ADMINISTRATIVE PROCEEDING
FILE NO. 3-5845

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of :

JAMES E. RYAN :

(National Securities Corporation)

:

INITIAL DECISION

Washington, D.C.
September 4, 1980

Max O. Regensteiner
Administrative Law Judge

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APPEARANCES: George N. Prince and Felice P. Congalton, of the Commission's Seattle Regional Office, for the Division of Enforcement.

C. Dean Little, of LeSourd, Patten, Fleming, Hartung & Emory, for James E. Ryan.

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"), the issues remaining for consideration are whether James E. Ryan engaged in misconduct as alleged by the Division of Enforcement and, if so, what if any remedial action is appropriate in the public interest. Ryan is vice-president of National Securities Corporation ("registrant"), a registered broker-dealer located in Seattle which is a member of the Spokane Stock Exchange and the National Association of Securities Dealers ("NASD").[1/]

As amplified in a "more definite statement," the Division alleged that in the sale of Nesco Mining Corporation common stock in October 1978, Ryan made material misrepresentations and failed to disclose material facts, in willful violation of certain antifraud provisions of the securities laws,[2/] and willfully violated registration provisions of the Securities Act of 1933.[3/] The Division further alleged that during the period beginning in October 1978 and ending March 1, 1979, in connection with the sale of Nesco stock and other mining stocks traded on the Spokane Stock Exchange or in the Spokane over-the-counter market, Ryan willfully violated those antifraud provisions by

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1/ Registrant was also named as a respondent in these proceedings. It submitted an offer of settlement which the Commission accepted.

2/ Section 17(a) of the Securities Act of 1933, Section 10(b) of the Exchange Act and Rule 10b-5 under the latter provision.

3/ Sections 5(a) and 5(c).

selling such stocks at prices which were not reasonably related to the market prices, without disclosing that fact. Finally, the Division charged Ryan with willfully aiding and abetting violations of Rule 17a-3 under the Exchange Act by failing to make memoranda of customer orders which showed the times when those orders were actually received.

Following hearings, the parties filed proposed findings and conclusions and supporting briefs, and the Division filed a reply brief.

The Respondent

Ryan, who is 56 years old and a graduate of the University of Pennsylvania's Wharton School, has been in the securities business since 1951. Immediately prior to his association with registrant, he was vice-president of Pennaluna & Co., which is headquartered in Wallace, Idaho, and is also a member of the Spokane Stock Exchange. Ryan was located in the firm's Coeur D'Alene, Idaho,office. On October 1, 1978, he joined registrant as vice-president.

Early in his career, Ryan became interested in "natural resource companies," particularly silver and other mining companies. By his account, he became an expert on the "general mining area" of the Western United States and the Coeur D'Alene area in particular. Ryan testified that his expertise, acquired through reading of all pertinent material, personal contacts, "snooping" (Tr. 725), etc., encompassed the mining geology, relevant economic factors and the particular

circumstances of the various mining companies. Some 120 publicly-owned companies hold mining claims in the Coeur D'Alene area. The trading market for those companies' stocks is centered in Spokane, where some are listed on the local stock exchange and others are traded in the over-the-counter market. For the most part, these companies have only mining claims and are not active producers; their stocks trade in the penny range.

Ryan, who described himself as "probably the best-known broker" in silver stocks in the country (Tr. 519), brought a large clientele with him to registrant. From the outset of his association with registrant, he has been the firm's largest producer. Within a short time after his arrival, Ryan had one outgoing and two incoming WATS lines. He testified that he received up to hundreds of calls a day. Many of these were from persons in California who had seen Ryan interviewed on television programs in Los Angeles and San Francisco. During the period under consideration here (October 1978 through February 1979, sometimes referred to hereafter as "the relevant period"), Ryan dealt almost exclusively in the low-priced mining stocks traded in the Spokane securities markets. All transactions were effected as principal transactions (on behalf of registrant, of course) through the "Ryan inventory account." The vast majority of his transactions were sales to retail customers of securities which he had purchased from Pennaluna.

Violations in Sale of Nesco Stock

The first transaction effected by Ryan after he joined registrant was the purchase, on October 4, 1978, of 75,000 shares of Nesco stock from Bruce R. McNett, Nesco's president, at 30¢ per share. On the following day, Ryan sold 30,000 of these shares to four customers for 40¢ a share. He sold the remaining 45,000 shares to seven customers at 45¢ per share a day later. As indicated above, the Division charges that in the offer and sale of these shares Ryan willfully violated antifraud and registration provisions of (and under) the securities laws.[4/]

Nesco, whose stock is registered on the Spokane Stock Exchange pursuant to Section 12(b) of the Exchange Act, at times here relevant owned or leased certain uranium and silver mining claims in the State of Washington. As of early 1978, however, it had been dormant for at least several years and its assets were negligible. In its annual report on Form 10-K for 1977, total assets were reported as $126,228, represented almost entirely by a flotation mill and by capitalized exploratory and development costs. Current assets consisted of cash in the amount of $32. Nesco had a retained earnings deficit of $199,319, and total stockholders' equity was $99,198. Total gross income for 1977 was $1,054, comprised of equipment rental and interest, as against expenses of more than $72,000, consisting

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4/ Alleged violations of the antifraud provisions resulting from the prices which Ryan charged customers are discussed below, beginning at page 16.

principally of charged-off exploratory and development costs. Since Nesco was unable to pay its bills, they were paid by McNett.

In February 1978, Ryan, who was then working for Pennaluna, purchased 14,000 shares of Nesco stock for his own account at 8¢ per share and 10,000 shares for his wife's account at 13¢ per share. The following month Nesco entered into a contract with an oil and gas company which at least on its face provided Nesco with the potential of sharing in the income from the other company's production as well as from possible operation of Nesco's uranium and silver claims. As discussed below, however, the agreement ultimately came to naught, and the potential was not realized. Apparently fueled by press reports concerning the anticipated and later the executed agreement, trading in Nesco stock became active and the price rose substantially.

Registration Requirements

No registration statement was filed with respect to the 75,000 shares of Nesco stock distributed by Ryan on October 5 and 6, 1978. Accordingly, the offer, sale and delivery of the shares, effected by use of the mails and the facilities of interstate commerce, violated Section 5 of the Securities Act unless an exemption was available. 5/

5/ The fact, noted by Ryan, that Nesco had once made a filing pursuant to Regulation A under the Securities Act and presumably made an offering of its securities thereunder is irrelevant. See Gearhart & Otis, Inc., 42 S.E.C. 1, 27 (1964), affd, 348 F.2d 798 (C.A.D.C., 1965): ("Neither registration itself nor ... an exemption therefrom ... attaches to the security. A subsequent offering of securities that have ... once been sold pursuant to some valid exemption ... must stand on its own feet. The sale to the public by a controlling person of a large block of securities previously exempted from registration entails all of the dangers incident to a new offering of securities to the public.")

McNett, as Nesco's president, was concededly a controlling person of that company.[6/] Under Section 2(11) of the Securities Act, which defines the term "underwriter," registrant, having purchased the 75,000 shares from an "issuer" (defined to include, for purposes of that section, a controlling person of the issuer) with a view to their distribution, was an underwriter. As such, it and Ryan were not covered by the exemptions from the Act's registration requirements provided by Section 4(1) or 4(3) of the Act.[7/] And the Section 4(4) exemption only extends to unsolicited brokers' transactions, whereas here Ryan's sales were solicited principal transactions.

Ryan claims that the transactions came within Rule 144 under the Securities Act. As here pertinent, that Rule permits controlling persons to sell limited amounts of stock without going through the registration process, provided all of the Rule's conditions are met. It does so by deeming such transactions not to constitute a distribution and therefore deeming a person selling the securities on behalf of a control person not to be an underwriter. McNett and Ryan attempted to avail themselves of Rule 144.[8/] But the basic condition that the securities be sold either in "brokers' transactions" or in transactions directly with a "market maker" was not met. Registrant acted as principal,

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6/ McNett also owned about 15 percent of Nesco's outstanding stock, apparently representing by far the largest single holding.

7/ See Quinn and Company, Inc. v. S.E.C., 452 F.2d 943, 946 (C.A. 10, 1971).

8/ McNett filed copies of Form 144, the "notice of proposed sale" required to be filed under the Rule, with the Commission and the Spokane Stock Exchange. He also delivered a copy to Ryan.

not as broker. And it (through Ryan) solicited orders to buy the Nesco shares, which is not permitted for "brokers' transactions." The "market maker" provision, which was added to the rule on the eve of the transactions under consideration,[9/] is also of no avail to Ryan because Ryan (or registrant) was not a market maker in Nesco stock at the relevant time, i.e. when he bought the 75,000 shares. Ryan contends that he was a market maker during the ensuing period, a claim which the Division disputes; but in any event under Rule 144 a broker-dealer may not initiate its market making with the Rule 144 transaction. Rather, it must have previously held itself out and must currently be holding itself out as being willing to buy and sell the security involved.[10/] That was not the case here.

Accordingly, I find that Ryan willfully violated Sections 5(a) and 5(c) of the Securities Act.[11/]

Antifraud Provisions

Three of the purchasers of Nesco stock from registrant through Ryan on October 5 or 6, 1978 testified at the hearings.

9/ Securities Act Release No. 5979 (September 19, 1978), 15 SEC Docket 1109. It may be noted that the Form 144 was dated September 15, 1978, thus preceding the market maker amendment.

10/ See Securities Act Release No. 6099 (August 2, 1979), 17 SEC Docket 1422, 1439 (Question 55).

11/ Wilfulness does not require an intent to violate the law, or even, as Ryan contends, a realization by the respondent that he is doing a wrong act. As the Commission recently stated in a Section 5 context, citing Tager v. S.E.C., 344 F.2d 5, 8 (C.A. 2, 1965), it is sufficient if the respondent intends to commit the act which constitutes the violation. First Pittsburgh Securities Corporation, Securities Exchange Act Release No. 16897 (June 16, 1980), 20 SEC Docket 401, 403, n. 10.

Mr. A., a mortgage banker, who bought 10,000 shares at 40¢ a share on October 5, had bought mining stocks through Ryan earlier in 1978 when Ryan was working for Pennaluna. In October 1978, he wanted to invest additional funds. He called Ryan and asked him to recommend a stock. On Ryan's recommendation, he made the Nesco purchase. Ryan told him that Nesco was "involved in mining, oil, natural gas, and that it had a good potential for appreciation" or words to that effect. (Tr. 112-3) According to Mr. A., Ryan gave him no negative information about Nesco other than the fact that the stock, like the others Mr. A. had bought, was speculative in nature.

Mr. T., a retired businessman, had bought 10,000 shares of Nesco stock at 20¢ a share in March 1978 upon Ryan's recommendation. On October 6, he bought an additional 10,000 shares at 45¢ per share, as a result of a call from Ryan in which the latter stated that Nesco was "going to move" and was a "good buy" and that "it" would be a "good deal" even if Mr. T. had to borrow the money to pay for the stock. (Tr. 351) Mr. T. could not recall having been given any information of an unfavorable nature about Nesco.

Mr. S., who manages an apartment building and is in the carpet cleaning business, had invested in silver mining companies with claims in the Coeur D'Alene area. Following an inquiry by Mr. S. to the Spokane Stock Exchange and/or Pennaluna, his name was referred to Ryan who contacted him on October 6, 1978. The result of their initial conversation was that Mr. S. purchased

10,000 shares of Nesco stock at 45¢ per share. Mr. S. recorded his first conversation with Ryan, and he and his wife recorded some subsequent conversations with Ryan.[12/] In the initial conversation, following a discussion of other mining company securities, Ryan stated:

> Now also there's a little cheapy and write this one down and move on it immediately. There's a little cheapy listed on the Exchange called Nesco, N E S C O .... We don't normally buy any of the cheap stuff unless there's some good reason to it. Now they're pretty heavy into oil and gas .... Besides silver and uranium .... Now, get on, if you do anything, get onto that Nesco right away. In fact, I would suggest you pick up at least 5 or 10,000 shares at the current prices .... If you want to do it before Monday [the conversation was on a Friday afternoon] get back to me right away .... because it's a tremendous buy and there's news coming on it. (Div. Ex. D-34)

The Division contends that Ryan's recommendations of Nesco stock and his representations concerning it were materially misleading and did not have an adequate basis grounded in a reasonable investigation. Such an investigation, the Division asserts, would have revealed that Nesco was nothing more than a corporate shell and, contrary to Ryan's statements, did not have a "vested interest" in any oil and gas production. The Division further maintains that Ryan's failure to disclose to his customers that he had just acquired the Nesco stock from the company's president with whom he had collaborated in preparing a recent false and misleading public announcement (discussed below) stimulating the market for the stock, was fraudulent. Ryan, on

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12/ At the hearings I overruled Ryan's objection to the admission of the tape recordings (which were made without Ryan's knowledge) and transcripts of their contents. His renewed motion to exclude these exhibits is denied. See p. 25 , infra.

the other hand, denies that he made any misstatements or omissions of material facts.

Resolution of some of the issues thus raised necessitates a closer look at Nesco's relationship with the oil and gas company to which reference has been made, as well as at the nature of the information which Ryan had concerning that relationship. On March 31, 1978, Nesco entered into an agreement with Milan R. Ayers and Thornton Dewey, who held certain oil and gas leases in Montana. Under the agreement's terms, Ayers and Dewey, whose partnership was known as Milan R. Ayers Oil & Gas Company, were to drill eight core holes to a specified depth on Nesco's uranium claims by the end of 1978. Upon completion of the drilling program, they were to assign a two percent "carried working interest" in specified oil and gas leases to Nesco. In return, Nesco was to assign to them part of its interest in the uranium claims, to designate them as "operator" of certain "silver claims," and to issue 500,000 shares of Nesco common stock to them.[13/] Drilling on the uranium claims began in the summer of 1978, but due to an equipment mishap and inclement weather, operations were suspended in November 1978. At that point, only one hole had been drilled and a second apparently had been partially drilled. Thus, the precondition to the exchange of the various interests between the parties was not fulfilled. McNett was of the view that the parties had agreed on an amendment to the contract under which the drilling deadline was extended for a year

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13/ At that time, 7.5 million shares were outstanding.

and the oil and gas interests were to be assigned to Nesco retroactive to March 31, 1978. The other side, however, disputed McNett's interpretation. And, as McNett acknowledged, the fact is that the oil and gas interests were never assigned to Nesco. Ryan's assertion that the Division failed to establish that fact is unwarranted.[14/] Also unfounded is his claim that in an injunctive action which the Commission brought against Nesco, McNett, Ayers and Dewey,[15/] it failed to establish that as of September 22, 1978, when Nesco issued a shareholder letter that was alleged to be misleading, Nesco had not already received an interest in the oil and gas leases. To the contrary, in a decision rendered in August 1979, the Court found that McNett, in issuing the letter which stated that Nesco already had such interest, had misled the public.[16/]

It follows from the above that when Ryan told Mr. S. that Nesco was "pretty heavy into oil and gas" and advised Mr. A. that the company was "involved" in oil and natural gas, those statements were untrue or at least misleading.[17/] Ryan contends,

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14/ Pursuant to the holdings in Collins Securities Corp. v. S.E.C., 562 F.2d 820 (C.A.D.C., 1977) and Whitney v. S.E.C., 604 F.2d 676 (C.A.D.C., 1979), findings on the fraud charges herein are based on the clear and convincing standard of proof.

15/ U.S.D.C., E.D. Wash., No. C-79-31.

16/ The Court entered a preliminary injunction against Nesco and McNett requiring them to make full public disclosure of all material facts concerning the publicity generated by them with regard to the relationship between Nesco and Ayers-Dewey. Pursuant to the Court's order, McNett caused a letter to be published in a Spokane newspaper, and presumably in other newspapers as well, acknowledging that the shareholder letter was inaccurate in stating that Nesco had received an interest in the oil and gas production.

17/ Ryan's assertion that those statements did not amount to a representation that Nesco had a current interest in oil and gas production is without merit.

however, that he made a reasonable investigation into Nesco's relationship with Ayers-Dewey and had reasonable grounds for believing that Nesco had an existing interest in the oil and gas production.

Ryan admittedly never saw the March 31, 1978 contract. Such information as he had concerning Nesco's oil and gas interests came from the principals of the contracting parties and apparently from newspaper reports. Beginning even before the above contract was signed and continuing into the fall of 1978, articles appeared in mining and other publications which stated or indicated that Nesco already had an interest in the oil and gas leases. The record also includes a letter from Ayers to Ryan dated April 25, 1978 (Resp. Ex. R-20), in which Ayers referred to "the interest traded to Nesco." 18/ Most significantly, sometime in September 1978 Ryan met with McNett and Dewey in connection with the preparation of a letter from McNett to Nesco's shareholders. There is conflicting evidence as to whether Ryan actually drafted the letter, as claimed by McNett, or whether, as Ryan testified, he merely helped to edit some material. In either event, he was given or read information supplied by McNett and Dewey, which, as reflected in the letter, was to the effect that uranium drilling was under way, that a resumption of silver mining was planned the following year, and that:

> Earlier this year Nesco and Ayers Oil & Gas completed negotiations resulting in a merger of interests between the companies. Nesco Mining received a 2% carried interest in

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18/ Ayers enclosed articles pertaining to a "drilling program" involving Ayers-Dewey wells. The record does not indicate the background of this letter.

> any and all oil and gas production from the over 80,000 acres that were under lease to Ayers. This acreage is in the Sweet Grass Arch of northwest Montana, and is thought to be one of the most prolific gas production areas in northwestern Montana.
>
> Twenty-one commercial producing wells have been drilled to date, and eight more are contemplated in a package now being put together between Ayers-Nesco and American Quasar Petroleum Company. Additional drilling programs will be finalized as the year winds down.
>
> Because of what has happened to date and what is being contemplated in the near future, substantial income should start flowing into your company in 1979. (Div. Ex. D-30)

Under all the circumstances, Ryan cannot be deemed unreasonable in accepting as reliable the information he had been given by representatives of both parties to the March 31 contract that Nesco did have an interest in the Ayers-Dewey oil and gas production.[19/] It does not follow, however, that he met the obligation of fair dealing which rests on every securities salesman[20/] when he made his unqualified recommendations

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19/ As further support for his argument that he made a reasonable investigation of Nesco's relationship with Ayers-Dewey, Ryan states that before buying the 75,000 shares he checked with the Commission about its investigation of Nesco. Ryan testified that he called a staff attorney to inquire whether a Form 144 was on file and was told that it was. Further, referring to the fact that he had heard the Commission was "looking into" Nesco, Ryan asked whether the attorney (who was familiar with the matter) had any information indicating that purchasers might be harmed by buying Nesco stock and that Ryan should therefore not purchase the block. According to Ryan, the answer was in the negative. However, absent any indication regarding the status or focus of the investigation at the time, or whether the attorney was authorized to make any disclosures (see 17 CFR 203.2), the colloquy as recalled by Ryan did not provide an adequate basis for any representations concerning Nesco. During the hearings herein, Ryan's counsel acknowledged that he did not think that, in terms of Ryan's question whether there was "anything wrong" with Nesco, the staff attorney knew at that time that there was "anything wrong." (Tr. 768)

20/ See First Pittsburgh Securities Corporation, Securities Exchange Act Release No. 16897 (June 16, 1980), 20 SEC Docket 401.

of Nesco stock, particularly in the unrestrained and urgent form in which they were imparted to Mr. T. and Mr. S. It may well be that in the context of an issuer such as Nesco whose stock is in the penny range and whose prospects for success rest almost entirely on a recently concluded agreement, disclosure that its book value is negligible and that it has had no earnings in the past, matters of the type which are ordinarily of the first order of materiality, would not be material.[21/] However, the information in the shareholder letter of September 22 which, so far as the record shows, was the most detailed information that Ryan had concerning Nesco's current status, included no current financial data and was in far too general a form to provide an adequate basis for Ryan's recommendations. Yet Ryan made no disclosure regarding his lack of detailed information;[22/] on the contrary, he recommended the stock unqualifiedly. And his conduct was of a reckless or "knowing" nature and thus constituted the scienter which under Aaron v. S.E.C.[23/] appears to be requisite to a finding of violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder as

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21/ Accordingly, I do not make the adverse findings sought by the Division based on Ryan's failure to disclose those matters.

22/ In Hanly v. S.E.C., 415 F.2d 589, 597 (C.A. 2, 1969), the Court stated:
> In summary, the standards ... are strict. [A salesman] cannot recommend a security unless there is an adequate and reasonable basis for such recommendation.... By his recommendation he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation. Where the salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information.

23/ U.S. , 48 U.S.L.W. 4609 (June 2, 1980).

well as Section 17(a)(1) of the Securities Act.[24/] Accordingly, I find that Ryan willfully violated those provisions as well as Sections 17(a)(2) and (3).[25/]

However, I find no basis for making the further fraud findings sought by the Division based on Ryan's nondisclosure of the source of the Nesco stock which he sold or his role in preparing the shareholders' letter of September 22. Under the circumstances, I agree with Ryan's argument that these were not material omissions. The only case cited by the Division in support of its position, Lewelling v. First California Company,[26/] involved a "scheme to enable insiders to bail out of various corporations which were failing."[27/] In that context,

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24/ Aaron dealt with the need to prove scienter in injunctive actions under Section 10(b), Rule 10b-5 and Section 17(a). But there can be little doubt that the Supreme Court's holdings apply with equal, or possibly even greater force, to administrative proceedings. See Steadman v. S.E.C., 603 F.2d 1126 (C.A. 5, 1979), cert. granted __U.S.__.

The Court in Aaron,as had the Court in Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n. 12 (1976), left open the question whether scienter may include reckless behavior. Following Hochfelder, the Commission, citing decisions by courts of appeals of several circuits, took the position that reckless conduct can satisfy a scienter requirement. Nassar and Company, Inc., Securities Exchange Act Release No. 15347 (November 22, 1978), 16 SEC Docket 222, 226, aff'd without op., 600 F.2d 280 (C.A.D.C. 1979). See also S.E.C.v. Blatt, 583 F.2d 1325, 1334 (C.A. 5, 1978) ("knowing" conduct satisfies scienter requirement); Nelson v. Serwold, 576 F.2d 1332, 1336-7 (C.A. 9, 1978) ("knowing" or "reckless" conduct sufficient); S.E.C. v. Falstaff Brewing Co., (C.A.D.C., May 29, 1980) CCH Fed. Sec. L. Rep. §97,505 (not necessary to show that defendant believed his actions to be illegal; sufficient if he had knowledge of what he was doing and the consequences of his actions); Mansbach v. Prescott, Bell & Turben, 598 F.2d 1017, 1023 (C.A. 6, 1979) (recklessness sufficient for scienter).

25/ As the Commission recently noted in the First Pittsburgh case, supra, n. 20, a finding of scienter carries with it a finding of willfulness.

26/ 564 F.2d 1277 (C.A. 9, 1977).

27/ Id. at 1278.

the trial court's conclusion that the failure of a brokerage firm to disclose the "bail-outs" to a customer was a material omission was held not to be clearly erroneous.[28/] Here, there is no evidence of a "bail-out" by McNett. He testified that he sold the 75,000 shares, which represented a small percentage of his total holdings, simply because he needed money. I have no reason not to credit that testimony.

The Division's argument regarding disclosure of Ryan's role in the publicity concerning Nesco, i.e., the shareholder letter, appears to be that McNett and Ryan sought to stimulate the market for Nesco stock in anticipation of the distribution of the 75,000-share block, and that Ryan's customers were entitled to know this. However, the evidence is not clear that at the time Ryan participated in preparing the shareholder letter or even at the time it was distributed, McNett had raised with Ryan the subject of selling the 75,000 shares.[29/]

Excessive Markups

Ryan based the prices at which he sold securities to customers on the asked quotations as published by the Spokane Stock Exchange for both listed and over-the-counter securities,[30/] or

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28/ See also The S.T. Jackson & Co., Inc., 36 S.E.C. 631, 655 (1950). Cf. James D. Lang, Jr., Securities Exchange Act Release No. 12607 (July 7, 1976), 9 SEC Docket 1051, 1052.

29/ The Division does not appear to claim that the letter was used by Ryan as sales literature. At any rate, the record would not support such a claim.

30/ It appears that the quotations, published once a day, reflect the highest bid and lowest asked quotations submitted by Exchange members.

on current asked quotations obtained directly from other dealers. On this basis, the retail prices, which were at or close to the published asked quotations,[31] would have been reasonable. The Division maintains, however, that the base from which markups should be computed is Ryan's contemporaneous cost or the price in contemporaneous transactions between other dealers. Computed on this basis, markups in a majority of Ryan's transactions were excessive. Concededly, Ryan made no disclosure of his costs or of prices in other interdealer transactions. The Division's argument is consistent with the long-established Commission position that, in the absence of countervailing evidence, a dealer's contemporaneous cost is the best evidence of current market price.[32] On the other hand, Ryan's elaborate analysis in support of his pricing practice, which he sought to buttress with expert testimony, does not reflect the actual nature of his business during the relevant period and runs directly counter to the Commission's decisions.[33]

During the relevant period, Ryan made 316 sales to customers. The Division prepared and introduced into evidence a schedule

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31/ The record does not reflect the quotations obtained from other dealers.

32/ See First Pittsburgh Securities Corporation, Securities Exchange Act Release No. 16897 (June 16, 1980), 20 SEC Docket 401, and cases cited in n. 22.

33/ Ryan dismisses those decisions as merely raising a presumption. (Brief p. 78).

(Ex. D-54) computing markups for 249 of those transactions.[34/] A "markup basis price" was selected for each of those transactions. Same-day cost or same-day interdealer prices were used to the extent available, with the highest price (and lowest resulting markup) being selected if several prices were available. In the absence of same-day data, previous-day data was used. In a few instances, data from the second previous business day was used, but only where there was no change in published quotations. Based on these calculations, markups (i.e., the spread between the markup basis price and the price charged customers) in 179 transactions exceeded 10 percent; those in 97 transactions exceeded 15 percent; and those in 56 transactions exceeded 20 percent.

Ryan has not suggested any flaws in the Division's computations.[35/] Rather, he urges, as noted, that it is the asked quotations, and not contemporaneous cost, which are the best evidence of the "inside" market. That this was not the case here, however, is demonstrated by the fact that Ryan was generally

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34/ Markups were not calculated for (1) certain transactions as to which there was no contemporaneous purchase by Ryan or other interdealer transaction and (2) transactions where Ryan made short sales which he covered the following day.

35/ There may be some minor flaws. For example, the reports of interdealer transactions in listed securities which appear in the records of the Spokane Stock Exchange (See Div. Ex. D-11) and are published by it (See Resp. Ex. R-50) as of or for a certain day frequently reflect transactions effected on the preceding business day, after the close of the Exchange, and not reported to the Exchange until the next day. Even if adjustments were made in the markup calculations to compensate for this fact, however, the effect would be at best insignificant.

With respect to the use of other than same-day data, the Commission has held that "contemporaneous cost" is not limited to same-day cost, but includes prices paid in transactions "closely related in time" to sales. First Pittsburgh Securities Corporation, supra, 20 SEC Docket at 406.

able to buy securities from Pennaluna, its almost exclusive supplier, at prices much closer to the quoted bids than to the asked quotations. While a pattern of buying at or near the bid market would be normal for a market maker, Ryan's claim that registrant was a market maker in various securities is not supported by the record. Ryan testified that during the relevant period he submitted quotations to the Spokane Exchange through Pennaluna, but the record includes no detailed evidence in support of this general statement. And, as the Division points out, his trading pattern was of a nature inconsistent with market maker status. He had almost no transactions with broker-dealers other than Pennaluna. He purchased securities from Pennaluna either in anticipation of or (as found in the next section of this decision) offsetting retail orders and in most instances promptly resold to Pennaluna the securities he bought from customers. Moreover, registrant's executive vice-president and compliance officer testified that registrant was not a market maker in any securities listed on the Spokane Exchange or traded in the Spokane over-the-counter market during the relevant period.

Under the circumstances, the Commission's observation in the First Pittsburgh case regarding the use of asked quotations as evidence of market price applies here with equal force: "Since registrant was not a marketmaker in the securities at issue, it is clear that the asked quotations were regularly subject to negotiation, and therefore not a reliable guide to

the prevailing market price."[36/]

Ryan's concern that basing markups on cost makes no allowance for the risk which he assumed in maintaining positions in various securities is misplaced, since the use of a contemporaneous cost standard makes allowance for any increase in market price between the time he bought and the time he sold the securities. Moreover, as discussed in the next section of this decision, at least some of Ryan's transactions were in fact riskless.

As the Commission has held, markups of more than 10 percent are fraudulent even in the case of low-priced securities.[37/] Accordingly, I find that Ryan willfully violated the antifraud provisions previously designated.[38/]

Inaccurate Records

Rule 17a-3(a)(7) under the Exchange Act, as pertinent here, requires a registered broker-dealer, in connection with any principal transaction with a customer other than another broker-dealer, to make a memorandum of the customer's order which shows, among other things, the time when the order was received. The

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36/ 20 SEC Docket at 406. See also, e.g., Naftalin & Co., Inc., 41 S.E.C. 823 (1964).

37/ See J.A. Winston & Co., Inc., 42 S.E.C. 62, 69; First Pittsburgh Securities Corporation, supra, 20 SEC Docket at 406.

38/ Because Ryan must have realized the consistently large disparity between what he paid for securities and what he charged customers, I find that he had the scienter requisite to findings of violations of Section 10(b) of the Exchange Act, Rule 10b-5 thereunder and Section 17(a)(1) of the Securities Act. However, my findings are also made under Sections 17(a)(2) and (3), under which scienter is not required.

Division alleges that, in contravention of this requirement, Ryan engaged in a systematic falsification of registrant's records as to dates and times when customers' orders were actually received. He did so, it is claimed, by not filling out or timestamping the order tickets in many instances until the following business day. The Division further asserts that in these instances Ryan, after receipt of the customer's order, made an offsetting purchase from Pennaluna which was promptly recorded, and that, as a result, registrant's records reflected the sale and offsetting purchase in reverse from the actual sequence. According to the Division, the apparent purpose of the alleged scheme was to make riskless transactions look like risk transactions and to conceal their actual nature from registrant's compliance personnel who reviewed only one day's tickets at a time.

Ryan acknowledges that on occasion order tickets filled out on one day were not stamped until the following day. But he attributes this to laxity in registrant's procedures during his early weeks with the firm and to the volume of his business. Ryan denied that he ever intentionally held a customer's order to the next business day before stamping it as received. And the woman who became his secretary in late October 1978 and whose responsibilities included the stamping of order tickets testified that because of work pressure the tickets were not always stamped immediately following receipt of customers'

orders, but further testified that Ryan never instructed her to hold an order without stamping it and that she never saw Ryan do so himself.

It is apparent from the above that the focus of the parties' arguments is not on whether there were any violations of the Rule. As discussed more fully below, the record establishes a number of violations. And, as has been indicated, Ryan, while seeking to shift the blame to others, does not dispute that violations occurred. The parties disagree vehemently, however, as to the extent of the violations and whether they were deliberate or merely reflective of lax office procedures. These issues have an obvious bearing on the determination of the appropriate sanction.

In support of its position of systematic record falsification, the Division relies on the following evidence:

1. Mr. A. placed orders for the purchase of six different securities with Ryan on the morning of Friday, November 3, 1978.[39/] In the case of two of the securities, which Ryan then had in inventory, the transactions were confirmed with a trade date of November 3.[40/] As to the other securities, which Ryan either did not have in inventory at all when the orders were placed or not in sufficient quantity to fill the orders, Ryan purchased such securities from Pennaluna later that morning.

39/ The exact time of the conversation was fixed by a record of the telephone company. (Div. Ex. D-37)

40/ Under registrant's recordkeeping system, the trade date on a confirmation was based on the date of the time stamp on the order ticket.

The order tickets for the sale of those securities to Mr. A. were not timestamped until early on Monday, November 6, and his purchases were confirmed with that as the trade date. No explanation has been offered to rebut the inference, arising from the disparity in the manner in which the customer's orders were handled, that, for whatever reason, the processing of the orders for those securities which Ryan did not have in inventory was deliberately delayed until after he had made offsetting purchases.

Similarly, customers B., C. and W. each ordered securities from Ryan on a certain (not the same) day; that day Ryan purchased those securities in the quantities ordered or in larger quantities from Pennaluna; and the customers' order tickets were not timestamped until the following business day, which was also the trade date reflected on the confirmations.[41/]

2. In several other instances relating to customers who did not testify, the record shows a telephone call from Ryan to the customer on one day, mostly in the morning, a purchase by Ryan from Pennaluna (claimed by the Division to be an "offsetting" purchase) of certain securities later on that day and a time stamp and confirmation date for the customer's purchase of those securities on the next business day. Although in these instances there is no direct evidence of the date

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41/ As to those transactions where the record does not directly reflect the timestamp date, the confirmation dates were those of the next date.

each customer placed his order or orders, the sequence of transactions combined with evidence of the telephone calls warrants the inference that the customers placed their orders during those conversations, and that the order tickets were not timestamped until the following day.

3. Finally, the Division points to a large number of instances during October and November 1978 where, according to registrant's records as reflected in Division Exhibit D-55, Ryan purchased various securities from Pennaluna on one day, sometimes in "unusual" amounts, and sold the same amount to a customer or customers on the next business day. The Division maintains that these were in fact riskless transactions in which Ryan had the customer's order first and then made an offsetting purchase from Pennaluna. It would follow, of course, that the order tickets for the customer purchases were not made out or at least were not stamped on a timely basis. Absent further evidence as to the dates when customers' orders were received, however, there is not in my view an adequate evidentiary basis in these instances for drawing the inference that the sequence of the transactions was in fact the reverse of that reflected on registrant's records.

The fact remains that there were numerous violations of Rule 17a-3(a)(7), at least some of which were of a deliberate nature. Even as to those which may have been attributable to lax office procedures, Ryan, as the salesman who took customers' orders, had the primary responsibility for seeing to it that the times when he received those orders were duly recorded. Accordingly, I find that Ryan willfully aided and abetted the above violations.

Admission of Tape Recordings

Ryan has renewed his objection to the admission into evidence of the tape recordings (and transcripts of their contents) of telephone conversations between Ryan and Mr. S. or Mrs. S., which were made without Ryan's knowledge. (Division exhibits D-34 and D-35) He relies principally on a statute enacted in 1968 (the Omnibus Crime Control and Safe Streets Act of 1968, 18 U.S.C. §§2510 et seq.) which created a comprehensive scheme regulating the interception of oral and wire communications.[42/] One of the exceptions to the Act's general prohibition on the interception of such communications is found in 18 U.S.C. §2511(2)(d), which reads as follows:

> It shall not be unlawful under this chapter for a person not acting under color of law to intercept a wire or oral communication where such person is a party to the communication or where one of the parties to the communication has given prior consent to such interception unless such communication is intercepted for the purpose of committing any criminal or tortious act in violation of the Constitution or laws of the United States or of any State or for the purpose of committing any other injurious act.

42/ The Act "attempts to strike a delicate balance between the need to protect persons from unwarranted electronic surveillance and the preservation of law enforcement tools needed to fight organized crime." United States v. Phillips, 540 F.2d 319 (C.A. 8), cert. denied 429 U.S. 1000 (1976).

Ryan also relies on (1) the law of California (where the recordings were made) making it a crime to intentionally record confidential communications without the consent of all parties and making such recordings inadmissible as evidence, and (2) cases dealing with the exclusion of evidence obtained in violation of the Fourth Amendment to the Constitution. However, lawfulness of the recordings under state law does not govern their admissibility in a federal proceeding. United States v. Armocida, 515 F.2d 49, 52 (C.A. 3, 1975); United States v. Horton, 601 F.2d 319, 323 (C.A. 7, 1979). As to the Constitutional argument, aside from the fact that the exclusionary rule does not apply where a private party commits the offending act (Burdeau v. McDowell, 256 U.S. 465 (1921); United States v. Janis, 428 U.S. 433, 456 (1976)),the recording of conversations by one of the parties to them did not violate Ryan's constitutional rights. See United States v. White, 401 U.S. 745 (1971); Meredith v. Gavin, 446 F.2d 794, 797 (C.A. 8, 1971).

Ryan urges that the recordings here come within the "unless" clause of that provision in that they were made (1) in violation of California law pertaining to the recording of conversations and (2) for the purpose of injuring Ryan by turning them over to the Commission if Mr. and Mrs. S. lost money on their investment These contentions are without merit.

Assuming that the recordings were made in violation of state law, that did not bring the "unless" clause into play. The plain words of the Section indicate that it is not the recording or interception itself which is referred to as the "criminal or tortious act," but the purpose of the interception. This view is supported by the provision's legislative history which indicates that the "unless" clause was added as an amendment to the original bill in order to meet the objection that without it the "surreptitious monitoring" of a conversation by a party to the conversation would be permitted, even though done "for insidious purposes such as blackmail, stealing business secrets, or other criminal or tortious acts in violation of Federal or State laws." 43/

Further, Ryan has not sustained the burden of proving that the recordings were made for the purpose of committing an "injurious act." 44/ The only light cast on the meaning of

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43/ 2 U.S. Code Cong. & Adm. News, 90 Cong., 2d Sess. 2236 (1968). See Meredith v. Gavin, supra.

44/ For the proposition that the party against whom a recording is offered has the burden of proving that it falls within the "unless" clause, see United States v. Phillips, supra, n. 42.

that phrase is a statement by Senator Hart, in discussing a proposed amendment to the legislation which added the "unless" clause. As here pertinent, the Senator referred to the purpose of prohibiting a "one-party consent tap," except for law enforcement officials and private persons "who act in a defensive fashion." 45/ He went on to state:

> Whenever a private person acts in such situations with an unlawful motive, he will violate the criminal provisions of Title III and will also be subject to a civil suit. Such one-party consent is also prohibited when the party acts in any way with an intent to injure the other party to the conversation in any other way. For example the secret consensual recording may be made for the purpose of blackmailing the other party, threatening him or publicly embarassing him. The provision would not, however, prohibit such activity when the party records information of criminal activity by the other party with the purpose of taking such information to the police as evidence. Nor does it prohibit such recording in other situations when the party acts out of legitimate desire to protect himself and his own conversations from later distortions or other unlawful or injurious uses by the other party. 46/

There is nothing in the record here which remotely suggests an intent to injure in the sense reflected in the above passage. The record indicates that Mr. S. recorded the conversations principally to preserve the information given him by Ryan, which related to a number of different stocks, as well as to make that information available to his business associate who was also interested in investing in mining stocks and who in fact purchased Nesco stock after listening to the tape of the original conversation between Ryan and Mr. S. There is nothing in the record to

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45/ This is quoted in United States v. Phillips, supra, at p. 325.

46/ Quoted in United States v. Phillips, supra, at p. 325.

indicate that Mr. S. planned to use the recordings against Ryan when he made them. That he turned them over to Commission staff members subsequently, when the price of Nesco stock was far below what he had paid for it, does not bear on his original purpose.

As recently stated by the Court of Appeals for the Ninth Circuit,[47/] Congress could not have intended the term "injurious act" to encompass every act which disadvantages the other party to the communication. Such a reading, the Court noted, would in effect nullify the exception created by Section 2511(2)(d).

Public Interest

The Division urges that it is in the public interest to bar Ryan from association with any broker-dealer. It contends, first of all, that all the violations were of a serious nature. In this connection it argues, among other things, that Ryan used high-pressure tactics in the sale of the 75,000 Nesco shares, that he took advantage of customers' ignorance of market prices in selling stock to them at excessive prices, and that the registration and recordkeeping violations also contributed to Ryan's scheme to defraud. In addition, the Division claims that Ryan's testimony and demeanor demonstrate

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47/ Moore v. Telefon Communications Corp., 589 F.2d 959 (1978).

character deficiencies, particularly those portions of his testimony in which he described his professional qualifications in glowing terms. The Division also asserts that Ryan's testimony was inconsistent in various respects. And it maintains that nothing in the record suggests that he will comply in the future with applicable requirements. Finally, it points to disciplinary action previously taken against Ryan by the NASD.

Ryan, on the other hand, maintains that no case has been made for the imposition of any sanctions and certainly not any drastic sanctions. He asserts that any violations he may have committed were at most of a technical nature and not intentional or willful. He further claims that when deficiencies were pointed out by staff members, such as in the timestamping area, registrant and he took prompt action to remedy them, and that they have sought in every way to cooperate with the staff. Ryan also asserts that his misconduct was no more culpable than that of registrant, which received only a mild sanction.

Ryan's last-noted argument can be readily put to one side. As the principal actor in the violations which have been found, his culpability is indeed greater than that of registrant. But in any event, the sanction imposed on registrant was based on a settlement offer which the Commission deemed it appropriate to accept, while the determination of a sanction as to Ryan is based on an evidentiary record.[48/]

As reflected in preceding sections of this decision, I was unable to find sufficient record support or a legal basis

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48/ See Cortlandt Investing Corporation, 44 S.E.C. 45, 54 (1969).

for some of the most serious of the Division's allegations in the contexts of Ryan's fraud in the sale of Nesco stock and the recordkeeping violations. Under the circumstances, the extreme sanction sought by the Division would not be justified. The violations that I have found, including the somewhat high-pressure recommendations of Nesco stock without an adequate basis and the sales of various stocks at consistently excessive prices, are nevertheless of a serious and not merely of a technical nature.

The Division perceives Ryan's glowing endorsements in his testimony of his own qualifications and reputation, together with unspecified aspects of his demeanor on the witness stand, as reflecting adversely on his character. None of his statements of a factual nature has been shown to be untrue. The more subjective statements smack of at least some degree of hyperbole. My observation of Ryan's demeanor, and the content of his testimony, leave me with the impression that he tends to be somewhat arrogant and self-righteous in his dealings with others, whether they be subordinates, customers or other persons. This aspect of his character, considered together with his past conduct, raises concerns regarding the degree of commitment to future compliance with regulatory requirements which can be reasonably anticipated. However, I believe that the inevitable impact of this proceeding and the substantial sanction being imposed will impress upon Ryan the need for scrupulous propriety in all aspects of his securities activities. Everything considered, it is my conclusion that a three-month suspension of Ryan from association with a

broker or dealer is appropriate in the public interest.[49/]

Accordingly, IT IS ORDERED that James E. Ryan is hereby suspended from association with a broker or dealer for a period of three months.[50/]

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.

Max O. Regensteiner
Administrative Law Judge

Washington, D.C.
September 4, 1980

49/ In the NASD action referred to by the Division, Ryan was censured and fined $250 in 1975 for (1) preparing and using an advertisement without thereafter filing it with the association's advertising department, and (2) preparing and transmitting to members of the public two letters concerning tax shelters which were of a misleading nature.

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