ADMINISTRATIVE PROCEEDING
FILE NO. 3-3277

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of

NAFTALIN & CO., INC.
NEIL T. NAFTALIN

INITIAL DECISION

Washington, D.C.
May 17, 1973

Warren E. Blair
Chief Administrative Law Judge

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APPEARANCES: Joseph L. Grant and Mark A. Potter of the Chicago Regional Office of the Commission, for the Division of Enforcement

Joe A. Walters and Frank J. Walz, of O'Connor, Green, Thomas, Walters & Kelly, for Naftalin & Co., Inc., and Neil T. Naftalin

BEFORE: Warren E. Blair, Chief Administrative Law Judge

These proceedings were instituted by an order of the Commission dated September 30, 1971, pursuant to Sections 15(b) and 15A of the Securities Exchange Act of 1934 ("Exchange Act") to determine whether respondents violated Section 17(a) of the Securities Act of 1933 ("Securities Act") and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, whether Naftalin & Co., Inc. ("registrant") violated and Neil T. Naftalin ("Naftalin") wilfully aided and abetted violations of Section 17(a) of the Exchange Act and Rule 17a-3 thereunder ("Bookkeeping Rule"), and whether remedial action is appropriate.

In substance, the Division of Enforcement ("Division") alleged that during a period from about August 1, 1969 to on or about October 27, 1969, respondents engaged in fraudulent conduct by failing to inform those with whom registrant was doing business (1) that respondents were placing orders for the sale of securities by registrant which registrant did not own and could not deliver, and (2) that registrant was insolvent and unable to meet its obligations as they matured. The Division also alleged that registrant, aided and abetted by Naftalin, did not record certain sell orders and otherwise failed to make and keep current registrant's books and records.

General denials of the alleged misconduct and affirmative defenses were set forth in answers filed on behalf of respondents. Both respondents appeared through counsel who participated throughout the hearing.

As part of the post-hearing procedures, successive filings of proposed findings, conclusions, and supporting briefs were specified. Timely filings thereof were made by the parties.

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

Respondents

Registrant, a Minnesota corporation with its principal office in Minneapolis, Minnesota was formed on February 10, 1960 and has been registered as a broker-dealer under the Exchange Act since February 25, 1960. Registrant became a member of the National Association of Securities Dealers, Inc. ("NASD") in March, 1960 and is still a member of that organization.

As a result of involuntary Petitions in Bankruptcy filed against registrant in February, 1970 in the United States District Court for the District of Minnesota, [1/] registrant was adjudicated a bankrupt. [2/] The Trustee in Bankruptcy appointed by the Court is now in possession of registrant's assets. [3/]

1/ In re Naftalin & Co., Inc., 4-70 Bky. 137, 170 (D. Minn., 4th Div.).

2/ This adjudication of bankruptcy is one of the issues now on appeal. Naftalin & Co., Inc., appeals docketed, Nos. 71-1634, 71-1672, 8th Cir., 1971.

3/ Counsel for the Trustee in Bankruptcy appeared at the hearing for the purpose of stating that the Trustee in Bankruptcy had no objection to these proceedings going forward.

Naftalin is and has been president, principal executive, and majority shareholder of registrant since its organization.

Fraud Violations

There is little dispute concerning the circumstances which gave rise to the Division's charges against respondents. The basic underlying facts were stipulated between the Division and respondents at the outset of the hearing. Testimony of witnesses called by the Division expanded on details of respondents' conduct but did not conflict with the stipulation entered into by the parties.

It is manifest from the record that respondents wilfully violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder by devising and carrying out a brazen fraud upon other broker-dealers doing business in Minneapolis by concealing the fact that sales of securities by respondents at prices aggregating approximately $8,634,000 were actually "short sales." 4/ As a result of respondents' misconduct, those other broker-dealers suffered losses of over $1,285,000.

The ability of respondents to carry out the scheme in question depended in large part upon business relationships that

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4/ As defined by Rule 3b-3 under the Exchange Act, a "short sale" includes any sale of a security which the seller does not own.

respondents had developed in Minneapolis. For the first two years of its existence, registrant carried on a general securities business in the over-the-counter market. In 1963 the character of that business changed and from that time until December, 1969 when it ceased doing business, registrant engaged almost exclusively in trading for its own account without dealing with the public.

During the period under consideration registrant maintained "special cash accounts" with over twenty broker-dealers and it was through those accounts that respondents commenced on July 18, 1969 to place sell orders. In ensuing weeks until October 2, 1969 respondents continued to place sell orders for securities registrant did not own, and failed to deliver those securities to the broker-dealers to or through whom they were sold.

At the time of placing the sell orders, respondents did not advise the broker-dealers accepting the orders that registrant was making a "short sale" or that registrant did not own the securities being sold. Moreover, if a broker made inquiry regarding the nature of the sale, Naftalin would falsely represent that registrant actually owned those securities being sold. Thus on August 20, 1969 Naftalin placed registrant's order to sell 500 shares of American Research and Development stock with Merrill Lynch, Pierce, Fenner and Smith and told the representative of that firm that he owned the stock[5/] and that there would be a delay in the delivery of the stock because it was "purchased in the third market and

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5/ Tr. 218.

currently carrying due bills." 6/ In connection with the sale of another 500 shares of American Research and Development stock on July 22, 1969 Naftalin instructed the representative of the brokerage firm of Paine, Webber, Jackson & Curtis to "sell long," thereby in effect affirmatively representing that registrant owned that stock. In like vein, when queried by the representative of Dain, Kalman & Quail as to whether a sale of 1,000 shares of Control Data stock on August 8, 1969 was a "short sale," Naftalin replied, "No, just go ahead and sell it." 7/

Following the failure of registrant to honor the settlement dates specified in its contracts with the selling brokers, the latters' representatives began to ask registrant why delivery of the securities sold had not been made. Naftalin again resorted to deception to satisfy these inquiries, giving a variety of false reasons for the delays. Included in the misrepresentations were statements that the securities sold had been purchased in a third market and had not been received, that the stock sold had split and delivery was slow, that the stock was "coming" or en-route, that delivery of the securities had already been attempted. Equally false were other of Naftalin's statements that trades were being processed at the bank that handled registrant's clearances, that he was in the process of obtaining proper certificate denominations for delivery, and that registrant was having difficulty in obtaining delivery from a third party.

6/ Tr. 220.

7/ Tr. 11-12.

Respondents' fraudulent scheme and their efforts to stave off the consequences of rising market prices for the securities involved came to an end on or about October 27, 1969 when Naftalin notified all of the concerned broker-dealers that registrant did not own the securities which were sold to or through them and that registrant could not make delivery. Within the next few days, all of the broker-dealers "bought-in" the unsettled transactions, absorbing losses totaling $1,285,402.58.

Under Section 4(c)(1)(ii) of Regulation T promulgated by the Board of Governors of the Federal Reserve Board pursuant to Section 7 of the Exchange Act which was in effect during the period in question, a broker is permitted to sell a security in a customer's special cash account only "if the security is held in the account" of the customer or the broker "is informed that the customer . . . owns the security and the . . . sale is in reliance upon an agreement . . . that the security is to be promptly deposited in the account." The making of a "short sale" by a customer in a special cash account is forbidden. 8/

The restrictive provisions of Section 4(c)(1)(ii) of Regulation T required that registrant's "short sales" be placed in "General Accounts" or "Margin Accounts" as defined in Section 3(a) of Regulation T. Had this been done, registrant would have been required to make margin deposits with the selling broker-dealers in

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8/ 25 Fed. Res. Bull. 466 (1939).

amounts totaling approximately $6,900,000. By their deception respondents were able to undertake their gamble without use of funds, hoping to profit by purchasing at lower prices the securities registrant sold before delivery of those securities was required by the selling brokers.

Respondents do not attempt to argue that Naftalin's conduct did not constitute violations of Section 17(a) of the Securities Act and of Section 10(b) of the Exchange Act and Rule 10b-5. In fact, they concede that Naftalin engaged in a "serious course of conduct in entering sell orders for securities not owned by the Company [registrant], knowing that the broker-dealers with whom he was dealing were not entitled under the law and regulation to execute the orders in cash accounts." 9/

Bookkeeping Violations

Rule 17a-3, which was adopted pursuant to Section 17(a) of the Exchange Act, requires that every registered broker-dealer make and keep current certain books and records specified therein. As a registered broker-dealer, registrant was subject to and required to comply with that rule.

Testimony of a Commission investigator and the stipulated facts relating to registrant's bookkeeping practices establish that registrant did not make and keep current the required books

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9/ Respondents' Counterstatement of Proposed Findings of Fact, Conclusions of Law, and Brief in Support Thereof, March 2, 1973, at 11-12.

and records during the period from August 1, 1969 to about October 27, 1969 in that it failed to make entries in appropriate ledgers and other records to properly and adequately reflect registrant's 78 "short sales" which were effected in connection with respondents' fraudulent scheme. Additionally, registrant failed during that same period to maintain the required record of its net capital computations and of the proof of money balances of all ledger accounts, and falsely entered on its books fictitious entries reflecting the purported receipt and disbursement of a state income tax refund amounting to $27,000.

Respondents contend, however, that the bookkeeping requirements do not apply to a registered broker-dealer which has no public customers and conducts no public business. Since that position is in direct conflict with the plain language of Rule 17a-3 [10/] and is without supporting authority, it is rejected. It is concluded therefore that registrant, wilfully aided and abetted by Naftalin, wilfully violated Section 17(a) of the Exchange Act and Rule 17a-3 thereunder.

10/ Rule 17a-3(a) by its terms specifically applies to "every broker or dealer registered pursuant to Section 15 of the Securities Exchange Act of 1934, as amended." No exception is granted in the rule to registered broker-dealers who choose not to engage in a public business, and "registrants cannot be permitted to decide for themselves that in their own particular circumstances compliance with some or all [of the rule's requirements] is not necessary." Olds & Company, 37 S.E.C. 23 (1956).

Public Interest

Respondents view the remedial sanction to be imposed upon Naftalin as the "principal issue in this proceeding," [11/] and contend that the Commission does not have the power to impose a bar against Naftalin's associating with a broker-dealer for a period in excess of 12 months and, in the alternative, that if such power exists, then the appropriate sanction should be a bar for two years. On the other hand, the Division takes the position that the public interest requires not only the revocation of registrant's registration but also the imposition of a permanent bar against Naftalin's association with any broker-dealer.

No authority is cited in support of respondents' contention that a bar of an individual from association with a broker-dealer cannot exceed a period of 12 months, and respondents rely entirely upon their way of reading Section 15(b)(7) of the Exchange Act for support of their position. [12/] The construction placed by respondents on Section 15(b)(7) is found to be too narrow and is

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11/ At the commencement of the hearing on November 16, 1972 counsel for registrant indicated that registrant would not oppose the Division's request that registrant's registration as a broker-dealer be revoked, but would consent thereto. A written consent to revocation signed on behalf of Naftalin & Co., Inc. by Naftalin as its president and also by the Trustee in Bankruptcy was filed January 29, 1973. No action based upon that consent has been taken by the Commission.

12/ In pertinent part, Section 15(b)(7) provides:

> The Commission may, after appropriate notice and opportunity for hearing, by order censure any person, or bar or suspend for a period not exceeding twelve months any person from being associated with a broker or dealer . . . .

rejected as an unwarranted limitation upon the Commission's regulatory authority.[13/]

With respect to the alternative proposal that Naftalin's bar should be limited to two years, respondents urge that period on the seeming basis that the selling brokers must share in the blame for Naftalin's misconduct because, as respondents assert, those brokers failed to comply with Regulation T. There appears to be no merit to that approach. Naftalin's fraud remains outrageous whether viewed in the perspective insisted upon by respondents or that of entire propriety on the part of the selling brokers. As evidenced by the numerous lies which were resorted to when necessary to keep his scheme afloat, diligence on the part of the selling brokers would not have been a deterrent to Naftalin.

But not only the extent and character of Naftalin's fraud and the bookkeeping violations speak against the suggested limited bar. The record further reveals Naftalin's lack of character and tendency to advantage himself without regard to the rights of others in his defiance of the order of the United States District Court for the District of Minnesota[14/] directing him to retain possession

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13/ Vanasco v. S.E.C., 395 F.2d 349 (2d Cir. 1968); and see S. Rep. No. 88-379, 88th Cong., 1st Sess., at 78 (1963), and H.R. Rep. No. 88-1418, 88th Cong., 2d Sess., at 22-23 (1964).

14/ S.E.C. v. Naftalin & Co., Inc., Case No. 4-69 Civ. 385 (D. Minn. 1969), an injunctive action which predated the referred to bankruptcy action against registrant and in which a receiver for registrant's assets was appointed by the Court. On August 21, 1972 a consent order permanently enjoining respondents from violations of the anti-fraud provisions of the Federal securities laws was entered. In accordance with the Division's proffer, consideration of that injunction has been limited herein to the question of whether remedial action against respondents is appropriate in the public interest.

of the remainder of $600,000 face amount of U.S. Treasury bonds that registrant had transferred to him in October, 1969. Instead of complying, Naftalin transferred the bonds to a bank in New York City for the purpose of sale. Recovery of the bonds thereafter necessitated considerable effort on the part of the court-appointed receiver for registrant's assets.

In addition, it appears that Naftalin and registrant were subjects of disciplinary action by the National Association of Securities Dealers, Inc. ("NASD") for conduct in 1960 involving sales of securities at unfair prices, failure to make adequate disclosure of dual agency transactions and of an arrangement whereby registrant's representative acted as a principal in transactions effected through registrant, and violations of Regulation T. 15/ While the sanction imposed for those breaches of the NASD's rules of fair practice was not severe, being limited to a fine of $4,500 and a suspension of registrant's membership in the NASD for 20 days, those proceedings should have impressed Naftalin with the need for circumspect behavior. Obviously that lesson was not learned then, and it is equally obvious on the showing in this record that Naftalin cannot now nor at any foreseeable date be trusted to conduct himself properly in the securities business.

In view of the foregoing, it is concluded that the public interest requires that registrant's registration as a broker-dealer be revoked and that Naftalin be barred from association with any

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15/ Naftalin & Co., Inc., Securities Exchange Act Release No. 7220 (1964).

broker or dealer. This is not to suggest that Naftalin is beyond rehabilitation, only that the record is lacking in facts indicating other than deliberate and unscrupulous conduct on his part and is entirely barren of any indication as to when his reentry in the securities business would be in the public interest. Counsel for respondents take upon themselves the responsibility for Naftalin's not testifying at the hearing in these proceedings, stating that he testified openly and at great length in the bankruptcy proceeding. The latter may well be so, and no inference has been drawn from the fact that Naftalin did not here testify. But the fact remains nonetheless that there is no explanation in the record for apparent unconscionable conduct nor any evidence upon which a finding could be made that a bar for two years would be adequate in the public interest.

In this connection it also appears that the Division's proposal that Naftalin be permanently barred from association with any broker or dealer should not be accepted. At such time as Naftalin's reentry into the securities business would be consistent with the public interest, he should be permitted to do so. 16/ But that finding must be left to some future indeterminate time when it can be made on the basis of a showing of the nature of the proposed securities activities and of Naftalin's conduct prior and subsequent to the offenses here considered, 17/ a showing, it must

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16/ Cf. Robert L. Raff, Securities Exchange Act Release No. 10111 (1973).

17/ Cf. Ross Securities, Inc., 41 S.E.C. 509, 517, n. 10 (1963); and see Vanasco v. S.E.C., supra, at 353.

be emphasized, not to be found in the record of these proceedings.[18/]

Accordingly, IT IS ORDERED that the registration of Naftalin & Co., Inc., as a broker-dealer is revoked and that Neil T. Naftalin is barred from association with any broker or dealer.

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

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

Warren E. Blair
Chief Administrative Law Judge

Washington, D.C.
May 17, 1973

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