ADMINISTRATIVE PROCEEDING
FILE NO. 3-7604

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISISON

In the Matter of	)
KEVIN UPTON	)

INITIAL DECISION

Washington, DC
May 18, 1993

Max O. Regensteiner
Administrative Law Judge

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APPEARANCES: Kathryn A. Ashbaugh, Allen Meyer and Keith W. Miller, of the Commission's New York Regional Office, for the Division of Enforcement.

Melvin Brosterman and David Bolton, of Stroock & Stroock & Lavan, for Kevin Upton.

BEFORE: Max O. Regensteiner, Administrative Law Judge

I. INTRODUCTION

In these proceedings pursuant to Sections 15(b) and 19(h) of the Securities Exchange Act of 1934 ("Exchange Act"), the remaining issues for consideration are (1) whether Kevin Upton, who at relevant times was Chief Financial Officer ("CFO") of Financial Clearing and Services Corporation ("FiCS"), a registered broker-dealer, failed in his supervisory responsibilities as alleged by the Division of Enforcement, and (2) if so, what, if any, remedial action is appropriate. John Dolcemaschio, a former FiCS employee whom Upton allegedly failed reasonably to supervise, was also named as a respondent, but the proceedings as to him were disposed of by the Commission's acceptance of his settlement offer.1/

Following hearings, the parties successively filed proposed findings of fact and conclusions of law 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 Division alleged that from April 1988 to May 1989, FiCS, a clearing broker-dealer, violated Section 15(c)(3) of the Exchange Act and Rule 15c3-3 thereunder, that Dolcemaschio aided and abetted those violations and that Upton failed reasonably to supervise Dolcemaschio with a view towards preventing the latter's aiding and abetting of FiCS's violations. Under the rule, broker-dealers are required to maintain a Special Reserve Bank Account for the

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1/ John Dolcemaschio, Exchange Act Release No. 30634 (April 27, 1992), 51 SEC Docket 740.

Exclusive Benefit of Customers ("reserve account") and to perform a reserve formula computation as of the close of the last business day of the week to determine the amount of cash and/or "qualified securities" required to be deposited or maintained in that account. The Division alleged that FiCS engaged in a "paydown practice" that worked as follows: On the last business day of the week, FiCS paid down a bank loan collateralized by customer securities ("customer bank loan") with substitute financing consisting of unsecured, firm or non-customer loans. At the beginning of the following week the customer bank loan was reinstated and the substitute loan paid off. Under Rule 15c3-3, customer bank loans, but not unsecured, firm or non-customer loans, are included as a credit in the computation. The Division alleged that by paying down the customer bank loan, FiCS avoided including the loan as a credit in its reserve formula computation, thereby reducing the amount needed to be "locked up" in the reserve account. It further alleged that as a result FiCS had deposit deficiencies ranging from $4.2 million to $46.8 million and averaging 19.7 million.

Upton and Dolcemaschio

Upton, who has an MBA degree, has held positions in or related to the securities industry since 1967. Initially, he was employed by the New York Stock Exchange as a finance coordinator and then as an assistant compliance coordinator. Subsequently, and prior to his association with FiCS, he worked for various broker-dealers in financial and other capacities. Upton became CFO of FiCS in 1985 and remained in that position until December 1989.

Beginning in July 1988, the Money Management Department reported to him. As of the time of the hearing herein, Upton was CFO of another broker-dealer.

Dolcemaschio joined FiCS in May 1988 as assistant manager of the Money Management Department and was promoted to manager in July 1988. Prior to his association with FiCS, Dolcemaschio had worked as a research clerk and in money management for several other broker-dealers.

Rule 15c3-3 and the Paydown Practice

Rule 15c3-3 is designed to assure that customers' funds, including those obtained by the lending of customers' securities, are not used to finance activities for the broker-dealer's own account. To that end, the rule, as noted, requires, among other things, that every broker-dealer maintain a reserve account. The account is designed to protect customer funds and the cash realized through the use of customers' securities from the hazards of the brokerage business. It must be separate from any other bank account of the broker-dealer and must contain the amount specified by the rule.

The rule sets forth a formula for calculating the required reserve account balance. Computations must be made weekly, as of the close of the last business day, to determine the amount of money the broker-dealer is holding that represents either customer funds or funds obtained from the use of customer securities, such as loans secured by customer securities. From these "credit balances," the broker-dealer subtracts the amount of money it is

owed by its customers ("debit balances"). If the computation results in a net credit balance, the broker-dealer must deposit sufficient funds in the reserve account so that the account balance at least equals the net credit balance.2/ If the computation shows a net debit balance, or if the reserve account already contains sufficient funds, no deposit is necessary. In paragraph (e)(2), Rule 15c3-3 specifies that it is unlawful for a broker-dealer to use any amounts included in credit balances except for the specified purposes indicated under items comprising the debit balances.

At the time it adopted Rule 15c3-3, the Commission explained that one of the objectives of the rule was

> to insure that customers' funds held by a broker-dealer . . . and the cash which is realized through the lending, hypothecation and other permissible uses of customers' securities are deployed in safe areas of the broker-dealer's business related to servicing his customers, or to the extent that the funds are not deployed in these limited areas, that they be deposited in a reserve bank account.

(Exchange Act Release No. 9856 at 2 (November 10, 1972)).

Earlier proposed versions of the rule would have required that reserve formula computations be performed on a daily basis. In the final proposed version and in the rule as adopted, this was revised to provide for weekly computation. Based on comments it had received, the Commission noted, among other things, that daily computations would preclude the kind of separation of customer and

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2/ Such a deposit must be made within one hour after the banks open for business on the second business day following the date as of which the reserve formula computation is made.

firm items needed to afford maximum customer protection, and that many smaller broker-dealers felt that the cost of daily computations would be out of proportion to the additional protection intended for customers and in some cases might be prohibitive. (Exchange Act Release No. 9775 at 5 (September 14, 1972)).

In December 1987, the Commission instituted proceedings against a broker-dealer named Underwood, Neuhaus & Co., Inc., based on allegations, among others, that on six occasions in 1985 the firm paid down loans secured by customer securities for the computation day only and was therefore underdeposited on those days by amounts averaging $3 million. Pursuant to the firm's settlement offer, in which it neither admitted nor denied the allegations, but consented to findings of violations, the Commission issued an order finding that the firm had violated Rule 15c3-3 by failing to maintain required balances in its reserve account. It found that on six occasions in a four-month period and on earlier occasions, the firm excluded from the credit part of the formula loans secured by customer securities which it had chosen to pay down for the computation day. Exchange Act Release No. 25531 (March 30, 1988), 40 SEC Docket 1015. There is no evidence, however, that Upton or other FiCS personnel were aware of the institution or resolution of this proceeding.3/

3/ As a consent order issued without an accompanying opinion, the Underwood, Neuhaus order carried "little, if any, precedential weight." Carl L. Shipley, 45 S.E.C. 589, 591 n.6 (1974).

The record shows that prior to and during the period under consideration, a number of New York Stock Exchange ("NYSE") member firms engaged in the paydown practice. In instances where these were discovered by SEC staff examiners, the staff questioned the propriety of the practice and commented to the NYSE about the failure of the Exchange's examiners to comment on the practice in inspection reports. Beginning in about late 1987 and continuing until August 1989, there were meetings and discussions involving SEC and Exchange staff members as well as representatives of the securities industry dealing with clarification of Rule 15c3-3's application in the paydown situation as well as the appropriate means of communicating such clarification to the industry. Finally, in August 1989, subsequent to the period at issue here and after many drafts, the Exchange issued Interpretation Memo 89-10 to members and member organizations. Upton contends that this was the first time that the industry had reasonable notice of the Commission's views on the subject. Apart from the fact that the Memo, other than citing the Commission's Underwood, Neuhaus order, referred only to SEC staff views, he is substantially correct.4/

The Memo was entitled "Broker-Dealer Censured for Violation of S.E.C. Rule 15c3-3 and Discussion of the Intent and Objective of the Rule." (Resp. Ex. H). It noted the Commission's censure of Underwood, Neuhaus for, among other things, "violating Rule 15c3-

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4/ Inexplicably, the Division contends that the Commission had earlier communicated its views to the industry through the NYSE staff's internal circulation of materials, including the release announcing institution of the Underwood, Neuhaus proceeding.

3 by substituting proprietary bank loans for customer bank loans prior to making the weekly Reserve Formula computation and reinstating the customer loans shortly thereafter." (Id. at 1). It stated that the SEC had advised that the intent and objective of the rule, as reflected in a 1972 release, was to perfect the objective of eliminating use by broker-dealers of customer funds and securities to finance firm overhead and firm activities through the separation of customer related activities from other broker-dealer operations. The Memo further stated that

> [t]he SEC staff advised that broker-dealers that would otherwise have had a higher reserve deposit requirement should be aware that substitution of proprietary or non-customer bank loans for customer bank loans only for the week-end or on the day of the Reserve Formula Computation may be regarded as an intentional circumvention of the rule if the customer loans are reinstated shortly thereafter.

(Ibid.) The Memo cited additional activities that the SEC staff had advised "may be considered circumventions of the rule," including the substitution of securities "borrowed from sources outside the firm" for customer securities in stock loans just before reserve computations were made, as well as any other device, window dressing or restructuring of transactions made solely to reduce an excess of credits over debits in the computation and "not otherwise a normal business transaction." (Id. at 2). The Memo went on to state that the SEC staff had stated that such techniques could be in violation of the rule's requirements in that customer derived funds were used during the period between computations "in areas of the firm's business such as underwriting, trading and overhead, contrary to the purpose of the rule." (Ibid.).

II. FINDINGS OF FACT, DISCUSSION AND CONCLUSIONS

To make its case against Upton, the Division must prove 1) that FiCS violated Section 15(c)(3) of the Exchange Act and Rule 15c3-3 thereunder, 2) that Dolcemaschio aided and abetted those violations and 3) that Upton failed reasonably to supervise Dolcemaschio.

FiCS' Violations of Rule 15c3-3

Toward the end of March 1988, FiCS, faced with a reduced ability to obtain unsecured financing, began using customer bank loans. On Friday, April 8, it paid the customer loan balance of some $16 million with the proceeds of an unsecured loan of about $18 million. On Monday, April 11, it reinstated the customer bank loan and on that day and the next day paid the unsecured loan. From that time until the end of May 1989, almost every week, FiCS had an outstanding customer bank loan throughout the week which it paid down at the end of the business week by obtaining a substitute loan that was not a credit in the reserve formula computation and then reactivated the customer bank loan at the beginning of the following business week.5/ FiCS did not include the amount of the customer bank loan in the reserve formula computation. As computed by FiCS, its reserve account balances always exceeded the minimum required by Rule 15c3-3. Had the customer bank loans been included

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5/ The substitute loans included unsecured loans, non-customer bank loans (loans collateralized by the securities of the broker-dealer's officers and directors or those of correspondent broker-dealers' officers and directors) and firm bank loans (loans collateralized by the firm's proprietary securities)

as credits, the amount in the reserve account would have been insufficient most of the weeks in question, with these "hindsight deficiencies" averaging about $20 million.

The effect of the weekend paydowns was that, even though the customer bank loan was outstanding almost the entire business week, this was not reflected in the reserve account. The Division contends that the paydown practice was designed to circumvent the rule, allowed FiCS to use customer-derived funds for proprietary purposes and exposed FiCS' customers and the customers of the broker-dealers clearing through FiCS to serious risks. It argues that if broker-dealers were allowed to manipulate the reserve formula computation by engaging in weekend paydowns purely to decrease the credit balances in the computation, the financial protection contemplated by Rule 15c3-3 would be abrogated. The Division also points out that when the Commission opted for a weekly instead of a daily reserve formula computation, it did so to reduce the administrative burden on smaller broker-dealers and not to weaken customer protection.

Upton contends that Rule 15c3-3 does not prohibit a broker-dealer from paying down loans secured by customer securities on a computation day and reinstating them on the next day, and that FiCS was in full compliance with the terms of the rule and in fact deposited substantially more in the reserve account than what it was required to deposit. He asserts that the firm's decisions about which loan to use were based solely on economic considerations and were not motivated by a desire to reduce the

required reserve deposit. Upton urges that the Commission should be held to the standards enunciated in the NYSE's Interpretation Memo, claiming that it represented the first reasonable notice of the Commission's views on the subject. He asserts that the Memo did not speak in terms of a violation, but only a circumvention, of Rule 15c3-3, and even in that context indicated that a conclusion as to whether there was such circumvention depended on the surrounding circumstances. Upton urges that it is improper to base a proceeding on the alleged "spirit" of the rule, where the terms of the rule do not proscribe the conduct in question and where, at the time of such conduct, there was no published information in standard references concerning the Commission's views of the rule's objectives.

FiCS' practice of routinely paying down customer loans just prior to the reserve account computation and reinstating them on the following business day warrants the conclusion that this was simply a device designed to evade the requirements of the rule. I cannot agree with Upton that specific notice was required that such circumvention could be considered as a violation of the rule. Since customer loans were outstanding during almost the entire business week, and since the amounts realized through the loans were not considered in the computations, FiCS was enabled to use those amounts in its proprietary business activities in violation of Rule 15c3-3. While Upton asserts that no evidence was adduced that FiCS actually used customer funds to finance its proprietary activities, under the circumstances it seems reasonable to place the burden of

showing that they were not so used on the broker-dealer (or, in this case, the respondent). Upton did not meet that burden.6/ Finally, while I do not agree that the Commission is somehow bound by the standards set forth in the NYSE Memo, the above conclusions are not inconsistent with those standards. Contrary to Upton's contention, the Memo referred not only to circumvention, but also to violations. Thus, it referred to the Commission's findings of violations in the Underwood, Neuhaus case and, in discussing the SEC staff view of devices used solely to reduce an excess of credits over debits in the formula computation, referred interchangeably to circumventions and violations.

I agree with Upton that a different conclusion might follow if the record showed that the weekly substitution of loans was based on economic factors unrelated to the reserve account computations. However, the record does not support such a finding. There was testimony both from Dolcemaschio and from Colette Rex, assistant manager of the Money Management Department beginning in October 1988, referring to such an economic factor. It appears that the California bank which carried the customer loan had a relatively early deadline, whereas funds could be received by FiCS until a later time, with the result that a loan locked in by the deadline on Friday could turn out to be more than needed and, considering weekend interest charges, unduly expensive. However,

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6/ I reject Upton's argument that there was no proof that FiCs even engaged in proprietary activities. Although the firm, as a clearing broker, did not engage in trading for its own account, market-making or underwriting, it does not follow that it had no proprietary activities.

neither Dolcemaschio nor Rex claimed that this was in fact the reason for the Friday paydowns. The former testified that he continued a practice that his predecessor at FiCS had followed, without explanation to Dolcemaschio, and that he himself had followed in his employment with two prior firms. And Rex testified that when she became employed at FiCS, she was told that the first thing to do on Friday was to pay off the customer bank loan; that no one told her why it was done that way; and that at her previous firm it had been done the same way. She also acknowledged that when Lori Whitaker, a Commission securities compliance examiner who participated in the examination of FiCS that led to these proceedings, asked her the reason for the Friday paydowns of customer bank loans, she replied that it was "for 15c3 (sic)." (Tr. 175).

Whitaker testified that in the course of her examination she spoke to various FiCS personnel about the paydown pattern. According to her testimony, a FiCS vice-president whom she questioned about it stated that it was "primarily for what he said reserve purposes"; (tr.61) Rex told her that FiCS' incentive was "to avoid putting the balance of the customer's (sic) bank loan in the formula";7/ (tr. 68) and Dolcemaschio, whom she had presented

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7/ I cannot agree with Upton that in her own testimony, Rex controverted the statement attributed to her by Whitaker. That statement and her testimony are not inconsistent in substance. And Rex was not asked whether she made such a statement. Moreover, Upton's assertion that Rex testified that at the time she spoke to Whitaker she did not even know how customer secured loans impacted the reserve formula computation is inaccurate. Rex testified that as a result of working at the (continued...)

with a recalculation of the computation for a date in January 1989 reflecting the customer loan as a credit, stated "what do you expect us to do, lock it up." (Tr. 96). As Upton stresses, Whitaker's testimony as to what she was told was hearsay testimony. While that does not preclude reliance on it for findings,8/ I consider equally significant the fact that no claim was made to her that the paydowns were based on business factors unrelated to the reserve formula computation.

Accordingly, I conclude that FiCS violated Section 15(c)(3) of the Exchange Act and Rule 15c3-3 thereunder.

Aiding and Abetting by Dolcemaschio

As previously noted, Dolcemaschio was hired by FiCS in May 1988 as assistant manager of the Money Management Department and became manager in July 1988. As manager, he was responsible for determining whether to increase or decrease the various loans utilized by the firm and for implementing those determinations. After Rex was employed as assistant manager, either he or Rex made the determinations as to how much to borrow and which loan to utilize. The Division alleged that he aided and abetted FiCS' violations by signing and approving substitute loans and customer bank loan modifications, and by being generally aware that his role was part of an overall activity that was improper.

7/(...continued)
money desk for FiCS and previously for another firm, she observed that "when my customer loans were up on a Friday, my [reserve] requirement was up on a Tuesday," and vice versa. (Tr. 175).

8/ See, e.g., Charles P. Lawrence, 43 S.E.C. 607, 613 (1967).

In William R. Carter, 47 S.E.C. 471, 503 (1981), the Commission held that three elements must be present to support a finding of aiding and abetting: (1) an independent securities law violation by another party; (2) knowing and substantial assistance by the aider and abetter of the conduct constituting the violation; and (3) the aider and abetter's awareness or knowledge that his role was part of an activity that was improper or illegal. The Commission further recognized that the awareness or scienter requirement incorporated in the third element could be satisfied not only by knowledge, awareness or intent, but also by recklessness. (Id. at 504).

There is no question here regarding the presence of the first two elements.9/ For the third element the Division points to testimony regarding two occasions when Dolcemaschio was told that there were concerns or problems with the paydown practice. Dolcemaschio testified that in about 1977, when he was working at the money desk of another firm, his supervisor indicated a possible concern about the practice. The testimony, however, is too vague to merit giving it any weight on the question of Dolcemaschio's awareness or knowledge that the paydown practice was improper.10/ The second occasion had far more substance. Rex testified that in November 1988 a friend named Eng, with whom she had worked at

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9/ In fact, Upton has not addressed the question whether Dolcemaschio aided and abetted any violations by FiCS.

10/ Dolcemaschio testified that his supervisor "just asked me about it. What are you doing with this, and I explained it. He said I'll get back to you on that, I'm discussing it with someone. And I never heard anything about it." (Tr. 258).

another firm and who was then an NYSE examiner, told her, in the course of a discussion of the paydown practice that had been followed at that firm and that FiCS was then following, that "we did not technically have a violation but that there was a problem with the spirit of [Rule 15c3-3] in what we were doing and that it was being looked at closely by the regulatory bodies." (Tr. 162). He advised that FiCS stop the practice. Rex further testified that she told Dolcemaschio, who also knew Eng, exactly what Eng had told her. According to her testimony, Dolcemaschio responded that "everybody on the Street does it and if they cite us, they have to cite everybody and I don't want to hear about it." (Tr. 164). The paydown practice continued as before. Dolcemaschio testified that he did not recall using those words but may have said something similar. He further testified that he did not recall the exact conversation or any reference to Eng, but that the essence of the conversation was that Rex did not think that the paydown practice was in accordance with the rules, whereas he thought that it was.

Rex appeared to have a good recollection of her conversations first with Eng and then with Dolcemaschio, and I credit her testimony concerning those conversations. 11/ Dolcemaschio was made aware of the possible impropriety or illegality of the paydown practice. Accordingly, I find that he aided and abetted FiCS' violations of Section 15(c)(3) of the Exchange Act and Rule 15c3-3.

11/ As previously noted, at the time of those conversations the NYSE and the Commission's staff were in fact looking closely at paydowns in relation to Rule 15c3-3.

Upton's Failure to Supervise

The next issue to be addressed is whether Upton failed reasonably to supervise Dolcemaschio, with a view to preventing the latter's aiding and abetting of FiCS' violations. The Division alleged that Upton regularly received reports and documents which showed the paydown practice, and that, despite his review, he failed reasonably to discharge his duties and obligations by failing to investigate the questionable information contained in the reports or by failing to take sufficient steps to halt the practice.

Under Section 15(b)(6) of the Exchange Act, which incorporates Section 15(b)(4)(E) by reference, the Commission may, if such action is in the public interest, sanction an associated person of a broker-dealer if he has failed reasonably to supervise, with a view to preventing securities violations, another person who commits such violations and is subject to his supervision.12/ However, no adverse finding may be made if (1) there were established procedures and a system for applying them which would reasonably have been expected to prevent and detect, insofar as practicable, any such violation by such other person, and (2) such person reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that they were not being complied with.

12/ Upton's argument that a failure to supervise an aider and abetter, as distinguished from a violator, is not encompassed within the Exchange Act's provisions regarding supervisory failure is discussed at a later point in this decision.

The Money Management Department, which had been under Upton's supervision for about a year at an earlier time, was reassigned to him in July 1988, shortly before Dolcemaschio became manager. It was subject to his supervision throughout the balance of the relevant period. During that period, Upton also supervised certain other departments, including the Accounting Department, which made the actual reserve formula computations. That department reported to him during his entire tenure at FiCS.

During the relevant period, Upton was admittedly familiar with Rule 15c3-3. Shortly after joining FiCS, he had taken a comprehensive three-month course on the rule. And it was a part of his duties to review the weekly reserve formula computations. As pertinent here, he was aware that customer bank loans are treated as credits in the computation, while other types of loans are excluded from the computation. At the time the Money Management Department came under his supervision again, he knew that FiCS had a customer bank loan "facility," (tr. 351), and that this, along with other loans, was generally being used.

Upton testified that, although he spoke to Dolcemaschio or Rex almost daily, prior to May 1989 he was not aware of the paydown practice or of the fact that most of the time there was no customer bank loan included in the reserve formula computations. He further testified that in that month, a Commission staff member advised him that FiCS was engaging in the paydown practice and told him that it might be violating the spirit of Rule 15c3-3, and that he then immediately stopped the practice. The Division contends, however,

that if he did not know earlier, he was negligent in failing to discover the paydown practice and that he should have stopped it much sooner.

In seeking to hold Upton responsible for supervisory failure, the Division asserts that, based on his experience in the securities industry and his understanding of Rule 15c3-3 and because of various "red flags," he should have known that FICS was engaging in the paydown practice. With respect to red flags that assertedly came to Upton's attention, the Division argues that he received various documents and reports which contained contradictory information as to whether FICS maintained a customer bank loan and which should have indicated to him that it was engaging in a paydown practice. The documents and reports on which the Division relies consist of the weekly reserve formula computation pursuant to Rule 15c3-3 and monthly FOCUS reports which had the most recent computation attached, a "Daily Profit & Loss Statement" ("the P&L Report") and a daily bank loan report. The Division also points to the fact that in or about November 1988 Upton received a call from Rex alerting him to problems in the Money Management Department. Upton denies that there were red flags.

My analysis of the record leads me to the conclusion that one of the red flags cited by the Division in fact put Upton on notice of irregularities that should then have been further pursued. During the July 1988-May 1989 period, as before, Upton received, reviewed and initialled the weekly reserve formula computations

prepared by the Accounting Department. Any increase or decrease in the reserve account had to be approved by him. Upton also reviewed, and he signed, the monthly FOCUS reports, which included the most recent reserve formula computations. With very few exceptions, no customer bank loan was reported in the reserve formula computation. Line 2 of the computation, the line for reporting customer bank loans, always had a figure. However, that figure reflected another item, namely, a margin deposit with the Options Clearing Corporation, which was also reported in Line 15. Thus, a comparison of the two lines shows that no customer bank loan was being reported. Moreover, the amounts reported in Line 2 were very small compared to what would be normal amounts for a bank loan. Most of the time they were in a range between $2 million and $5 million.

Upton testified regarding the nature of his review of the computations. He stated that he reviewed the entire report and that he "would look at the report. If I saw that it was something that jumped out at me I might say okay, well let's take a look at this and let's see what happened. Other than that, I would just look at it." (Tr. at 359). He further testified that he did not look to see if a customer bank loan was included in the computation and did not notice that most of the time no such loan was included. He also testified that there was always a number in Line 2 and that he knew that a figure from Line 15 was included in the Line 2 figure. While denying that he did not look at the two lines together, Upton testified that he did not recall specifically comparing the two lines to see whether a customer bank loan was included on Line 2.

He acknowledged knowing that FiCS had a bank loan facility which was generally being used.

I agree with the Division that Upton should have noted from his review of the reserve formula computations that customer bank loans were not included among the credits. Because of the nature of the amounts reported in Line 2, it was not even necessary to do a comparison with Line 15 to ascertain that that was the case. In view of his awareness that at least from time to time FiCS was using a customer bank loan along with other loans, the consistent absence of such a loan from the computations put Upton on notice that some further inquiry was required. Any inquiry would readily have disclosed the paydown practice, a practice which he should have recognized as an improper circumvention of Rule 15c3-3. As the Commission recently stated in Louis R. Trujillo, Exchange Act Release No. 26635 (March 16, 1989), 43 SEC Docket 690, 694, "those in authority [must] exercise particular vigilance when indications of irregularity reach their attention."

The remaining factors cited by the Division as putting Upton on notice of irregularities do not in my judgment support its position. Nevertheless, I make findings concerning them because they were the subject of extensive testimony and because they may again be in issue in the event of a review of this decision.

On most days, Upton received and reviewed a daily P&L Report prepared by the Accounting Department, which, according to the Division, indicated that FiCS maintained a customer bank loan throughout the week. The Division offered in evidence one such

report for a day in each month between March 1988 and June 1989. Typically, each report consisted of several pages. The first page showed daily revenues and expenses and the resulting profit or loss in essentially summary terms. The other pages were detailed schedules of various kinds. One schedule, entitled "Loan Interest Calculation," showed outstanding loan balances for the day of the report and all prior days of the month, together with interest rates and the resulting daily charges. The Division maintains that these schedules showed that during the relevant period, FiCS generally maintained a customer bank loan on Monday through Thursday, but not on Friday through Sunday.

The schedules that are in evidence show the following: those for March through December 1988 (Div. Exhs. 300, 300A, 301-304, 325, 337, 355 and 366) have separate columns for secured and unsecured loans, with no further breakdown. Prior to July, the only secured loan was the customer bank loan, and the schedules, which do not show days of the week, do reflect a pattern where the secured bank loan for several days in a row had an outstanding balance followed by several days with a zero balance. During that period, however, Upton was not the supervisor of the Money Management Department. Beginning with the July schedules and through December, no pattern is apparent because during those months FiCS had other secured loans whose balances were lumped together with the customer secured loans in the secured loan column. Beginning in January 1989 and for the balance of the relevant period, the schedules (Div. Exhs. 371, 372, 384, 399 and

408) had separate columns for customer secured loans on the one hand and firm and non-customer secured loans on the other, and as a result the pattern was again discernible.

The fact that the pattern was not discernible in the reports from July through December 1988, a fact not adverted to by either party, materially diminishes the "redness" of this flag. Upton denied that he perceived a pattern. In his investigative testimony, he stated that he reviewed the P&L reports in their entirety, including the bank loan section, looking for "normalcy." (Div. Exh. 1100 at 99). He added that he looked at the reports "from a P&L point of view" (Id. at 120), and that his main interest was in seeing the profit or loss for the day in question; that he would look to the back-up information for an explanation as to why the day had been profitable or not; and that he saw nothing abnormal in relation to bank loans. At the hearing, Upton testified that the purpose of the report was to give him an indication of the firm's profitability and that he did not review pages beyond the first page with any regularity, doing so only if he saw "a very large loss" or "a very large difference in that particular day." (Tr. at 397).

I am unable to find that Upton was negligent in not discovering the paydown practice from the P&L reports. As noted, for many months the pattern was not discernible from the loan interest calculation schedules. Even when it was, however, the focus of Upton's review of these reports was the firm's profitability. The Division contends that a reasonable supervisor

and particularly a CFO would not have reviewed only the front page of "such an important and fundamental report" as the P&L Report. (Reply Brief at 11-12). However, the record does not indicate what other reports or information was reviewed by Upton. There simply is no evidentiary support for the Division's contention.

The Division also relies on daily bank loan reports prepared by Dolcemaschio that listed outstanding balances of all of FiCS' loans. (Div. Ex. 1000). As the Division points out, these reports indicated that FiCS used customer bank loans throughout the week but not on Friday. Dolcemaschio testified that he originally prepared the reports for the Accounting Department, and that he circulated copies to his superiors, including a copy to Upton's office. He further testified that he "may have given" one of the reports to Upton personally, but that he did not do so on a regular basis. (Tr. 242). Upton testified that he never saw any such report. I credit his testimony. The Division contends that this report was distributed to Upton for his review, and that if he did not review it, he was negligent. There is no evidence, however, that Upton was even aware of the existence of the report.

The final "red flag" relied on by the Division relates to a telephone call from Rex to Upton shortly after her conversations with Eng (the NYSE examiner) and Dolcemaschio in November 1988 concerning the paydown practice. Rex testified that she told Upton, "there's shit going on down here that you need to know about." (Tr. 166). According to Rex, Upton arranged to meet with her, but then postponed the meeting, "and it just never happened." (Ibid.). Rex

further testified that she tried to speak to Upton more than once. On cross-examination, Rex acknowledged that in her call with Upton, she made no reference to loans, to Rule 15c3-3, or to a conversation with an NYSE employee. She further acknowledged that she had previously brought to Upton's attention that she and Dolcemaschio did not get along. Rex also acknowledged that Upton was accessible and that she could simply have gone to his office to see him.

Obviously, it would have been better if Upton had at least inquired of Rex regarding the matter that she wanted to bring to his attention, even if he might have assumed that it related to her relationship with Dolcemaschio. It does not follow that he was unreasonable in not promptly following up on her call. The likelihood is that after he postponed his initial meeting with Rex, he forgot about the matter. It would not have been unreasonable for him, however, to have assumed that if Rex perceived a serious problem in her department, she would have persisted in her efforts to bring it to his attention.

The Division further asserts that, as a result of circumstances attendant upon a change in the ownership of FiCS, Upton had a "heightened awareness" that the firm might have reserve formula computation problems. (Proposed Findings of Fact and Conclusions of Law at 15).

Prior to mid-February 1988, FiCS was owned by Security Pacific Corporation, a bank holding company. Under that ownership, it was able to obtain virtually unlimited unsecured financing from

Security Pacific National Bank ("SPNB"), another subsidiary. As noted previously, unsecured bank loans are excluded from the reserve formula computation. In February 1988, FiCS was acquired by a life insurance subsidiary of Integrated Resources, Inc. SPNB thereupon significantly reduced the amount of unsecured financing available to FiCS, but provided the firm with a substantial customer bank loan facility. FiCS drew on this facility for the first time toward the end of March 1988, well before Dolcemaschio became manager of the Money Management Department and before Upton was again assigned responsibility for that department. Somewhat later, FiCS began to clear transaction for Integrated Resources Asset Management ("IRAM"), an Integrated affiliate and a retail broker-dealer. IRAM had free credit balances of roughly $100 million, which FiCS was required to include as a credit in its reserve formula computation. In management discussions before FiCS took over the clearing business for IRAM and another Integrated subsidiary, it was noted that the addition of the large free credit balances would probably require that deposits be made in the reserve account. The Division contends that under the circumstances Upton should have carefully scrutinized all financial reports to ensure that the customer free credits were properly "locked up."

I am unable to find on the basis of the above factors that Upton had a "heightened awareness" that FiCS might have reserve formula computation problems in light of the new ownership. As he points out, he knew that the free credit balances existed and had to be accounted for in the reserve formula computation, and he made

sure that the reserve account deposits required as a result of those balances were in fact made. Moreover, the evidence does not support the Division's assertion that in the discussions before FiCS took on IRAM's clearing business, "concern" was expressed regarding the impact of the free credit balances.

Upton contends that he established and followed procedures designed to prevent and detect violations and reasonably discharged his supervisory duties, and that his conduct therefore falls within the "safe harbor" of Section 15(b)(6) of the Exchange Act. The evidence he cites, however, does not support that argument. Thus, he points to his testimony that he was an open, accessible manager who was in constant contact with his staff, including Dolcemaschio, and he urges that he reasonably relied on the experience and competence of those he supervised to perform their jobs in accord with applicable rules and to bring any deviation to his attention. This essentially passive approach, however, in placing primary reliance on the volunteering of information concerning irregularities by the supervised employees, does not add up to the kinds of procedures and a system for applying them that the statute contemplates.

Accordingly, I find that Upton failed reasonably to supervise Dolcemaschio, with a view to preventing the latter's aiding and abetting of FiCS' violations.

Failure to Supervise Aider and Abetter as Within Exchange Act

Upton contends that under the statutory scheme, a failure to supervise finding cannot be predicated on a subordinate's aiding

and abetting of a violation as distinguished from a violation. As noted above, Sections 15(b)(4)(E) and 15(b)(6) provide that broker-dealers or persons associated with broker-dealers may be sanctioned for failing reasonably to supervise, "with a view to preventing violations [of the securities acts and rules thereunder], another person who commits such a violation." Upton points out that the statute lists violations and aiding and abetting as separate and distinct bases for disciplining associated persons, and he contends that aiding and abetting, unlike violations, does not provide a basis for failure to supervise liability.

In support of his contention, Upton relies on the decision in Arthur James Huff, Exchange Act Release No. 29017 (March 28, 1991), 48 SEC Docket 878. There the Commission held that a branch manager's deficient supervision of a salesman was not a "violation," within the meaning of the above provisions, and therefore was not a statutory basis for sanctioning a principal charged with failing to supervise the branch manager. The Commission stressed that the statute clearly distinguished between violations and supervisory deficiencies and that deficient supervision therefore could not be treated as a violation. Upton argues that the Exchange Act likewise distinguishes between violations and aiding or abetting of violations, and that aiding or abetting does not constitute a violation.

In a number of cases that were settled, respondents have been found to have exercised inadequate supervision with respect to persons who aided and abetted violations. See, e.g., Goodrich

Securities, Exchange Act Release No. 28141 (June 25, 1990), 46 SEC Docket 975, 977; First Affiliated Securities, Exchange Act Release No. 23335 (June 18, 1986), 35 SEC Docket 1580, 1587. As far as I am aware, however, this is the first instance in which the issue raised by Upton has been presented in a contested context.

While the issue is by no means free of doubt, I believe that the claimed analogy to the Huff analysis is misplaced. Key to the appropriate analysis here is the fact that various statutory provisions and the rules under them, including Section 15(c)(3) of the Exchange Act and Rule 15c3-3 thereunder, by their terms run against broker-dealers only, with the result that associated persons whose conduct actually results in violations can only be found to have aided and abetted those violations. At least where, as here, the aiding and abetting allegation and finding are of that nature, it would be hypertechnical to treat them differently, for purposes of Sections 15(b)(4)(E) and 15(b)(6), than an allegation and finding of violation of the same substantive provisions. Under those circumstances, the only reasonable construction of those sections is to treat aiding and abetting as synonymous with violation.

III. PUBLIC INTEREST

The remaining issue concerns the remedial sanction, if any, to be imposed on Upton. The Division asks that I impose a sanction that "meaningfully" suspends him from association with a broker or dealer in a supervisory capacity. (Proposed Findings of Fact and Conclusions of Law at 38). Upton, on the other hand, contends that

the public interest would not be served by imposition of a sanction against him.

In support of its position, the Division urges that Upton's conduct reflects blatant disregard of one of the most significant investor protection rules over an extended period of time and exposed customers' funds to the risk that FiCS could go out of business without sufficient funds to protect customers. It further contends that there is no evidence that Upton recognizes the wrongful nature of his conduct and that his position as CFO of another firm presents the opportunity for similar misconduct.

Upton asserts that at most he was guilty of excusable neglect with respect to conduct "about which the Commission itself struggled for over 3 years." (Brief at 41). He contends that it has not been shown that a sanction is necessary to impress on him the seriousness of his supervisory obligations or to deter future conduct. Upton points out that because he was conservative in approaching determination of the amount to be "locked up" in the reserve account, he always insisted on locking up millions of dollars more than was required under the Accounting Department's computations. He stresses that in his long career in the securities industry, he has never been the subject of any other disciplinary action.

As found above, Upton was derelict in failing to note the consistent absence of customer bank loans from the reserve formula computations. Had he taken a more "hands-on" approach in relation to money management, he would certainly have learned of the paydown

practice. On the other hand, it is true that during the relevant period there was uncertainty concerning the circumstances under which the paydown practice violated Rule 15c3-3. My observation of Upton on the witness stand, and the testimony of an NYSE official who had dealt with him for many years, satisfy me that he is committed to compliance with applicable requirements and that, as a consequence of these proceedings, he will be more diligent about carrying out his supervisory responsibilities. Considering also his previously unblemished record, I conclude that a sanction of censure is appropriate in the public interest.13/

IV. ORDER

Accordingly, IT IS ORDERED that Kevin Upton is hereby censured.

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 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.

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

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, DC
May 18, 1993