ADMINISTRATIVE PROCEEDING
FILE NO. 3-6321

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	:
ANNETTE LANGHEINRICH	:
	:

INITIAL DECISION

November 21, 1984
Washington, D.C.

Max O. Regensteiner
Administrative Law Judge

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APPEARANCES: Delano S. Findlay and Donald M. Hoerl, for the Commission's Division of Enforcement.

Thomas R. Blonquist, for Annette Langheinrich.

BEFORE: Max O. Regensteiner, Administrative Law Judge.

In these proceedings pursuant to Sections 15(b) and 19(h) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 14(b) of the Securities Investor Protection Act of 1970 ("SIPA"), the principal remaining issues are (1) whether Annette Langheinrich ("respondent") willfully aided and abetted various securities law violations committed by the broker-dealer with which she was associated, as alleged by the Division of Enforcement; (2) if so, what if any remedial action under the Exchange Act is appropriate in the public interest; and (3) whether respondent should be sanctioned because she was an officer and director of a broker-dealer for whom a trustee was appointed under SIPA.

During the period under consideration (essentially the year 1981), respondent was associated with the broker-dealer firm of Langheinrich & Fender, Inc. ("registrant") in Salt Lake City. Registrant and its two principal officers, Don R. Fender ("Fender"), president, and Frank Langheinrich ("Langheinrich"), vice-president, who is respondent's husband, were also named as respondents in the order for proceedings. The proceedings with respect to them were disposed of through settlement.

Following hearings, the Division and respondent filed proposed findings and conclusions and supporting briefs, and the Division filed a reply brief. The findings and conclusions herein are based on the preponderance of the evidence as determined from the record and upon observation of the witnesses.

The Allegations

The order for proceedings includes a broad array of alleged violations by registrant, each of which Fender, Langheinrich and respondent were alleged to have willfully aided and abetted. The alleged violations include doing business when the firm did not have sufficient net capital; failing to make required deposits in the "Reserve Bank Account;" filing false and misleading financial reports; making inaccurate entries in registrant's books and records; improperly extending credit to customers; and engaging in fraudulent and deceptive practices in connection with several best efforts underwritings. Respondent was also charged with failure to exercise reasonable supervision. She admitted that most of the alleged violations by the registrant in fact occurred. Her defense is that Fender and Langheinrich had responsibility for the matters in question and that she had no responsibility for, participation in or even awareness of them. Respondent did not take the witness stand in her defense.

Registrant and Respondent

Registrant became registered with the Commission and commenced business in 1978. Financial difficulties led to the closing of its doors on or about September 10, 1981. On September 22, a trustee was appointed for it under SIPA. At relevant times, registrant was a member of the Pacific

Stock Exchange ("PSE").

Respondent and her husband, and Fender and his wife, were registrant's initial directors and remained such throughout the firm's existence. At all times Fender was president and Langheinrich vice-president and registered financial principal. Respondent initially was secretary-treasurer. In January 1981, Fender and Langheinrich, who originally owned 50 percent each of the firm's common stock, divided their interests equally with their wives. At the same time, respondent relinquished the title of "secretary" to Mrs. Fender and continued as treasurer. In registrant's operations manual, she was designated as controller and operations manager.

Respondent is an accountant, who has had several years' experience in brokerage firm accounting. She has passed the CPA examination and needs only auditing experience to qualify as a CPA. Respondent established registrant's back office and supervised back office employees and operations throughout the firm's existence. While initially she handled the back office alone, by the summer of 1981 she had about seven other employees under her supervision. In April 1981, she took and passed the Financial and Operations Principal Examination administered by the National Association of Securities Dealers ("NASD"), but did not become registered as a financial principal. [1/]

1/ It was stipulated that a PSE examiner would testify that he suggested to registrant's principals in December 1980 that respondent should become qualified and assume the position of financial principal because Langheinrich had too much to do.

Specific aspects of her responsibilities and activities are discussed below. Subsequent to registrant's demise, respondent became financial principal and vice-president of another broker-dealer, positions she now holds.

Alleged Violations of Net Capital and Customer Protection Rules and Related Notification Requirements

By late May 1981, there were strong indications that registrant was in financial straits. Its operating bank account, which had been overdrawn at various times earlier in the year, now was in a consistent overdraft position and the amounts of the overdrafts were sizeable. At May 29, the account was overdrawn by $95,766 as per the bank's records and by $159,716 according to registrant's records. On May 28, at the bank's insistence, the two Fenders and respondent and her husband signed a "continuing guarantee" under which they jointly and severally guaranteed registrant's indebtedness to the bank. When the overdrafts continued, registrant, through Langheinrich and Fender, executed a general pledge agreement to the bank on June 12. Securities from registrant's inventory were delivered to the bank pursuant to this agreement. Subsequently, at a time not specified in the record, the bank made a $90,000 loan to a partnership of Fender and Langheinrich, which transferred the funds to registrant with a view to clearing up the overdrafts. In late August, with the overdrafts still continuing, the bank stopped honoring registrant's

checks. As noted, registrant's demise followed soon thereafter.

Respondent admitted that on or about June 30, July 31 and August 31, 1981, registrant engaged in business when its net capital was less than required under the Commission's net capital rule (17 CFR 240.15c3-1).

Net capital reports prepared by Langheinrich and filed by registrant showed it to be in compliance with the net capital rule as of June 30 and July 31. Thus, registrant's Focus Report Part II for the quarter ended June 30, 1981 showed net capital of $76,500 as of that date, giving it excess net capital of $46,276 in relation to its reported aggregate indebtedness of $453,362.[1a/] This report, dated July 20 but not filed until after August 10, was signed by Fender as principal executive officer, Langheinrich as principal financial officer and respondent as principal operations officer. Registrant's Focus Report Part I for July 1981 showed net capital of $79,000 as compared to aggregate indebtedness of $582,000, again more than enough.

However, registrant's auditors, in their audit for the year ended June 30, 1981, found that registrant actually had a negative net capital of $268,247. Added to net capital required in relation to aggregate indebtedness,

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1a/ Under the net capital rule, aggregate indebtedness may not exceed 15 times net capital. Put another way, net capital must not be less than 1/15th of aggregate indebtedness.

there was a net capital deficiency of $310,182. A major difference between the computations was that the auditors excluded from net capital almost $166,000 as additional non-allowable assets. Of this amount, about $125,000 represented unsecured loans and advances to registrant's officers and directors. [2/] The auditors also determined that registrant had an unsecured bank overdraft of $283,462 ($329,640 total overdraft, less $46,178 secured by marketable securities), which had to be included in aggregate indebtedness. By contrast, registrant's Focus II report showed an overdraft of only $142,909, and showed all of that as secured and therefore not part of aggregate indebtedness. The difference in the overdraft figures reflected principally two payments into registrant's bank account which had not been received by registrant at month's end and were not received by the bank until several days into July. Respondent, who had the function of reconciling the monthly bank statements with registrant's books, treated those payments as "deposits in transit" on June 30 and as such includible in registrant's bank balance at that date. One item was a $120,000 wire transfer to registrant's bank from Pershing & Co., a New York broker-dealer firm which handled

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2/ Under the net capital rule, unsecured advances and loans are not "allowable" assets. Subparagraph (c)(2)(iv)(B).

In addition to the exclusion of additional non-allowable assets, the auditors made a series of other, smaller adjustments.

transactions in listed securities for registrant. This payment was not credited to registrant's account until July 6. The other item was a $90,000 payment representing underwriting commissions to registrant on an offering of Magnum Resources, Inc. This payment was made by check dated July 8 and credited to registrant's account on July 9. The auditors' partner in charge of registrant's audit testified that the treatment given these two items by registrant was not in accord with generally accepted accounting principles.

As part of an examination of registrant by the PSE in September 1981, its examiner made a net capital computation as of July 31, which showed a net capital deficit of $367,247, compared with the $79,000 net capital reported by the firm. It is undisputed that registrant also had a very large net capital deficiency as of August 31, 1981. Even by registrant's computation, the deficiency amounted to $299,556. A Commission staff accountant's computation showed a deficiency of $459,617.

The above net capital calculations all included as allowable assets two certificates of deposit ("CDs"), one for $25,000 purchased in July 1980 and the other for $100,000 purchased in May 1981. Unbeknownst to registrant's auditors and to PSE and Commission examiners, these CDs had been pledged to registrant's bank to secure loans used to purchase them. As such, they were not readily convertible into cash and

therefore should have been deducted from net worth in computing registrant's net capital, thereby further increasing the deficits and deficiencies indicated. The CD transactions made no economic sense because the interest rates on the loans exceeded those on the certificates by 2 percent. Langheinrich's explanation, that the firm was expanding and needed more capital and that it was his understanding that "instruments" having a contingent as opposed to a direct liability were allowable assets for net capital purposes, is disingenuous. A more likely explanation is that the transactions represented an attempt to deceive the auditors and the regulatory authorities.

There was a further item which it appears was also improperly recorded by registrant and escaped the auditors' attention. A $70,000 item included among the June 30 "deposits in transit" represented a check which was actually given to registrant on that day by a Mr. B., a customer. The record shows, however, that Fender induced the customer to give him the check on the representation that it would not be deposited. Although the check was subsequently deposited, it was understood between Mr. B. and Fender that it would never be paid by Mr. B.'s bank. 3/

3/ I do not credit Langheinrich's testimony that Mr. B. told him his check was good and would clear.

And in fact it was not. It seems clear that Fender was using the customer to "park" some securities temporarily in order to present a better net capital picture. 4/

Rule 17 CFR 240.15c3-3, known as the customer protection rule, requires a broker-dealer to make deposits in a "Special Reserve Bank Account for the Exclusive Benefit of Customers" ("Reserve Bank Account") under specified circumstances. Registrant's Focus II report as of June 30, 1981 showed that no deposit was required at that date. The auditors concluded, however, that a deposit of $229,717 was required. The difference was attributable largely to the bank overdraft discrepancy discussed above. Similarly, in its Focus I report for July, registrant reported that no deposit was required on July 31. Subsequent calculations by the Commission staff showed that a deposit of $154,548 was required on July 31 as well as a deposit of $81,234 on August 31. A PSE examination concluded that the required deposits for those dates were $378,566 and $525,614, respectively. None of these deposits was made.

When completion of the audit of registrant's financial statements on August 28 disclosed the June 30 net capital deficiency and the fact that a deposit was

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4/ The auditors did not exclude the $70,000 from registrant's June 30 bank balance because the check had actually been received by registrant on June 30 and, contrary to Mr. B.'s understanding, was subsequently deposited. Of course, the auditors were not aware of the arrangement between Mr. B. and Fender.

required as of that date, registrant sent telegraphic notices to that effect to the Commission and the PSE. Under Rule 17 CFR 240.17a-11, however, it was required to give *immediate* telegraphic notice at times when its net capital was insufficient and to file certain Focus reports. Correspondingly, under Rule 15c3-3, registrant was required to, but did not, give immediate telegraphic notice, followed by written confirmation, of its failure to make required deposits in the Reserve Bank Account.

I turn now to the issue of respondent's responsibility for the above violations. The bases on which the Division relies for imposing such responsibility run the gamut from a broker-dealer principal's assertedly absolute responsibility to insure compliance with Commission rules, particularly the financial responsibility requirements, to the aider and abetter liability test that has gained wide acceptance in recent years and which has as one of its elements an "awareness of wrongdoing" or "state of mind" requirement. [5/] As an intermediate position, the Division asserts that respondent is culpable because she knew or at least was on notice of registrant's net capital and reserve bank account deficiencies.

Although there are Commission decisions which speak in broad terms about the absolute duty of a broker-dealer

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5/ See, *e.g.*, *Investors Research Corp.* v. *S.E.C.*, 628 F.2d 168, 176-79 (D.C. Cir. 1980).

principal to be informed of the firm's financial condition and to take necessary steps to insure compliance with applicable requirements, [6/] I do not regard these as warranting the conclusion that respondent, simply by virtue of her status as an officer, director and shareholder, was under an absolute duty to insure that registrant complied with the net capital and reserve bank account requirements. First, it is doubtful that the line of cases noted above extends to someone in respondent's relatively subsidiary position. Moreover, the Commission has also frequently held that there may be a division of responsibility among the officers of a broker-dealer. By way of example, in one instance the Commission, while holding that a broker-dealer's treasurer who was admittedly responsible for net capital compliance was responsible for violation of the net capital rule, absolved the firm's secretary on the ground that his responsibilities did not extend to the net capital area. [7/] Even the president of a broker-dealer, who is normally responsible for the firm's compliance with

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6/ The case most frequently cited for this proposition is Aldrich, Scott & Co., Inc., 40 S.E.C. 775 (1961), involving a vice president, secretary, director and 20 percent shareholder who was not active in the business. See also, e.g., Herman M. Solomon, 44 S.E.C. 910 (1972) (treasurer and 50 percent shareholder).

7/ Management Financial, Inc., 46 S.E.C. 226, 228 (1976). See also Midwest Planned Investments, 42 S.E.C. 558, 562 (1965); Schmidt, Sharp, McCabe & Company, 42 S.E.C. 745, 748 (1965).

all applicable requirements, may absolve himself from responsibility for particular functions by a reasonable delegation, provided of course that he neither knows nor has reason to know that the delegate is not properly performing his duties. 8/

On the other hand, the Commission has not applied in broker-dealer proceedings the three-part test for aider and abetter liability which has been applied in many securities law cases. As enunciated in Woodward v. Metro Bank of Dallas, 522 F.2d 84 (5th Cir. 1975) and followed in Investors Research and many other cases, the elements of this test are that (1) another party has committed a violation; (2) the alleged aider and abetter had a general awareness that her or his role was part of an overall activity that was improper; and (3) he or she knowingly and substantially assisted the principal violation. The second element has been variously characterized as an "awareness (or knowledge) of wrongdoing" or an intent or scienter requirement. 9/ No matter how characterized, it precludes liability for mere negligence, even where scienter or something akin to it is not a necessary element of the underlying violation. The

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8/ See, e.g., Jerome A. Shapiro, 46 S.E.C. 472, 474 (1976); Walter David Weston, 44 S.E.C. 692, 694 (1971).

9/ See William R. Carter, Securities Exchange Act Release No. 17597 (February 28, 1981), 22 SEC Docket 292, 314-319.

aider and abetter liability standards were adopted to determine the liability of one having only a secondary role in the alleged misconduct. And the second element is "designed to insure that innocent, incidental participants in transactions later found to be illegal" are not subjected to sanctions.[10/]

By contrast, in a broker-dealer proceeding involving allegations that its principals aided and abetted violations by the firm, the broker-dealer's misconduct, if any, is in fact accomplished by the acts or inaction of those principals. It is through them that the firm must act. Thus, particularly in the context of alleged violations of the net capital requirements and other Exchange Act provisions which by their terms apply only to broker-dealers, principals named as respondents are normally aiders and abetters in a technical sense only and not in the sense of being merely secondary participants.[11/] Hence, if scienter is not required to find a violation, it or a similar standard should also not be a requisite for a finding of aiding and abetting.[12/]

10/ Investors Research Corp. v. S.E.C., supra, 628 F.2d at 177. See Ruder, Multiple Defendants in Securities Law Fraud Cases, 120 U. Penn. L. Rev. 597 (1972).

11/ A situation could be postulated where a broker-dealer principal was in fact an incidental, secondary participant in the broker-dealer's violation. This is not such a case.

12/ If the underlying violation requires findings of scienter, the result would normally be the same whether the three-part aiding and abetting test or the Commission's traditional approach (discussed infra) is applied.

The Commission's traditional approach, and the one followed herein, lies between the other two. Under it, the Commission has analyzed a broker-dealer principal's culpability, whether she or he be charged as a direct violator or as an aider and abetter, in terms of her or his responsibility with respect to the particular requirement or prohibition involved, and/or in terms of her or his actual participation in violative conduct or awareness or notice of facts indicating such conduct.

Here Langheinrich was the firm's registered financial principal and had accepted responsibility for preparing and filing net capital and other regulatory reports and for compliance with the net capital and customer protection rules. That primary responsibility for these functions rested with her husband cannot, however, absolve respondent if she was actually aware of net capital or reserve bank account problems or if she knew or was on notice of facts indicating that the firm had financial problems of a magnitude likely to result in violations of the net capital and reserve bank account requirements. [13/] Under

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13/ Cf. Carrol P. Teig, 46 S.E.C. 615, 619 (1976): "Teig [vice-president and secretary] cannot find shelter in the assertion that primary responsibility for compliance with the net capital rule rested with other persons. . . . [H]is knowledge of the nature of the problem required him to take or demand steps to assure that it would promptly be corrected."

those circumstances, she would have a duty, as a principal of the firm, particularly one with responsibilities in related areas, to take appropriate action.

As noted, during the period under consideration respondent was treasurer, a director and a 25 percent shareholder of registrant. She was registrant's accountant, controller and back office manager; the firm's day-to-day accounting records were maintained by her or under her supervision. Reference has already been made to the fact that she reconciled the monthly bank statements. Respondent also prepared monthly trial balances from the accounting records. Langheinrich used these and various supporting schedules also prepared by respondent as the basis for his computations of net capital and of deposit requirements under Rule 15c3-3. Although, as noted, respondent took and passed the NASD examination for financial principals in the spring of 1981, she did not become registered as a financial principal of registrant. Only her husband occupied that position. The record shows that one section of the examination, a section given more weight than any other section, consists of multiple choice questions on and a computation under the net capital rule. Another section deals with Rule 15c3-3.

The evidence is persuasive that respondent knew or was on notice of facts sufficient to impose responsibility on her to take action. In this connection, respondent's experience

as an accountant and the fact that she had at least some familiarity with the net capital and reserve bank account requirements as a result of having studied for, taken and passed the financial principal examination canot be ignored. Moreover, the Division is correct in arguing that in a non-criminal case such as this, the failure of a party to testify in explanation of suspicious facts and circumstances peculiarly within her knowledge fairly warrants the inference that her testimony would have been adverse. 14/

Respondent was obviously aware that registrant's cash shortage and resultant overdraft situation were becoming more persistent and serious by May 1981. The fact that late that month the bank required respondent, her husband and the Fenders each personally to guarantee registrant's indebtedness to the bank as a condition for its continuing to clear registrant's checks, served as further notice to respondent of the seriousness of the situation. She also was aware that within a short time securities owned by registrant were delivered to the bank as collateral. Respondent points to her husband's testimony that at about this time she expressed her concern about the increased amounts of the

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14/ See, e.g., N. Sims Organ & Co., Inc., 293 F.2d 78, 80-81 (2d Cir. 1961), cert. denied 368 U.S. 918. See also Baxter v. Palmigiano, 425 U.S. 308, 318 (1976).

overdrafts, and that he advised her that per arrangement with the bank checks would continue to clear. In answer to her question as to why there were overdrafts, he explained that it was primarily due to registrant's inventory being too big, and that the problem would be solved by a partial inventory liquidation and by income to be derived from underwritings then being processed. While these explanations may have reassured respondent temporarily that registrant's checks would not bounce and that the situation would improve, the records maintained by her or under her supervision showed not improvement but an almost steady deterioration from that point forward. The overdraft position, shown on registrant's records as $159,716 at the end of May, increased to $266,941 by June 29 and would have been significantly higher than that on June 30 were it not for the "deposits in transit," which totalled $283,000. The deterioration continued in July. Again based on registrant's own records, its net cash position worsened by almost $200,000 during that month. While it may be true, as respondent argues, that she did not have sufficient knowledge to make net capital and Rule 15c3-3 calculations herself, she obviously knew that there was a correlation between financial condition, in particular liquid assets, and net capital. Under the circumstances, she could not

simply rely on her husband's assurances or even on his net capital and Rule 15c3-3 computations.

However, my conclusion as to respondent's culpability does not rest only on the existence of a duty to act because of the "red flags." The way in which the "deposits in transit" were created warrants the inference that respondent was in fact a party to an attempt to conceal registrant's true financial condition at June 30. Her failure to testify about this matter strengthens that inference. As noted, the unsecured portion of a bank overdraft is included in "aggregate indebtedness" and as such affects both net capital and reserve bank account requirements. Absent the "deposits in transit," registrant would have had to make a very large deposit in the Reserve Bank Account, a deposit which it was in no position to make. Respondent, as noted, recorded as "deposits in transit" on June 30 two items totalling $210,000 which were not received by registrant or the bank, and were in no sense in transit, until July.[15/] With respect to the additional

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15/ Respondent asserts that treating these items as receivables instead of cash received would not have affected their being allowable assets for net capital purposes. However, the difference in treatment had a significant impact on the computation of aggregate indebtedness. Respondent is also wrong in her argument that for purposes of the Reserve Bank Account it made no difference whether funds had been received or were treated as receivables. In fact, the increase in the unsecured bank overdraft determined by the auditors had the effect of increasing the Reserve Bank Account requirement by the same amount.

$70,000 item included in "deposit in transit," representing Mr. B.'s check, I credit his testimony that he told respondent in substance that the check was not to be deposited. Under the circumstances, she was on notice that the check could not properly be included among "deposits in transit." While the check was in fact subsequently deposited, Mr. B.'s bank returned it unpaid pursuant to his instructions. Respondent argues that there is no evidence that she knew at the time of her bank account reconciliation which produced the "deposits in transit" calculation that the check had not cleared. But she was on notice that this was a "parking" transaction and not one in the ordinary course of registrant's business.

The Division also asks me to find that respondent knew or should have known that (1) loans and advances to officers and directors were largely unsecured and to that extent were not allowable assets for net capital purposes and (2) the CDs totalling $125,000 were pledged as collateral for loans and therefore also not allowable assets. I do not consider that the record warrants such further findings.

With respect to the first item, the only reference to such an item in the June 30 trial balance which respondent furnished her husband was a "note receivable-officers" for $96,597. The Focus II Statement

of Financial Condition prepared by Langheinrich did not include an item labeled "receivables from officers and directors," but did include one entitled "Receivables from non-customers" totalling $189,291. Registrant's audited balance sheet lists "Receivables from officers/ directors" at $190,365. Note 2 to the financial statements breaks this down into notes receivable of $96,598, of which about $65,000 was collateralized, and advances of $93,767. While I agree with the Division that respondent must have known that unsecured receivables, including those from officers or directors, are not allowable assets, the unsecured portion of the notes receivable was a relatively small amount. The record is silent regarding the circumstances giving rise to the advances item, respondent's awareness of it, and why it did not appear on the trial balance.

With reference to the CDs, the Division points out that they were in the bank's possession and comprised essentially all of the firm's cash assets and that respondent signed the request to the bank to confirm the CDs to the auditors. The Division urges that under the circumstances, it is hard to believe that someone with respondent's accounting background and in her position would not have physically inspected

the CDs or ascertained why they were being held by the bank. However, the fact that the bank had custody of the CDs was not of itself a red flag. The auditors apparently did not consider it a circumstance calling for further inquiry. In its confirmation to the auditors, the bank gave no indication that the CDs were encumbered.

On the basis of my other findings, however, it follows that respondent willfully aided and abetted registrant's violations of Sections 15(c)(3) and 17(a) of the Exchange Act and Rules 15c3-1, 15c3-3 and 17a-11 thereunder.

Alleged Misconduct in Connection with Underwritings

During the period from January through August 1981, registrant was the underwriter for best efforts "all or none" or "part or none" offerings by Great American Gold Company ("GAG"), Gusher Oil and Gas Corp., Magnum Resources, Inc. and Questronics, Inc. The order for proceedings alleges that in connection with these offerings, registrant violated the general antifraud provisions of the securities laws (Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder) and Rules 15c2-4 and 10b-9 under the Exchange Act, and that respondent wilfully aided and abetted those violations. There is little, if any, dispute regarding the underlying facts and even regarding the fact that violations were committed by registrant. It is on the issue of respondent's culpability that the parties disagree.

Rule 15c2-4 defines as fraudulent certain practices by a broker-dealer participating in a best efforts distribution with respect to the transmission of payments received. As relevant here, it requires that (1) where the offering is on an "all or none" or "part or none" basis, sales proceeds be promptly transmitted to a bank escrow account, to be held there until the designated contingency occurs; and (2) where the offering is not of that nature, that money received be promptly transmitted to the issuer. Commenting on the requirement applicable to contingency offerings, the Commission has stated that its purpose is

> to insulate the proceeds of the offering from possible unlawful activities by, or financial reverses of, the broker-dealer participating in the offering, and thus to ensure that the issuer will receive the full proceeds promptly if the contingency occurs, or investors will receive a prompt reimbursement of their funds if the contingency does not occur. 16/

Respondent admits that in each of the above underwritings, registrant failed promptly to transmit funds to the escrow account as required by Rule 15c2-4. It was registrant's practice to leave underwriting proceeds in its operating bank account for extended periods of time, until a substantial amount or even the entire amount needed to meet the contingency had accumulated, and only then to transfer them to the escrow account. In the GAG

16/ Securities Exhange Act Release No. 11532 (July 11, 1975), 7 SEC Docket 403.

offering, registrant first received sales proceeds on February 18. By May 28, it had accumulated $583,347 in its operating account. On that day, it transferred that amount to the escrow account, together with an additional $370,000 received the same day. 17/

In the Gusher underwriting, registrant paid the entire $150,000 required to "break" escrow into the escrow account on April 24, 1981. The record does not indicate the inclusive dates when registrant received payments from customers, but does show that it took in $17,900 between March 20 and March 31. In the Magnum underwriting, registrant began receiving sales proceeds from customers and depositing them in its operating account on June 1. It made no deposit in the escrow account until July 10, when $100,000 was transferred. A second transfer of $40,000 was made on July 14. Finally, in the Questronics offering, registrant received $109,750 from stock sales between August 17 and August 28. None of these funds had been transmitted to the escrow account at the time registrant ceased doing business in September.

An additional violation of Rule 15c2-4 occurred in connection with the Magnum underwriting, in that registrant

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17/ As further discussed *infra*, the $370,000 represented non-*bona fide* purchases designed to give the appearance that the offering had been completed within the specified time.

failed to transmit to the issuer $148,150 which it received after the minimum amount of the offering had been sold and the escrow account had been closed. Registrant's check for that amount was not honored by its bank because of insufficient funds in registrant's operating account. 18/

Registrant also violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. As noted, substantial sums derived from underwritings were deposited in registrant's operating bank account and remained there for extended periods. During much of this time, there were large overdrafts in the account. At times when the account was not overdrawn, it would have been if underwriting proceeds had been transferred to an escrow account as they should have been. By May 27, the day before registrant transferred funds to the GAG escrow account, it had deposited underwriting proceeds totalling $583,347 in its operating account, which according to the bank statement was overdrawn by $83,483. On May 28, registrant was obliged to borrow $377,000 from GAG and to obtain its underwriting commissions of $225,000 in advance, so as to enable it to transmit to escrow the funds it had received in the underwriting.

It is clear from the above that registrant used underwriting proceeds which should have been put into escrow

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18/ Magnum never received this amount. The Securities Investor Protection Corporation denied Magnum's claim.

accounts for its own business expenses and to cover overdrafts. There was of course no disclosure in the selling documents for the various offerings that proceeds would be used in registrant's business operations and would be subject to the risk of loss, which was considerable in light of registrant's precarious financial situation. To the contrary, these documents represented that proceeds would be promptly transmitted to the escrow accounts and ultimately, upon completion of the offering, to the issuers. By its conduct, registrant clearly violated the above designated antifraud provisions.

Registrant further violated those provisions in connection with the GAG underwriting by arranging fictitious purchases by two customers, Mr. P. and Mr. S., for $185,000 each, to give the appearance that the offering was completed within the specified time. As a result, proceeds of the offering were released to the issuer, when they should have been refunded to investors. Langheinrich arranged for GAG to lend the funds to these customers to purchase the remaining shares. The customers gave promissory notes to GAG, collateralized by the stock. Over a year later, GAG arranged for the stock to be sold to others. GAG cancelled the notes and waived the accrued interest. It is clear that the original transactions were not <u>bona fide</u> sales and that the offering was not completed within the specified time.

Rule 10b-9 under the Exchange Act in substance makes it a deceptive device for a person to represent that an offering is on an "all or none" or "part or none" basis unless the offering is made on the condition that the purchase price will be promptly refunded unless all of the securities (or, in the case of a "part or none" offering, a specified number of units) are sold within a specified time and the total amount due the seller is received by him by a specified date. While the GAG underwriting originally did not violate this provision, the condition that refunds would be made to purchasers if the offering was not completed through bona fide sales within the specified time was not complied with, thus rendering the representation as to the nature of the offering false. The Division alleged that there was a further violation of Rule 10b-9 in the Questronics offering which, as noted, was aborted when registrant ceased doing business. The amount that registrant had collected was not refunded to purchasers. Under the circumstances, however, it is not clear that this was a violation of Rule 10b-9.

On the issue of respondent's responsibility for the above violations, it is true, as respondent points out, that the handling of underwritings was not as such one of her functions or responsibilities. And the record is not

clear as to what functions registrant's back office actually performed or was responsible for handling in connection with underwritings, aside from processing customers' purchase orders. I credit Langheinrich's testimony that it was only he or Fender who determined when funds would be transferred from registrant's operating account to an escrow account. However, respondent knew, of course, that registrant was engaged in underwritings. She further knew that at least some of these underwritings involved escrow accounts. 19/ Respondent also knew that underwriting proceeds went into registrant's operating account and, in light of the overdraft situation, were being used in registrant's business. Under the circumstances, she had a duty to insist that such proceeds be promptly transmitted to the escrow accounts. By failing to carry out that duty, she willfully aided and abetted registrant's violations of Rule 15c2-4 as well as of the "general" antifraud provisions. There is no evidence, however, that she was aware or on notice of the fictitious nature of the purchases of GAG stock by Mr. P. and Mr. S. 20/ Hence, I cannot find her responsible for violations arising from the failure to complete the GAG offering.

19/ Respondent prepared some of the checks made payable to escrow accounts and signed at least one herself.

20/ It was stipulated that if called, Messrs. P. and S. would testify that they had no dealings with respondent in connection with the GAG arrangements and transactions.

Other Alleged Violations

1. Books and Records

Registrant violated Section 17(a) of the Exchange Act and Rule 17a-3 thereunder by recording in its books and records the fictitious transactions that have been previously discussed. These were (a) the purported purchases of GAG stock by Mr. P. and Mr. S. and (b) the purported $70,000 transaction with Mr. B.

Consistent with my previous finding regarding the GAG matter, I cannot find that respondent willfully aided and abetted registrant's record-keeping violations in that respect. 21/ As to the transaction with Mr. B., however, she was on notice that this was not a legitimate transaction. On registrant's records, it was shown as a sale to Mr. B. of certain securities from registrant's underwriting account. In fact, the securities were merely "parked' with Mr. B. Respondent willfully aided and abetted this record-keeping violation. She is also responsible for the inaccuracies in registrant's records resulting from the improper use of the "deposits in transit" category. 22/

21/ The records respecting the GAG transactions were further falsified in that entries on confirmations and account statements were back-dated. The evidence in this respect is insufficient, however, to hold respondent responsible.

22/ I disagree with the Division's argument that the making of inaccurate records also violates Rule 17a-4. That Rule requires the preservation for specified periods of records required to be maintained. No claim is made that any of registrant's records were not preserved.

2. Reporting Requirements

Registrant violated Rule 17a-5 under Section 17(a) of the Exchange Act in that

a. the Focus reports filed as of June 30 and July 31, 1981 were false in the respects previously set forth; and

b. they were filed late.

For reasons already discussed, and in view of the fact that respondent signed the June 30 report, I find that she willfully aided and abetted the filing of false reports. The record does not, however, warrant an adverse finding as to the late filing of the reports.

3. Notice Regarding Free Credit Balances

Rule 15c3-2 under the Exchange Act in substance requires a broker-dealer which uses customers' free credit balances in the operation of its business to notify each customer for whom a free credit balance is carried at least quarterly in writing that such funds (a) are not segregated and may be used in the operation of the business and (b) are payable on the customer's demand. Registrant was subject to this requirement. However, the only notice it gave to customers was a statement printed on the monthly account statements that free credit balances were payable on demand. This was clearly insufficient under the Rule. Therefore registrant violated the Rule. And respondent, who as back office and operations manager must be

deemed to have at least a shared responsibility (with her husband) for compliance with this requirement, willfully aided and abetted the violation.

4. Regulation T

Respondent admits that registrant violated Regulation T of the Board of Governors of the Federal Reserve System. She further admits that Regulation T violations were a constant problem in 1981. A PSE examiner, upon a review of about 2,400 customers' purchase transactions during the period December 1, 1980 through May 31, 1981, found 45 apparent violations of Section 4(c)(2) of the Regulation as then in effect, in that payment was received 1 to 70 days after the 7-day payment period specified in that section. Those transactions should have been promptly cancelled or otherwise liquidated. 23/

Respondent claims that she was not responsible for Regulation T compliance, and that at various times it was either Langheinrich or Mrs. Fender who had that responsibility. She also argues that she made reasonable

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23/ The examiner found two other categories of "apparent violations." One category, involving 27 apparent violations of Section 4(c)(8), was described as accounts which were not "frozen" for late payment. The other category was described as five "free rides," i.e., selling before full payment had been made. As I read that Section, however, an account is "frozen" (i.e., restricted for 90 days to purchases covered by funds already in the account) only in the "free ride" situation, not the late payment situation.

efforts to bring the problems under control, but was impeded by the other principals.

The record shows that following an examination in December 1980, the PSE forcibly brought to the attention of all four of registrant's directors the need to clear up a continuing problem with Regulation T compliance. Nevertheless, the problem continued. During the period when the above violations occurred, it appears that Langheinrich had the principal responsibility for Regulation T compliance. However, the matter was discussed at various times among the four principals.

Under the circumstances, I find that respondent, in light of her awareness of the continuing nature of the problem and her position in the firm, willfully aided and abetted the above violations.

Alleged Failure to Supervise

The Division alleged that respondent failed reasonably to supervise persons subject to her control with a view to preventing various of the violations discussed above. In its proposed findings and brief, the Division indicated that it sought a finding pursuant to this allegation only to the extent the evidence were deemed insufficient to warrant findings that she aided and abetted those violations. In any event, however, there is no basis in the record for a finding that any person subject to respondent's supervision

committed a violation. Under Section 15(b)(6) of the Exchange Act, such a finding is a necessary element of a finding of supervisory failure. This allegation is therefore dismissed.

Imposition of Sanctions Under SIPA

Section 14(b) of the SIPA, as pertinent here, provides that the Commission may bar or suspend from association with a broker-dealer any officer, director or owner of ten percent or more of the shares of a broker-dealer for whom a trustee has been appointed, provided that such bar or suspension is in the public interest. As noted, a SIPA trustee was appointed for registrant in September 1981. Respondent was associated with registrant in each of the three designated categories.[24/]

In Carrol P. Teig, 46 S.E.C. 615, 621-23 (1976), the Commission set forth the bases on which a sanction may be imposed under Section 14(b). The fact that a person falls within the reach of that Section is not enough. At the other pole, imposition of a sanction need not be predicated (although of course it can be) on a finding that a respondent has violated substantive provisions of securities laws. The Commission described the proper approach to the interpretation of Section 14(b) as follows:

24/ As of March 31, 1984, the trustee had disbursed over $1 million, including about $514,000 to pay claims of customers.

> We consider it significant that the category of persons subject to potential sanction all share one common trait -- each could reasonably be expected to be aware of the broker-dealer's practices and financial condition and to take or demand action to avoid the financial collapse that leads to SIPC trusteeship. This fact, coupled with the fact that the fiscal irresponsibility and the resulting collapse of some broker-dealers during the sixties was the major motivating factor for passage of the Act, persuades us that failure to act in such a responsible manner can form the basis for a bar or suspension from association with a broker or dealer. Thus, simple neglect or nonfeasance can provide an adequate basis for sanction under Section 10(b) [now 14(b)], even in cases in which the conduct might not give rise to a finding of aiding and abetting a specific violation of the securities laws or support a charge of failure to supervise, provided adequate notice of the charge is given and an opportunity to defend against it is afforded. It follows, of course, that substantive violations of the federal securities laws or other laws can likewise form a basis for sanctions under Section 10(b) of the SIPA.

Here, the finding that respondent willfully aided and abetted registrant's net capital rule violations places her squarely within that analysis.

Public Interest

In light of the findings that respondent willfully aided and abetted various violations and is subject to sanctions under the SIPA, the remaining issue concerns the remedial action which is appropriate in the public interest. The Division takes the position that respondent should be barred from association with a broker-dealer, with the proviso that

after an "appropriate" period she could apply for permission again to be so associated. Respondent, consistent with her argument that she did not aid or abet registrant's violations, urges that no sanction is warranted under the Exchange Act. She also urges that no sanction should be imposed against her under the SIPA, asserting that the culpable principals (Fender and Langheinrich) have been sanctioned and that she, in contrast, acted in a responsible manner.

As my earlier findings indicate, the record does not support respondent's limited view of her role in registrant and of her knowledge regarding various facets of the firm's financial condition and activities. And the responsibilities which she assumed by virtue of her position and knowledge were not as narrowly compartmentalized as she would have me hold. Her failure to take appropriate action when confronted with notice of registrant's financial difficulties permitted the firm to continue in business for several months at great risk to its customers. When registrant finally closed its doors, many customers, although ultimately paid by the Securities Investor Protection Corporation ("SIPC"), suffered at least inconvenience and very likely losses in some cases as well. SIPC, of course, had to expend large sums to pay customers' claims and for other expenses. While respondent was apparently not a participant in most of the deceptive maneuvers by which Langheinrich

and Fender contrived to conceal registrant's true financial condition for some time, she did participate in the totally unwarranted creation of the "deposits in transit" items. Furthermore, with knowledge that registrant was using underwriting proceeds in its business, she took no steps to cause those proceeds to be transferred to the escrow accounts where they should have been. Indeed, her obvious awareness beginning in May 1981 that registrant actually lacked the means to transfer underwriting proceeds must have brought its desperate financial situation home to her.

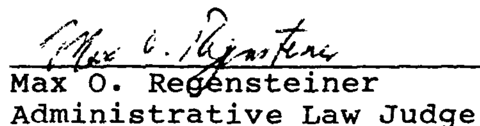
I cannot give weight to respondent's argument that she was not in a position to take strong action because it would have put great strain on her marriage. In her capacity as a broker-dealer principal, her first responsibility was to the firm's customers and to the issuers for which it acted as underwriter. Moreover, it may well be that respondent, by taking a strong stand, could have induced her husband and Fender to face up to their responsibilities. Depsite the seriousness of respondent's misconduct, however, the facts that she was clearly in a subordinate position in registrant's management and operations and that her record is otherwise unblemished must be taken into account in fashioning the appropriate remedial action. Under all the circumstances, I conclude that a four-month suspension of respondent from association with a broker-dealer

should serve adequately to impress her with the need to avoid similar misconduct in the future.

Accordingly, IT IS ORDERED that Annette Langheinrich is hereby suspended from being associated with a broker or dealer for a period of four months. 25/

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

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



Max O. Regensteiner
Administrative Law Judge

Washington, D.C.
November 21, 1984

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