value of the collateral securing the credit. Finally, in the credit area, the Order additionally alleges that RFG willfully violated and the individual respondents willfully aided and abetted violations of Section 7(f) of the Exchange Act and Regulation X [4/] thereunder in that RFG obtained credit from its lending banks in contravention of Regulation U.

In addition, the Order alleges that RFG willfully violated, and Rintels, Fleischman, and Guy willfully aided and abetted violations of Section 17(a) of the Exchange Act and Rules 17a-3 and 17a-4 thereunder in that RFG failed to maintain as part of its books and records copies of purpose statements submitted to its lending banks and failed to require its banks to file with the Commission a statement to the effect that the purpose statements retained by the banks were the property of RFG, would be promptly surrendered upon request by RFG, and would be available for examination by the Commission.

3/ Regulation U. 12 C.F.R. 221, revised August 31, 1983

4/ Regulation X, 12 C.F.R. 224, revised January 23, 1984.

Summary of Charges and Respondents' Defenses

The Division has charged that the stock and bank borrowings outlined above, which will be described in detail later, violated certain applicable regulations, i.e., FRB Regulations T, U, and X.

The Division alleged in the Order that RFG violated Regulation T because RFG's stock borrowings did not comply with Section 6(h), (now Section 16), of Regulation T. 5/ Section 6(h) essentially provides that stock may be borrowed only for the purpose of making delivery of securities in the case of short sales, failure to receive securities required to be delivered, and other similar situations. According to the Division, RFG's stock borrowings were not made for any of these permitted purposes and, therefore, were illegal.

Respondents contend that RFG's stock borrowings were exempt from the provisions of 6(h) because Section 4(d), (now 7), of Regulation T exempts any borrowing obtained to finance a bona fide arbitrage transaction from the otherwise applicable credit limitations of Regulation T. Alternatively, RFG maintains that its stock borrowings constituted a "similar situation" within the ambit of Section 6(h).

5/ Regulation T was revised, effective November 21, 1983, and Section 6(h) was renumbered as Section 16. This revision did not cause any substantive change in the provisions of 6(h) which are relevant here.

The Division has also alleged that RFG's bank borrowings contravened Sections 3(a) and 8, (formerly 1[a] and 4), of Regulation U [6/] because the amount of such borrowings exceeded the "maximum loan value" of the collateral securing the credit. The Division asserts that RFG's banks were permitted to lend it only 50 percent of the market value of the stock pledged by RFG to the bank as collateral. [7/] RFG borrowed 75 to 90 percent of the market value of the pledged stock.

Respondents contend that Section 5(c)(5), (formerly 2[j]), of Regulation U exempts RFG from the credit limitations of Regulation U on any credit extended to finance bona fide arbitrage transactions. Therefore, since the dividend reinvestment program was a bona fide arbitrage transaction, RFG's bank borrowings were exempt from the otherwise applicable limitations imposed by Regulation U.

The Division alleged, further, that RFG also violated Regulation X. In essence, Regulation X prohibits a borrower from obtaining credit which is extended in violation of either Regulation T or Regulation U. Respondents contend, for the reasons set forth above, that RFG did not violate Regulation T

6/ Regulation U was revised, effective August 31, 1983, but the revision did not substantively affect any issue present here.

7/ The stock used by RFG to collateralize its bank borrowings in connection with the dividend reinvestment program was the same stock that RFG had borrowed from another broker-dealer.

or Regulation U and, therefore, there was no violation of Regulation X.

Finally, in the Order, the Division alleged that RFG violated Section 17(a) of the Exchange Act and Rules 17a-3 and 17a-4 thereunder pertaining to certain record-keeping requirements applicable to broker-dealers.

During the hearing the parties stipulated that RFG's alleged record-keeping violations pertained solely to the purpose statements which RFG was required to file with its lending banks.[8/] Specifically, the Division alleged that certain of RFG's purpose statements were false because they stated that the purpose of the bank borrowing by RFG was to finance its activities as a specialist on a national securities exchange.[9/] The Division also contended that RFG violated the record-keeping rules by not maintaining copies of its purpose statements on its premises and by not requiring its lending banks to furnish a written undertaking stating that the purpose statements: (a) would be deemed to be the property of RFG; (b) would be surrendered promptly on the request of RFG; and (c) would be made available for inspection by the Commission's staff.

8/ Purpose statements require a cash borrower whose loan is secured by stock to indicate which of the exemptions from the credit limitations of Regulation U is applicable, or to indicate that the borrowing is not made for the purpose of purchasing or carrying margin stock.

9/ Section 5(c)(10), (formerly 3[o]), of Regulation U provides an exemption for credit extended to a broker-dealer to finance its specialist activities.

Respondents assert that the Division in its proposed findings of fact and conclusions of law and supporting brief, has apparently abandoned its contention that RFG violated Rule 17a-3 of the record-keeping rules by submitting false purpose statements to its banks. Rather, respondents say, the Division now argues that RFG's reliance upon the "specialist exemption" in its purpose statements shows knowledge or awareness by the individual respondents that RFG was engaged in illegal or improper conduct and thus is pertinent only to the alleged aiding and abetting liability of the individual respondents.

With respect to the other record-keeping violation, RFG acknowledges that it did not maintain copies of its purpose statements on its premises and that it did not require its banks to furnish the Commission with the undertaking described above. However, RFG contends that it constructively maintained the purpose statements as required; further, that even if it did violate the record-keeping rule, under the circumstances, as more fully described hereinafter, RFG's "violation" is fairly characterized as hypertechnical and insufficient to warrant any sanction.

Findings of Fact and Conclusions of Law

From August 1979 (when RFG was founded) to July 1982, RFG's business consisted principally of specialist/market maker activity on the CBOE. During that period approximately 80 to

90 percent of RFG's business consisted of CBOE specialist activities. Rintels testified that RFG's activities as a CBOE specialist consisted primarily of various arbitrage transactions which included conversions, reverse conversions,[10/] and the creation of artificial puts and calls. RFG also engaged in option spread transactions.

During the period from August to July 1982, RFG engaged in 2 to 20 transactions a day and the position established by RFG would often consist of 50,000 to 75,000 shares of stock and corresponding option positions, involving 500 to 700 option contracts. Such transactions were effected on all of the major option exchanges; the average size of a typical reverse conversion transaction effected by RFG during this period involved between $15 million to $25 million worth of stock. In order to facilitate borrowing and lending of stock in connection with its conversion and reverse conversion transactions, RFG established a stock loan business.

In late 1981, Guy made a business trip to various institutions on the East Coast, including Harvard University (Harvard), Yale University (Yale), and the Ford Foundation (Ford) to

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10/ Arbitrage techniques used by firms to take advantage of pricing inefficiencies between the premium of a call option and the premium of a put option with an identical strike price and expiration date (corresponding put) are called conversions and reverse conversions. See Report of the Special Study of Options Markets to the Securities and Exchange Commission, (1978), p. 148.

arrange for the borrowing by RFG of securities in connection with its options business. During this trip he met Ms. Sophie Mills (Mills), head of the stock loan department at Harvard, who agreed to loan stock to RFG in connection with its options business.

In early 1982, during a trip to Chicago, Mills met with Rintels and Guy. When she learned that they were not participating in dividend reinvesting, she described the dividend reinvestment program that was being operated by Harvard. She also told them that other colleges, institutions, and firms were participating in dividend reinvestment; and, specifically, that the brokerage firms of Shearson Lehman American Express (Shearson), Prudential-Bache Securities (Bache), E.F. Hutton (Hutton), A.G. Becker (Becker), and Merrill Lynch, Pierce, Fenner and Smith, Inc. (Merrill Lynch) were all acting as stock lenders in connection with dividend reinvestment programs.

Following the Chicago meeting with Mills, Rintels and Guy explored the possibility of participating in dividend reinvesting and in that connection met with several brokerage firms to arrange for RFG to borrow stock. Rintels and Guy both testified that they understood that many brokerage firms participating in dividend reinvestment were financing their activities by borrowing funds in excess of 50 percent of the value of the stock used to collateralize those borrowings. However, they never obtained a legal opinion as to the validity of this understanding.

In addition, prior to July 1982, Rintels, and on occasion, Guy, and Michael Burroughs (Burroughs), controller of RFG, discussed financing of a dividend reinvestment program with several Chicago banks, including Continental Illinois National Bank & Trust Company (Continental), the Harris Bank & Trust Company (Harris), and the First National Bank of Chicago (First Chicago); also, the Chase Manhattan Bank (Chase) in New York. Later in 1983, Rintels met with two additional banks in New York, the Manufacturers Hanover Trust Co. (Hanover) and the Morgan Guaranty Bank (Morgan), and described the dividend reinvestment program to them.

Rintels testified that prior to August 1983, none of these banks questioned or expressed any reservation concerning the propriety of RFG's borrowings to finance its dividend reinvestment transactions, nor did they assert that the borrowings violated the margin rules. 11/ During the relevant period each of the banks loaned RFG funds needed to finance its dividend reinvestment program.

In July 1982 RFG began participating in dividend reinvestments plans, although it continued to claim the specialist

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11/ In August 1983 representatives of Continental met with RFG. Continental informed RFG that Continental had been notified by a member of the Commission's Washington, D.C. staff that the staff was concerned about the possible propriety of the program. Continental informed RFG that because of other problems Continental was having at that time, it had made a business decision that it would no longer lend funds to RFG for dividend reinvestment.

exemption to the margin requirements of Regulation T. [12/] RFG had no customers so that the only individuals sharing in these programs were the respondents. The firms that were offering their stockholders the opportunity to reinvest their dividends at a discount were primarily capital intensive companies such as public utilities. Among the programs in which RFG participated were AT&T, Florida Light & Power, Commonwealth Edison Co., and the Southern Co.

On November 30, 1982, RFG had provided stock lenders with approximately $32 million in cash credit obtained on 230,500 shares of AT&T and 540,300 shares of Florida Light & Power Co. On December 30, 1982, RFG had provided stock lenders with approximately $28 million in cash credit obtained on 1,072,360 shares of Commonwealth Edison Co. On June 30, 1983, RFG had provided stock lenders with $33,657,625 in cash credit obtained on 529,000 shares of AT&T. On November 7, 1983, RFG had provided stock lenders with $35,250,825 in cash credit obtained on 2,060,200 shares of The Southern Co.

Dividend reinvesting required the borrowing of large blocks of stock which in turn were used to collateralize the bank loans. Some of the sources of the stock borrowings were Yale University, Chase Manhattan Bank, and the brokerage firms of Merrill Lynch, Becker, Hutton, Rotan Mosle, Bache, and Shearson. Rintels

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12/ Regulation T, Section 220.12(b), as revised, exempts a specialist's market making activities from the FRB's current 50 percent margin requirement applicable to investors generally.

testified that during the relevant period RFG participated in the dividend reinvestment plan offerings of about 100 companies, involving some 800 dividend reinvestment transactions.

During the period from December 17, 1982 through January 7, 1983, a compliance examiner of the Chicago Regional Office (CRO) of the Commission made a routine audit of RFG. The examiner became aware of the reinvestment program and had discussions with Burroughs and Guy. Burroughs referred to the program either as a dividend reinvestment program or dividend play. Burroughs never referred to the dividend reinvestment program as arbitrage, nor did he ever refer to it as specialist or market maker activity. The SEC examiner asked for copies of purpose statements that had been given to lending banks but RFG did not have copies of them on the premises.

By letter dated May 11, 1983, the CRO requested that RFG provide copies of certain of the purpose statements which it had submitted to its lending banks. By letter dated May 16, 1983, RFG supplied the requested purpose statements from its Chicago banks: Continental, Chicago First, and Harris Trust. All of these purpose statements reflected that RFG was claiming the specialist exemption for its bank borrowings.

On May 20, 1983, the staff of the CRO requested Rintels to meet with them that same day. At that meeting, Rintels, who was accompanied by counsel, was informed of the staff's position that tne dividend reinvestment program as conducted by RFG vio-

lated Regulations T, U, and X.[13] RFG's counsel asked for time to review the facts and assess the staff's position. Following this meeting RFG employed new counsel to assist it in dealing with the questions raised by the CRO concerning the dividend reinvestment program. In July 1983, on advice of counsel, RFG began to claim the arbitrage exemption in addition to the specialist exemption on its purpose statements.[14] Burroughs testified that he executed all of the purpose statements for RFG.

Recapitulation

The Division asserts that on the basis of the foregoing facts RFG willfully violated and the individual respondents willfully aided and abetted violations of Section 7(c) of the Exchange Act in that RFG extended credit to customers on securities in contravention of Section 6(h) of Regulation T (Section 16 as revised), because RFG borrowed said securities for reasons other than for the purpose of making delivery of securities in the case of short sales, failure to receive securities required to be delivered, or other similar situations; that RFG and the individual respondents willfully aided and abetted violations by its lending banks of Section 7(d) of the Exchange Act in that said banks extended purpose credit to RFG secured by margin

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13/ Div. Exh. 1, Stipulation of Facts, p.13.

14/ A purpose statement dated November 3, 1983 filed with the Chicago Bank for a $16,700,000 loan, stated that the purpose of the loan is "to finance our activity as specialists on the floor of a national securities exchange; and to finance our customers' bona fide arbitrage transactions in securities; and to finance, and be secured by, securities in transit or surrendered for transfer."

stock in contravention of Section 1(a) of Regulation U (Section 3[a] as revised), because said banks extended the credit in amounts that exceeded the 50 percent maximum loan value of the securities; that RFG willfully violated and the individual respondents willfully aided and abetted violations of Section 7(f) of the Exchange Act and Regulation X in that RFG obtained credit from its lending banks in contravention of the limitations of Regulation U; that RFG violated and the individual respondents willfully aided and abetted violations of Section 17(a) of the Exchange Act and Rule 17a-4 thereunder, in that RFG failed to keep copies of the purpose statements it submitted to its lending banks.

Respondents' principal contention is that RFG's stock borrowings were exempt from the provisions of Section 6(h) of Regulation T by virtue of the provisions of Section 4(d), (now 7), of Regulation T (p. 9, supra). Section 4(d) exempts any borrowings obtained to finance a bona fide arbitrage transaction from the otherwise applicable credit limitations of Regulation T. 15/

15/ Section 4(d) provides: "In a special arbitrage account, a member of a national securities exchange may effect and finance for any customer bona fide arbitrage transactions in securities. For the purpose of this paragraph, the term 'arbitrage' means (1) a purchase or sale of a security in one market together with an offsetting sale or purchase of the same security in a different market at as nearly the same time as practicable, for the purpose of taking advantage of a difference of prices in the two markets, . . . "Section 2(j) of Regulation U is virtually identical.

Black's Law Dictionary, Fifth Edition, (1979) p. 95, defines "arbitrage" as: "The simultaneous purchase in one market and sale in another of a security or commodity in hope of making a profit on price differences in the different markets."

It is axiomatic that the burden of establishing the availability of an exemption rests upon the one who claims it. 16/ In support of their claim of an arbitrage exemption from the otherwise restrictive credit provisions of both Regulation T and Regulation U the respondents proposed calling seven witnesses who would be qualified as experts in this area. In their offer of proof respondents identified four of the proposed expert witnesses as university professors and three as members of the securities industry. Respondents stated that all seven would testify that RFG's dividend reinvestment activity could be defined as an arbitrage and, therefore, was exempt pursuant to the applicable provisions of Regulations T and U.

Steven Givot, a member of the CBOE, was qualified as an expert based on his educational background and business and governmental experience. Givot testified that he was familiar with discounted reinvestment programs; that they were used by capital intensive industries which are constantly looking for a supply of new capital; that there is virtually no speculative or risk component to these transactions; and that, in his opinion, they are arbitrage transactions.

Following Givot's testimony respondents moved to postpone the hearing so as to call additional experts who were not then available. The Division joined in the motion to the extent that it wished to consider presenting rebuttal evidence. The motion

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16/ S.E.C. v. Ralston Purina, Inc., 346 U.S. 119 (1953).

was denied on the grounds that any additional expert testimony would be repetitious and add no new insights.[17/]

The margin rules promulgated under Section 7 of the Exchange Act are designed to prevent the excessive use of credit in the purchase and carrying of securities. The FRB was chosen, as the best equipped government credit agency, to control the use of credit through margin requirements.[18/] Therefore, its interpretations concerning the application of its own rules warrant serious consideration.

The FRB has consistently expressed the position that the arbitrage exemption permits a credit extension only when it is used to finance transactions which perform a beneficial market function. This position was expressed by the Secretary of the FRB in an opinion letter dated March 13, 1961:

> The Board's regulation is primarily concerned not with arbitrage as such, but with the credit extended for the purpose of effecting some arbitrage transactions. The regulations recognize that, in some circumstances arbitrage transactions can have a beneficial effect in helping to maintain an orderly market in securities. It is for this reason that the Board has exempted certain arbitrage transactions from ordinary margin requirements.

17/ In their brief respondents contend that prejudicial error was committed at the hearing when, after Givot testified, they were denied the right to present additional expert testimony. However, when the Division moved to reopen the hearing for the purpose of taking additional expert testimony by both the Division and respondents, and to certify a denial of such motion to the Commission, the respondents strenuously objected. Both motions were denied.

18/ H.R. Rep. No. 1383, 73d Cong., 2d Sess. (1934).

The FRB's position was reiterated in an opinion letter dated June 28, 1976, which stated:

> The purpose of the arbitrage account is to allow special credit for certain types of transactions which perform a market function such as equalizing prices at an instant in time in different markets or between relatively equivalent securities. It does not provide special credit for all transactions which might come within the generic term of "arbitrage."

In a letter dated August 27, 1980, the Chief Attorney of the Securities Regulation Section of the FRB stated:

> The term "arbitrage" in that section of Regulation U is quite limited and does not cover all strategies that the public may consider as "arbitrage" transactions.

In addition to the foregoing expressions of opinion regarding arbitrage transactions, the FRB has published specific rulings concerning dividend reinvestment plans. On March 2, 1984, in its Regulation T (Rulings and Opinions) 5-615.1, a staff opinion stated:

> BORROWING AND LENDING SECURITIES -- Dividend Reinvestment Plan
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> To take advantage of a reduced price under a dividend reinvestment plan, Broker A borrowed stock from Broker B, against a deposit of cash, just before the dividend record date, using facilities of a depository trust company (DTC). As owner, on the records of DTC, Broker A, instead of receiving a cash dividend, elected to purchase additional stock at a discount of 5 percent less than the current market price of the stock. The borrowed stock was then returned for the cash deposit. Within a week, Broker A sold the stock obtained instead of a cash dividend and split the profit with Broker B. The procedures violated section 220.16 of Regulation T, because the stock was not borrowed for a permitted purpose. Also, the transaction did not qualify as a bona fide arbitrage and was therefore not permitted under section 220.7. (Underscoring supplied.)

On July 6, 1984, a second staff opinion concerning dividend reinvestment plans was issued, 5-615.61, as follows:

> BORROWING BY MEMBERS, BROKERS, AND DEALERS -- Dividend Reinvestment Plan
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> A company whose stock is listed on the New York Stock Exchange is concerned that large amounts of its common stock are being borrowed by broker-dealers and banks shortly before the company's dividend record date with the apparent purpose of using the borrowed shares to qualify for a discount under the company's dividend reinvestment plan. The borrower under this strategy becomes the record owner of the borrowed shares and is thus permitted, under the dividend reinvestment plan, to reinvest the cash dividend from the company by purchasing additional shares of the company's common stock at 95 percent of current market value. This has been a serious and recurring problem for the company because it views the strategy as contrary to the purposes for which the plan was adopted. On or shortly before a recent dividend record date, a national bank borrowed shares of the company's common stock, and on another dividend record date, a broker-dealer did the same. In both cases, the borrowed shares were returned on the day after the dividend record date.
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> Staff has recently reaffirmed its longstanding position that the lending and borrowing of stock by broker-dealers must be in connection with a permitted purpose, which does not include borrowing to take advantage of a reduced price under a dividend reinvestment plan (see 5-615.1). (Underscoring supplied.) These purposes include borrowing to cover short sales, failures to receive securities required to be delivered, or other similar situations (12 CFR 220.16).
>
> The described borrowing of the stock of the company would not comply with section 220.16 of Regulation T, which makes the use of special credit terms for the lending and borrowing of securities by brokers or dealers conditional on the transaction's having a purpose specified in that section (see Board interpretation 12 CFR 220.103 at 5-472). The parties involved, therefore, must be aware of the exact nature of the transaction prior to entering into it. A lender of securities who is not sure of the purpose for which the securities are being borrowed must make a good faith effort to determine the purpose. Otherwise, the lender risks liability either for violating or helping another to violate Regulation T if the borrowing is for a purpose not specified by the regulation. STAFF OP. of July 6, 1984.

Although RFG began investing in dividend reinvestment plans early in 1982, it continued to claim a specialist exemption from the requirements of Regulation U [19/] until July 1983. However, following the notification of Rintels by the CRO that such activity was in violation of Section 7 of the Exchange Act and Regulations T and U thereunder, RFG began claiming an arbitrage exemption. [20/]

Rintels testified that he thought that the specialist exemption was appropriate even after RFG began investing in dividend reinvestment plans; that it was his basic understanding that any market maker specialist on the CBOE was under an exemption and could borrow against stock for whatever reason; that he had discussions with Guy and Burroughs concerning the use of the specialist exemption in connection with the dividend reinvestment plans; and that he never received a legal interpretation prior to deciding that RFG could use the specialist exemption in connection with its dividend reinvesting program.

It is concluded that the respondents have failed to sustain the burden of establishing the availability of an exemption

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19/ Section 221.2 of Regulation U provides in pertinent part that no bank shall extend any purpose credit, secured directly or indirectly by margin stock, in an amount that exceeds the maximum loan value of the collateral securing the credit.

20/ Section 221.5 of Regulation U provides for special purpose credit to brokers and dealers without regard to the 50 percent margin requirements if the credit is for any of the specified purposes and meets the conditions set forth in paragraph (c) of this section. Credit to finance proprietary or customer bona fide arbitrage transactions are exempted by paragraph (c)(5).

from the credit restrictions of Regulations T and U, promulgated by the FRB pursuant to Section 7 of the Exchange Act.

Respondents assert that the CBOE, which was RFG's designated examining authority, had been made aware of RFG's dividend reinvesting plan as early as July, 1982, but took no action against RFG based on such activity. However, an official of the CBOE who was called by respondents testified that the CBOE was not aware that RFG was borrowing cash from banks to finance its extension of credit to the lenders of the stock it borrowed, and that the CBOE decided to let the SEC determine whether the dividend reinvestment activity violated the credit provisions.

On January 27, 1983, Rintels and Burroughs met with representatives of the CBOE at RFG's office. Rintels and Burroughs indicated that RFG would begin a customer dividend reinvestment program in February, 1983, but unlike RFG's own plan, RFG would not borrow securities in order to enable a customer to be eligible for a specific plan. However, no customer plans were ever initiated.

In any event, the fact that the CBOE did not bring action against RFG because of its dividend reinvestment plan is irrelevant. As the Commission has stated:

> We have repeatedly held that a broker-dealer cannot shift its responsibility for compliance with applicable requirements to regulatory authorities. 21/

21/ In In the Matter of Apex Financial Corporation, et al., 19 S.E.C. Docket 1221 (1980). See, also Don D. Anderson & Co., Inc., 43 S.E.C. 989, 991 (1968), aff'd 423 F.2d 813 (10th (FOOTNOTE CONTINUED)

Respondents contend, further, that they concluded that RFG could properly engage in dividend reinvestment inasmuch as they were advised that a number of major brokerage firms and institutions were participating in dividend reinvestment. However, respondents did not know whether these other participants were employing the same methods used by RFG, i.e., borrowing stock and obtaining cash to finance their operations. In fact, Guy testified:

> It was specifically indicated to me that Harvard was using a form of the repo market which I had no understanding of to finance their activities. It could have been through internal cash as far as I know.

Guy also testified that he did not know whether one of the large brokerage firms, Bache, even used a bank to finance its activity. Moreover, even assuming that others were dealing in a dividend reinvestment program identical to that of RFG, that in itself would not support RFG's position. Both the Commission and the courts have held that the determination of violative conduct cannot depend on an understanding of the practice of others. In this connection the Commission stated:

> Nor can the determination of violative conduct depend on the understanding or practice of other brokers. 22/

21/ (FOOTNOTE CONTINUED)
Cir. 1970); Melvin Y. Zucker, 11 S.E.C. Docket 1216, 1217, (1976; First Philadelphia Corporation, 11 S.E.C. Docket 1549, 1551 (1977); In the Matter of James J. Duane & Co., Inc., et al., Securities Exchange Act Release No. 21261/ August 22, 1984, S.E.C. Docket.

22/ In the Matter of Management Financial, Inc., et al., 46 S.E.C. 226,228 (1976).

Similarly, the the Commission has held:

> It is immaterial that others may also have violated the NASD's rules and have not yet been reached by the enforcement machinery. 23/

In Chasin v. Smith, Barney & Co., the court held:

> Appellant contends that the district court's holding went farther than any other decision in this area and that no court had ever found failure to disclose a "market making" role by a stock brokerage firm to a client-purchaser to be a violation of Rule 10b-5. Smith, Barney also asserts that all brokerage firms had followed the same practice and had never thought such disclosure was required; moreover, the SEC had never prosecuted any firm for this violation. However, even where a defendant is successful in showing that it has followed a customary course in the industry, the first litigation of such a practice is a proper occasion for its outlawry if it is in fact in violation. 24/

Following the meeting with the CRO on May 20, 1983 (p. 17, supra), Rintels informed Guy and Fleischman concerning what had taken place and a decision was made not to terminate RFG's reinvestment program, which then accounted for 90 percent of its income. They all testified that there was no formal meeting, that they never discussed stopping the program, and that they were never told to stop by any regulatory authority.

The Order charges Rintels, Guy, and Fleischman with willfully aiding and abetting RFG's violations of Sections 7(c), 7(d), and 7(f) of the Exchange Act and Regulations T, U, and X,

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23/ In the Matter of C.A. Benson & Co., Inc., et al., 42 S.E.C. 107, 111 (1964)

24/ Chasin v. Smith, Barney & Co., 438 F.2d 1167, 1171 (2d Cir. 1970),

respectively, promulgated thereunder. In Securities and Exchange Commission v. Coffey, [25/] the court said:

> . . . we find that a person may be held as an aider and abettor only if some other party has committed a securities law violation, if the accused party had general awareness that his role was part of an overall activity that is improper, and if the accused aider-abettor knowingly and substantially assisted in the violation.

Respondents argue that although Rintels and Guy may have substantially assisted RFG's operation of the dividend reinvestment program, none of the individual respondents knew or was aware that such activity was illegal or improper. Fleischman asserts that he did not knowingly and substantially assist the conduct that constitutes the violation; that although he was aware that RFG was operating some form of dividend reinvestment program he was a silent partner, entitled to rely on the integrity of the managing partners of RFG, Rintels and Guy; that he had no duty to act, and, therefore, his inaction cannot constitute a violation.

The record shows that Fleischman was one of three general partners of a broker-dealer registered with the Commission and that he has been registered with the Commission as a sole proprietor broker-dealer since 1977. Although he was not active in the day-to-day operations of RFG, he was present every day

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25/ S.E.C. v. Coffey, 493 F.2d 1304, 1316 (6th Cir. 1974), cert. denied, 420 U.S. 908 (1975). See also, Woodward v. Metro Bank of Dallas, 522 F.2d 84, 97 (5th Cir. 1975); In the Matter of Carter and Johnson, Securities Act Release No. 17597/February 28, 1981. 22 S.E.C. Docket 292, 316.

and was made aware of what was going on. He was informed of Rintel's meeting with the CRO on May 20, 1983, and agreed with his partners not to discontinue the dividend reinvestment plan despite the knowledge that such program as conducted by RFG was considered by the CRO to be in violation of the credit provisions of the Exchange Act and Regulations thereunder promulgated by the FRB.

Fleischman, as a general partner of a broker-dealer registered with the Commission, and the recipient of a 28 percent share of the profits generated by the dividend reinvestment program, cannot now shirk the duties which he assumed on becoming a general partner. The Commission has consistently held that a broker-dealer principal has a duty to insure compliance unless he makes a proper and reasonable delegation of responsibility.[26/] However, such delegation was not undertaken here.

In Pearlstein v. Scudder & German,[27/] the court said:

> The federal securities laws charge brokers and dealers with knowledge of the margin requirements and with the duty to obey them.

The record discloses that respondents' conduct brought them squarely within the requirements for aiding and abetting enun-

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26/ In the Matter of Collins Securities Corp., 46 S.E.C. 20, 36 (1975); In the Matter of Weston & Co., Inc., et al., 44 S.E.C. 692,694 (1971); In the Matter of Alfred Miller, et al., 43 S.E.C., 233, 239-240 (1966).

27/ 429 F.2d 1136,1141 (2d Cir. 1970). Cert. denied, 401 U.S. 1013 (1971). See also Naftalin & Co. v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 469 F.2d 1166,1181 (8th Cir. 1972).

ciated by the courts and the Commission. Accordingly, it is found that RFG, willfully aided and abetted by Rintels, Guy, and Fleischman, violated Sections 7(c), 7(d), and 7(f) of the Exchange Act and Regulations T, U, and X promulgated thereunder by the FRB. 28/

The Order also alleged that from August 1982 to May 30, 1984, RFG aided and abetted by the individual respondents, violated Section 17(a) of the Exchange Act and Rules 17a-3 and 17a-4 thereunder by improperly preparing and keeping certain records. However, in its proposed findings of fact and conclusions of law, the Division has asked for a finding of a violation only under Rule 17a-4 on the grounds that RFG failed to keep copies of the purpose statements it submitted to its lending banks.

The record shows that Burroughs, RFG's comptroller, executed and filed the purpose statements with the banks, and he testified that as long as they were available from the bank he did not know that RFG was required to keep copies on the premises until the CRO examiner requested them. RFG has stipulated that it failed to maintain copies of its purpose statements on its premises and was, therefore, in violation of Rule 17a-4 (p. 12, supra).

28/ It is not necessary that a respondent intends to violate the law in order to find his actions "willful." It is sufficient if he intentionally committed the act that constitutes the violation or, if charged with a duty to act, failed to meet his responsibility. In the Matter of Frank W. Humpherys, Securities Exchange Act Release No. 21991/ April 26, 1985; see Douglas & Co., Inc., 46 S.E.C. 1189, 1192-1193 (1978), and the cases there cited.

Respondents assert that this violation has been corrected and that RFG is currently maintaining copies of its purpose statements on its premises. When the CRO requested purpose statements by letter on May 11, 1983, they were promptly furnished (p. 17, supra). Under all the circumstances it is concluded that this violation does not warrant any sanction.

Public Interest

In view of the findings of violations, it is necessary to determine the remedial action appropriate in the public interest. In that connection the respondents argue that under the circumstances of this case, even if RFG, its lending banks, or the individual respondents are found to have violated the margin rules or to have aided and abetted such violations, sanctions are not necessary in the public interest. In support of that argument respondents have restated, as mitigating factors, all of the contentions previously addressed herein. In addition, they assert that they voluntarily terminated the dividend reinvestment plan when the Order for these proceedings was issued; that no investors were harmed; that RFG's dividend reinvestment plan had a salutory effect of promoting capital formation; that RFG has recently urged Congress to abolish Regulations T and U; and that each of the respondents has an unblemished record in the securities business.

The Division believes that the public interest requires that RFG's registration as a broker-dealer be suspended for three weeks; that Rintels and Guy each be suspended from associa-

tion with any broker-dealer for six weeks; and that Fleischman be suspended from association with any broker-dealer for three weeks.

The Division points out that the respondents continued to engage in violative conduct after being notified by the CRO that their activity was not in conformance with law. In this connection the Commission has said:

> The violations we have found here demonstrate either an inability or unwillingness to operate registrant's business in conformity with applicable requirements, even after these respondents were alerted to certain of these requirements by our staff. 29/

This inability or unwillingness is particularly relevant to the present situation because it pertains to the credit area where the Commission has noted:

> The Commission believes that it is of the utmost importance that officers, partners and other representatives of broker-dealers be cognizant of and adhere to the provisions of the federal securities laws pertaining to the extension, arranging and obtaining of credit for the purchase or carrying of securities. Broker-dealers and their members are crucial to the regulatory framework in this area. 30/

All of the mitigating factors submitted by respondents have been carefully considered. It is no defense that investors were unharmed. The purpose of the federal securities acts and

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29/ In the Matter of Babcock & Co., et al, 44 S.E.C. 350, 358 (1970).

30/ In the Matter of John Latshaw, Securities Exchange Act Release 11903/June 20, 1983, 28 S.E.C. Docket 233,239.

rules and the proceedings initiated to enforce them is to prevent future harm to the investing public. In such a case actual loss is far from crucial. 31/

The defense of respondents that they have had an unblemished record is not supported by the facts which show that on April 27, 1981, the CBOE censured RFG and fined it $1,000 based upon findings that "on or about November 30, 1980, . . . RFG conducted securities business when its net capital was insufficient to comply with the minimum requirement of paragraph (f) of SEC Rule 15c3-1." Again, on October 20, 1983, the CBOE censured RFG and fined it $500 based upon findings that "For the month ending August 1982, RFG Options Company prepared and maintained certain financial information which was inaccurate and improperly reported on its FOCUS Report . . . resulting in an overstatement of adjusted net capital by $562,154."

RFG consented to the above sanctions without admitting or denying the allegations of violations.

The rules and regulations of the FRB and the Commission concerning credit were instituted for reasons arising from unfavorable experiences in the financial markets. Respondents ignored these rules and continued to engage in dividend reinvestment programs at their own peril after being advised by the CRO that such activity was violative of FRB Regulations T, U, and X. Such conduct cannot be condoned.

31/ Lamb Brothers, Inc., et al, 46 S.E.C. 1053, 1063 (1977); Metropolitan Securities, Inc., 41 S.E.C. 365, 386 (1963).

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 respondents but also on others who may be tempted to engage in similar misconduct. 32/

Upon careful consideration of the record, the arguments and contentions of the parties, and the determination that the violation of Rule 17a-4 did not warrant a sanction, it is concluded that the public interest will be served by the suspension of RFG's registration as a broker-dealer for two weeks; the suspension of Rintels and Guy from association with any broker or dealer for four weeks; and the suspension of Fleischman from association with any broker or dealer for two weeks.

ORDER

Accordingly, IT IS ORDERED that:

(1) The registration as a broker-dealer of RFG Options Company is suspended for a period of two weeks.

(2) Eugene V. Rintels and Dennis G. Guy, and each of them, is suspended from association with any broker or dealer for a period of four weeks.

32/ Thomas A. Sartain, Sr., Securities Exchange Act Release No. 16561/February 8, 1980; Arthur Lipper Corporation v. S.E.C., 574 F.2d 171, 184-85 (2d Cir. 1976); Arthur Lipper Corporation, et al., 46 S.E.C. 78, 100 (1975).

(3) Andor A. Fleischman is suspended from association with any broker or dealer for a period of two weeks.

This order shall become effective in accordance with and subject to the provisions of Rule 17(f) of the Commission's Rules of Practice.[33/]

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.

Ralph Hunter Tracy
Administrative Law Judge

June 4, 1985
Washington, D.C.

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