

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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In the Matter of :  
:   
LESLIE A. AROUH : INITIAL DECISION  
: October 21, 2003

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APPEARANCES: William P. Hicks and John G. Westrick for the  
Division of Enforcement, Securities and Exchange Commission

Ira Lee Sorkin and Donald A. Corbett of Carter, Ledyard & Milburn LLP  
for Respondent Leslie A. Arouh

BEFORE: Carol Fox Foelak, Administrative Law Judge

### SUMMARY

This Initial Decision sanctions Leslie A. Arouh, a corporate bond salesman at a broker-dealer, for his role in a program trade in which an investment adviser sold the broker-dealer a group of bonds from one group of accounts, repurchased the bonds at lower prices into another group of accounts, and purchased additional bonds at prices intended to make up the broker-dealer's loss on the repurchase. The Initial Decision concludes that Arouh violated the antifraud provisions of the securities laws, fines him \$330,000, and suspends him from association with a broker-dealer for ninety days.

### I. INTRODUCTION

#### A. Procedural Background

The Securities and Exchange Commission (Commission) initiated this proceeding by an Order Instituting Proceedings (OIP) on September 3, 2002, pursuant to Section 8A of the Securities Act of 1933 (Securities Act) and Sections 15(b)(6) and 21C of the Securities Exchange Act of 1934 (Exchange Act).

The undersigned held a seven-day hearing in Miami, Florida, on March 17-21, 24-25, 2003. The Division of Enforcement (Division) called eleven witnesses from whom testimony was taken, including Respondent Leslie A. Arouh (Arouh). Arouh also testified in his case-in-

chief and called three additional witnesses from whom testimony was taken. Sixty-six exhibits were admitted into evidence, of which fifty-three were offered by the Division, and thirteen, by Arouh.<sup>1</sup>

The findings and conclusions in this Initial Decision are based on the record. Preponderance of the evidence was applied as the standard of proof. See Steadman v. SEC, 450 U.S. 91, 97-104 (1981). Pursuant to the Administrative Procedure Act, 5 U.S.C. § 557(c), the following posthearing pleadings were considered: (1) the Division's July 21, 2003, Proposed Findings of Fact and Conclusions of Law and Brief in support thereof; (2) Respondent's July 21, 2003, Posthearing Brief; (3) the Division's August 8, 2003, reply brief; and (4) Respondent's August 11, 2003, reply brief. All arguments and proposed findings and conclusions that are inconsistent with this Initial Decision were considered and rejected.

### **B. Allegations and Arguments of the Parties**

The OIP alleges that, in March and April 1998, Arouh, a registered representative associated with a broker-dealer, First Union Capital Markets Corp. (First Union), planned and transacted a series of adjusted trades in investment-grade corporate bonds with a portfolio manager associated with an investment adviser, ARM Capital Advisors LLC (ARM). The OIP describes adjusted trading as a fraudulent practice between two parties in which a purchase above the prevailing market price is offset by the sale of a second security above the prevailing market price. Thus, the OIP alleges, Arouh willfully violated antifraud provisions of the securities laws – Securities Act Section 17(a) and Exchange Act Section 10(b) and Rule 10b-5.

Arouh argues that First Union's head corporate bond trader was responsible for pricing the bonds and approving the trades, and that this trader orchestrated the scheme as an opportunity to unload stale First Union and other bonds in his inventory in line with the wishes of higher management. Thus, Arouh argues, the trader, not he, was responsible for any alleged violations.

The Division requests that Arouh be barred from association with any broker-dealer and be ordered to pay a civil penalty of \$2,530,000. Arouh requests that the proceeding be dismissed. In the alternative, Arouh argues that the sanctions that the Division seeks are too severe in light of the facts.

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<sup>1</sup> Citations to the transcript will be noted as "Tr. \_\_\_." The Division's exhibits are numbered, and Respondent's are identified alphabetically. Citations to exhibits will be noted as "Ex. \_\_\_."

## II. FINDINGS OF FACT

### A. Respondent and Related Entities

#### 1. Leslie A. Arouh

Arouh was born in 1953. Tr. 1403. He left college to work in his father's meat market and later owned an apparel business in the New York City area. Tr. 1404-05. He moved to Florida fifteen years ago and worked at various occupations; he entered the securities industry in 1994 at Meridian Bank. Tr. 1405-06. He soon became a star salesman of fixed income products, specifically investment-grade corporate bonds. He started at First Union in December 1997 in Charlotte, North Carolina. Tr. 152-53, 1412. He was First Union's best bond salesman. Tr. 823-24. First Union fired Arouh on May 6, 1998, as a result of the events in question. Tr. 151, 388, 1572; Ex. 19. Since late 1998, Arouh has worked as an institutional bond salesman at Raymond James, a broker-dealer. Tr. 151, 1572. There, he services some of the same accounts that he had at First Union, including ARM. Tr. 1242. He is one of the highest producing salesmen in his present office. Tr. 1242-43.

#### 2. First Union

First Union was, and is, a broker-dealer headquartered in Charlotte, North Carolina.<sup>2</sup> Owen Williams (Williams) was the head of its fixed income department, overseeing both sales and trading. Tr. 157. Arouh's supervisor, William Miles, reported to Williams, as did Keith Mauney (Mauney). Tr. 157, 640, 1431.

Mauney was First Union's head corporate bond trader. Tr. 165, 1419. After graduating from college, playing professional football, and earning an M.B.A., he commenced a career in the securities industry in 1974, when he joined Smith Barney and began trading bonds. Tr. 619-24. He joined First Union in March 1997. Tr. 624. His son committed suicide on February 26, 1998, shortly before the events at issue. Tr. 708. As a result of Mauney's involvement in the events at issue, First Union suspended him for one month, suspended his supervisory capacity for nine months, fined him, and required him to have training and counseling.<sup>3</sup> Tr. 708-09. According to First Union's director of compliance, First Union dealt leniently with Mauney because of his many years in the industry and with the firm without compliance problems and because his judgment may have been affected by his son's death. Tr. 1183. After the suspension, First Union reinstated him in his supervisory capacity as head corporate bond trader. Tr. 881. More recently, he moved to a non-supervisory role in underwriting; instead of trading

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<sup>2</sup> The broker-dealer is now known as Wachovia Securities, Inc. Tr. 972.

<sup>3</sup> As a result of the events in question, Mauney entered a settlement with the Commission by which he was ordered to cease and desist from further violations of the antifraud provisions. Keith J. Mauney, 78 SEC Docket 1232 (Sept. 3, 2002).

on a secondary basis, he is involved in underwriting and selling bonds brought to market; he deals with First Union's corporate bond sales force and with issuers. Tr. 619, 884.

As discussed below, Mauney's testimony as to certain facts is not entirely consistent with other, more credible evidence in the record, including the testimony of other First Union personnel. Because of this, the weight of Mauney's testimony on any disputed fact is lessened.

Scott Ilario (Ilario) was, and is, First Union's director of compliance. Tr. 971-74. He conducted an investigation into the transactions at issue at the behest of Williams; his view places responsibility on Arouh, in conjunction with ARM, and is protective of Mauney. Tr. 975-1204 passim. Brian Farrell (Farrell) was, and is, a bond salesman at First Union. Tr. 944. He worked with Arouh as partners, with Farrell as the junior partner; each had his own accounts and covered for the other when unavailable; they split their pooled commissions – 75% for Arouh and 25% for Farrell. Tr. 157-58, 902-03. Farrell was familiar with the transactions at issue but played no substantive role in negotiating or executing them.<sup>4</sup> Tr. 931-32. Essentially, his role was to pass information to Mauney or Arouh when one of them was unavailable. Tr. 931-32. When Arouh first described the transactions, Farrell was skeptical because Curtis Arledge, First Union's head mortgage bond trader, had rejected a similar program swap involving a group of mortgage bonds. Tr. 922-25.

### **3. ARM**

ARM was a registered investment adviser that had institutional accounts during the relevant period. Tr. 395, 914, 1000, 1213. During the time at issue, ARM employed Harvey Rubinstein as a portfolio manager.<sup>5</sup> Tr. 394. Rubinstein conceded that he cheated ARM customers and lied to Commission employees during the investigation of the events at issue. Tr. 496-501. He testified in this proceeding under a grant of immunity from criminal prosecution. Tr. 391-92, 501-02.

ARM was Arouh's largest account. Tr. 904, 1416. Arouh dealt with several portfolio managers at ARM, including Rubinstein. Tr. 1416-17. Rubinstein accounted for about 10% of Arouh's total business. Tr. 1417.

#### **B. Bond Trading**

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<sup>4</sup> Nonetheless, First Union considered that Farrell should have informed management or compliance of irregularities of which he knew; First Union suspended him for one week, imposed heightened supervision, and required him to have compliance training. Ex. 28.

<sup>5</sup> ARM, now known as Vanderbilt Capital Advisers LLC, and Rubinstein settled charges arising out of the events at issue. See Vanderbilt Capital Advisers LLC, 78 SEC Docket 1346 (Sept. 3, 2002) (ordering a censure, a \$125,000 fine, and undertakings); Harvey I. Rubinstein, 78 SEC Docket 1236 (Sept. 3, 2002) (barring him from association with an investment adviser, fining him \$25,000, and ordering him to cease and desist from violations of the antifraud provisions).

The bond trading market is over-the-counter, and trading is conducted primarily by telephone. Tr. 1263; Ex. 3 at 4. There is little transparency in pricing corporate bonds; “market” rates are negotiated; and the price discovery process includes an element of judgment. Tr. 964, 1329; Ex. 3 at 4. There is no central repository of trade records to track at what price a bond is trading or has traded at a given time.<sup>6</sup> Tr. 659-65, 874-75, 964, 1007-08, 1263-64, 1329; Ex. 3 at 4. Rather, broker-dealers’ traders set the price at which their firms are willing to buy or sell a bond at any given time. Ex. 3 at 4. With many bonds, the price may vary from dealer to dealer. Ex. 3 at 4. An inter-dealer market brokers trades between the traders of the various dealers; a trader obtains information from the inter-dealer market as well as from transactions with his firm’s customers to inform his judgment on pricing. Tr. 1264, 1360. A portfolio manager, such as Rubinstein, would call a number of broker-dealers for such information. Tr. 1264. A salesman, such as Arouh, would rely on his trader and also obtain information on his own from his customers. Tr. 1264, 1362-63.

Bonds may be priced in terms of price (e.g., bid – 99 1/2, offer – 99 3/4) or yield (e.g., bid – 5.35%, offer – 5.30%).<sup>7</sup> Ex. 3 at 4. A corporate bond may be priced in terms of spread, expressed in basis points, from the yield of a U.S. Treasury security of comparable maturity.<sup>8</sup> Tr. 482-83, 1013, 1256; Ex. 3 at 4. For example, if the comparable U.S. Treasury security is yielding 4.40%, a spread of bid – 105, offer – 95, indicates a yield quote of 5.45% - 5.35%. Ex. 3 at 4. A higher spread indicates that the bond has more credit risk (that it may fail to make interest and principal payments on time) than a bond with a lower spread. Ex. 3 at 5. Quoting in spreads is convenient for a participant in the bond market because new quotes are not needed to reflect a change in the overall market level of interest rates if the market is changing rapidly. Ex. 3 at 4-5. The longer a bond’s term, the less effect on yield a change in its price will have. Tr. 467, 1030.

A salesman, such as Arouh, negotiates the price of a bond trade with the customer within levels set by the trader, in this case, Mauney. Tr. 159-62, 1033. The trader approves the ultimate price and decides whether the trade will be executed. Tr. 165-66, 1033-34, 1364. At First Union, these communications between salesman and trader were conducted either by telephone<sup>9</sup>

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<sup>6</sup> It took the Division’s expert in bond pricing more than 154 hours to price thirty-seven bonds. Tr. 1330-31.

<sup>7</sup> Since a bond has a fixed coupon payment, if its price rises, its yield decreases. Ex. 3 at 4, 10. The “bid” is the price a dealer is willing to pay to buy a bond, and the “offer” or “ask” is the price at which a dealer is willing to sell a bond. Ex. 3 at 4, 78.

<sup>8</sup> A basis point is 1/100 of 1% (.01%). Ex. 3 at 10, 78.

<sup>9</sup> As a matter of general practice, First Union tape-recorded telephone calls of traders and salesmen. Tr. 37-38, 75. During his investigation of the events in question, Ilario ordered excerpts from First Union’s taping system to be made of phone calls between Arouh’s, Farrell’s, and Mauney’s lines and ARM. Tr. 37-43, 57, 76-77, 1044. Exhibits 1A, 1B, and 1C are tapes of the excerpts; Exhibits 1A1, 1B1, and 1C1 are transcripts of Exhibits 1A, 1B, and 1C. In these exhibits, Mauney appears only as a third party in calls to or from Arouh’s or Farrell’s lines. Tr.

or by yelling across the room.<sup>10</sup> Tr. 56, 164-67. Mauney set the sales credit on which Arouh's commission for corporate bond trades was based; thus, he controlled part of Arouh's compensation. Tr. 159, 661, 875-76, 905-06. If Arouh obtained a better price than the level set by Mauney, the sales credit included that additional markup, if Mauney ultimately approved the trade for execution at that price. Tr. 659-61, 664. Arouh and Farrell's shared portion of the sales credits in their transactions in corporate bonds was 50%. Tr. 157, 874. The remaining 50% was credited to Mauney's trading desk. Tr. 905.

### **C. Trading with ARM**

The trading at issue is described in the record as a program trade having three legs.<sup>11</sup> Tr. 399, 401, 450, 546-47. The first leg was the purchase by First Union of approximately \$100 million in high-grade corporate bonds from ARM accounts. The second leg was the repurchase by ARM, into different accounts, of the same bonds at lower prices, causing a loss to First Union.<sup>12</sup> The third leg was the sale by First Union to ARM of additional bonds at prices intended to make up First Union's loss from the first and second legs. The third leg is referred to as "make-up bonds" (referring to their role in making up the losses) and as "proceeds trades" (referring to the possible use of the proceeds from the first leg to buy the third leg). Tr. 401, 754-55, 1436. Each of the three legs was for approximately \$100 million. Tr. 451.

#### **1. The Program**

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41, 54, 56. Arouh maintains that these exhibits are incomplete and introduced expert testimony to the effect that there are gaps and anomalies in the tapes. Tr. 100-42.

<sup>10</sup> The First Union trading room was about 100 square feet, with about forty salespeople at rows of desks facing the trading desk across the room. Tr. 166. Arouh's desk was approximately thirty feet from Mauney's. Tr. 655.

<sup>11</sup> The term "program trade" indicates a transaction involving a number of securities or an unusually large transaction. Tr. 803, 998, 1269-70.

<sup>12</sup> The second-leg repurchase was subject to First Union's still owning the bonds, as stressed by Arouh, Mauney, and Ilario; there were no guarantees or promises. Tr. 184-85, 1001, 1434. There was an expectation, however, that ARM would buy them back. Tr. 668. As Farrell explained, ARM was selling to rebalance its portfolios, not because it disliked the bonds. Tr. 930-31. Mauney did not actively exhort the sales force to sell the bonds during the period First Union held them. Tr. 668, 797-98, 800.

Rubinstein proposed the program<sup>13</sup> to Arouh in early March 1998.<sup>14</sup> Tr. 178, 398-99, 628, 1433. Arouh brought the proposal to Mauney, who saw it as a business coup that would establish First Union as the best place for customers to buy and sell bonds, including First Union bonds. Tr. 646, 751, 850-51. Trading First Union bonds was a top priority at First Union. Tr. 850-51. Mauney then met with Williams and Ilario, on March 18. Tr. 640-41, 993, 997-98, 1439. Ilario discussed the possibility that ARM wanted to park securities over the month end to remove them from its books and stressed that there should be no promises or guarantees on selling the bonds back. Tr. 993, 996-1002.

Mauney's testimony about the proposed trades and the meeting was, to some extent, inconsistent with other credible evidence. Mauney stated that Arouh told him that ARM was soliciting bids on the first leg from several broker-dealers "in competition," and that he told Williams and Ilario that the program would be in competition, with the winner gaining the chance to sell ARM \$100 million of bonds with the proceeds of the first leg. Tr. 640-41, 643-44, 731, 751-52, 804. The testimony of everyone else involved – Arouh, Farrell, and Ilario – was that there was no discussion of the program's being in competition. Tr. 946, 949, 1086, 1441-42. Neither Ilario, nor Farrell, heard Mauney or anyone else state that the program would be in competition. Tr. 946, 948-49, 959, 1086. Further, Ilario testified that, at the meeting with Williams, Mauney described the first and second legs and did not mention the third leg, the supposed reward for winning the competition. Tr. 1086-87, 1097. In fact, Ilario did not learn of the third leg until he detected improprieties after the execution of the second leg and commenced an investigation. Tr. 1021-23. Mauney conceded that, when he began executing the first leg, he did not know what Rubinstein wanted to buy in the third leg and how he would fill the order – whether he had the bonds in inventory or whether he would buy or short the bonds. Tr. 782-83. Additionally, it is customary for the winner of a competition to be informed of the "cover," the second place bid, on being awarded the trade. Tr. 1377. Mauney conceded that he did not ask for the cover. Tr. 732-33.

Mauney's motive for maintaining that the program was in competition was to explain why he did not check the prices on the first leg. Mauney's motive for maintaining that the third leg was the reward for the first leg and for maintaining that he told Williams and Ilario about the third leg was to explain why the first purchase of the third leg – a NationsBank bond marked up two points for a \$200,000 "credit" against the losses – occurred on March 31, before the second leg and the realized losses. It is found that Arouh did not say to Mauney, and Mauney did not

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<sup>13</sup> Rubinstein's motive was to show gains in a group of so-called total return or performance accounts from which he sold the first leg; he repurchased the bonds into so-called insurance accounts, whose performance was tracked in a different manner so that their owners would be less likely to be able to detect that the accounts had not received best execution. Tr. 394-96, 399, 403, 409, 912-13; Ex. 3 at 9. The record does not show that Arouh was aware of the particular characteristics of the two groups of accounts. In any event, the OIP does not charge him with aiding and abetting fraud of ARM or Rubinstein.

<sup>14</sup> Rubinstein claims that he first proposed the program to Arouh on March 27, 1998. Tr. 399, 420, 513-14, 575. This testimony is rejected as inconsistent with the weight of credible record evidence, including the testimony of Mauney, Ilario, and Arouh.

say to Williams and Ilario, that the program would be in competition. It is also found that Mauney did not tell Williams and Ilario about the third-leg, make-up trades.

From the beginning, Mauney told Arouh that he was going to hedge the transaction. Tr. 684, 733-34. As the program unfolded, he told Arouh that he had hedged by selling short \$50 million in U.S. Treasury securities. Tr. 678-79, 681-82. Mauney, though, lied about the hedge; in fact, there was no hedge at all. Tr. 734, 844.

Mauney spoke with Arouh on the evening of March 26, and urged that the bonds be bought back before month end. Tr. 1467; Ex. 1A at counter 005, Ex. 1A1 at 2-3. On Friday, March 27, Arouh urged Rubinstein to identify the bonds to be sold to First Union as soon as possible and told him that First Union was going to hedge the position. Ex. 1A at counter 160, Ex. 1A1 at 7-8.

#### **a. The First Leg**

Rubinstein's lists of bonds, with prices at which he wanted to sell, were received by fax at First Union on March 30 and March 31. Tr. 1468, 1477; Exs. 5, 6. Mauney approved the trades without changing or checking the prices. Tr. 653, 667. He claims that his approval was based on his understanding that the trades were bid in competition. Tr. 653.

#### **b. The Second Leg**

The second-leg repurchase occurred on April 2 and 3 after Rubinstein faxed lists of the bonds he would repurchase and the prices he was willing to pay. Tr. 323-38, 344-46, 348, 1483-88; Ex. 1A at counter 663, Ex. 1A1 at 38-40, Exs. 8-10. In the interim, the bond market had risen somewhat. Tr. 674. Arouh noticed that the prices were lower than the first leg. Tr. 343. Mauney and Arouh claimed to be surprised by the difference in price. Tr. 345, 671-72. Mauney told Arouh to attempt to obtain some higher prices, which he did. Tr. 344-45, 674, 1484-85. Mauney also told Arouh that he would not earn any commission until a profit had been made on the entire program, including the nonexistent hedge. Tr. 675, 690-91. The loss on the repurchase – the difference between the amount First Union paid for the bonds and the amount for which it sold them – was \$1.376 million. Tr. 339-42. To this, Mauney added a nonexistent \$1.156 million loss from the nonexistent hedge for a total of \$2.532 million in losses.<sup>15</sup> Tr. 689-90. Mauney told Arouh that he would have to make up \$2.532 million before there would be any sales credit.<sup>16</sup> Tr. 690. To make up the losses, Mauney suggested selling long-term bonds, where the effect on yield of higher prices is less than with short-term bonds. Ex. 1C at counter 204, Ex. 1C1 at 11-12. The third-leg make-up bonds were marked up to recoup \$2.532 million in losses. Tr. 691.

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<sup>15</sup> Mauney conceded that it is not customary when selling a bond from inventory to charge the customer separately for the cost of the hedge; the cost is built into the price of the bond. Tr. 879.

<sup>16</sup> Mauney hoped to unload a large quantity of stale First Union bonds from his inventory, in accordance with the wishes of First Union management. Tr. 844, 848.



### **c. The Third Leg**

For the third leg, Mauney offered Arouh bonds at prices that Arouh was able to mark up about two points, which Mauney approved. Tr. 699-700, 703; Ex. 1A at counter 748, Ex. 1A1 at 41-44. Mauney believed, and told Arouh, that markups below five percent were acceptable. Tr. 876-78. Mauney urged Arouh to push First Union and NationsBank bonds. Tr. 844, 848; Ex. 1A at counter 748, 970 Ex. 1A1 at 44, 51. On April 6, the third leg was completed. Ex. 1B at counter 316, 418, Ex. 1B1 at 9, 14.

On March 30, before the second leg started, and before the first leg was even completed, Mauney told Farrell that he would have a \$2 million to \$3 million loss if the bonds were held over the March 31 quarter end and marked to market; Mauney wanted Rubinstein “to buy something now . . . to offset it.” Tr. 1448-50; Ex. 1C at counter 005, Ex. 1C1 at 2. Farrell conveyed this information to Arouh in a telephone call on March 30. Tr. 1448, 1450; Ex. 1C at counter 005, Ex. 1C1 at 2. At trial, Mauney conceded that he told Farrell that he would suffer a \$2 million to \$3 million loss if he held the bonds until April, but claimed that he had lied to Farrell, in order to put pressure on him and Arouh to sell the third leg to ARM. Tr. 869-71. Accordingly, the first sale of the third leg occurred on March 31 – \$10 million in NationsBank bonds, which Mauney urged Arouh to sell from First Union’s inventory, marked up two extra basis points for a \$200,000 credit against the expected loss from the first and second legs. Tr. 280-88, 659-60, 665-66, 1477-81; Exs. 7, 11, 12.

## **2. First Union’s Investigation**

Williams had cautioned Ilario to monitor the transactions closely to prevent improprieties. Tr. 1001-02. Ilario particularly watched for adjusted trading because the program involved the possibility of ARM’s repurchasing the bonds it sold First Union. Tr. 1006-09. He commenced an investigation on learning of the second leg. Tr. 1011. It is difficult to determine market prices of bonds because there is little transparency. Tr. 1007; Ex. 3 at 4. So Ilario looked for contemporaneous transactions with other broker-dealers to determine whether there were excessive markups; he also considered whether the pricing was inconsistent with the way interest rates moved during the period in question. Tr. 1007-08. He found that interest rates decreased over the interim period, which should have resulted in an increase in the prices of the bonds.<sup>17</sup> Tr. 1012-14. He found, however, that First Union had sold the bonds back at lower prices. Tr. 1014-15. After further investigation, he concluded that First Union had paid too much for the

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<sup>17</sup> During the period March 30 to April 6, 1998, the bond market was calm. Tr. 1274-77. The general tone of the market was modestly positive, and interest rates declined by 15 to 20 basis points. Ex. 3 at 11. Intra-day volatility was modest, as well. Ex. 3 at 11. Also, the yields and prices of corporate bonds were generally tracking U.S. Treasury securities, with the overall level of spreads unchanged to slightly lower. Ex. 3 at 11. There were exceptions, notably, a widening of spreads for securities issued by tobacco companies. Ex. 3 at 11.

bonds on the first leg.<sup>18</sup> Tr. 1015-18. Ilario determined the losses to be approximately \$1.3 million by subtracting the sale price from the purchase price. Tr. 1019. Ilario notified senior management and the legal division of the problem. Tr. 1019. Then, he became aware of more trades with ARM between March 30 and April 6 – the third leg. Tr. 1021-23. He suspected that these trades were intended to make First Union whole for its loss on the first and second legs – adjusted trading. Tr. 1023. Based on contemporaneous sales with other broker-dealers for each of the bonds in the third leg, Ilario concluded that the third-leg transactions were above market price.<sup>19</sup> Tr. 1023. First Union repriced the third-leg trades, some before settlement, and some after settlement, and sent ARM a check for \$1,875,750. Tr. 1058-60; Ex. 31. First Union did not net its \$1.3 million loss against the overpriced third leg, so the resolution was to the benefit of ARM. Tr. 1061-62. On or about April 8, First Union began to question Arouh and Mauney and suspended them.<sup>20</sup> Tr. 1194-95.

### **3. What did Arouh Know?**

Arouh did not know market values of specific bonds. Tr. 1469. Arouh knew before the trading started that First Union would be selling the bonds back to ARM at a loss. Tr. 305, 1438, 1449. In a March 27 conversation, when Arouh told Rubinstein that First Union was going to hedge the position, he stated that if the market goes up they would have “more of a loss to add in.”<sup>21</sup> Ex. 1A at counter 160, Ex. 1A1 at 8. As found above, Arouh knew on March 30 that Mauney was estimating the loss to First Union at \$2 to \$3 million. As found above, Arouh knew that that the prices on the second leg were well below the prices on the first leg, even though the bond market had risen. Arouh knew before 8:30 a.m. on April 3 that the bond market had in fact risen, well before First Union’s receipt of Rubinstein’s final list of bonds and prices for the second leg. Tr. 301-02, 309, 346, 1550, 1621; Ex. 1C at counter 167, Ex. 1C1 at 9, Ex. 10. Nonetheless, the trades went ahead, with Arouh’s full cooperation. Tr. 1617, 1623-24; Ex. 1A at

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<sup>18</sup> Dean Jackson Call Jr. (Call), who testified on behalf of the Division and was accepted as an expert in the pricing and trading of bonds, opined that at least seventeen of the thirty-seven bonds in the first leg were overpriced. Tr. 1279-81; Ex. 3 at 8, 11-57. Arouh described the first leg prices as “full,” that is, at the high end of the bid-offer spread, and Rubinstein described the prices as “aggressive,” that is, prices were set as high as possible. Tr. 565-66, 1435. Call opined that the second leg was priced at market levels. Tr. 1336-37, 1349-50; Ex. 3 at 8.

<sup>19</sup> Call opined that each of the five bonds in the third leg was overpriced. Ex. 3 at 57-65.

<sup>20</sup> On April 12 Mauney faxed to Arouh and Farrell a chronology that contained a number of misstatements, in the transparent hope of persuading them to back up a version of the story that placed him in a better light than the facts indicated. Tr. 709-15, 735-39; Ex. 25. Mauney denied sending it to Farrell, but Farrell confirmed that he received the fax and immediately turned it over to the First Union personnel who were conducting the investigation. Tr. 871, 958-59; Ex. 25.

<sup>21</sup> Arouh’s attempt to place an innocent interpretation on this is not completely convincing. Tr. 1457-58.

counter 982, Ex. 1A1 at 52. Similarly, Arouh negotiated with Rubinstein to mark up the bonds in the third leg to make up the losses that Mauney told him had occurred in the second leg. Tr. 535-41; Ex. 1A at counter 748, Ex. 1A1 at 44-45.

Arouh did not know precisely why Rubinstein wanted to do the program trade or which accounts sold the first leg and which bought the second leg, but he did know that some accounts received favorable prices on the first leg while other accounts received less favorable prices on the second leg.<sup>22</sup> He knew that the sale and repurchase prices in the first and second legs were at inconsistent levels. Additionally, Arouh knew that the ARM accounts that purchased the third-leg bonds were not getting best execution and that those accounts were charged higher prices to make up the difference to First Union for its loss on the first and second legs. Tr. 1631.

### III. CONCLUSIONS OF LAW

In this section it is concluded that Arouh willfully violated the antifraud provisions of the Securities and Exchange Acts – Securities Act Section 17(a) and Exchange Act Section 10(b) and Rule 10b-5.

#### A. Antifraud Provisions

Section 17(a) of the Securities Act makes it unlawful “in the offer or sale of” securities, by jurisdictional means, to:

- 1) employ any device, scheme, or artifice to defraud;
- 2) obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary to make the statement made not misleading; or
- 3) engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Section 10(b) of the Exchange Act and Rule 10b-5 thereunder proscribe similar practices “in connection with” the purchase or sale of securities.

Scienter is required to establish violations of Securities Act Section 17(a)(1) and Exchange Act Section 10(b) and Rule 10b-5. It is “a mental state embracing intent to deceive, manipulate, or defraud.” Aaron v. SEC, 446 U.S. 680, 686 n.5, 695-97 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976); SEC v. Steadman, 967 F.2d 636, 641 (D.C. Cir.

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<sup>22</sup> The Division argues that he knew that the bonds were being sold out of performance accounts and bought into insurance accounts. The record does not support such a finding, which would have to rest on the testimony of Rubinstein, who has admitted lying to the Commission and cheating customers. In any event, Arouh was not charged with aiding and abetting fraud at ARM.

1992). Recklessness can satisfy the scienter requirement. See David Disner, 52 S.E.C. 1217, 1222 & n.20 (1997); see also Steadman, 967 F.2d at 641-42; Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-69 (9th Cir. 1990). Reckless conduct is conduct which is “‘highly unreasonable’ and represents ‘an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.’” Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 47 (2d Cir. 1978) (quoting Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977)).

The parties agree that “adjusted trading” is a violation of the antifraud provisions. The OIP defines adjusted trading as “a fraudulent trading practice where a person sells a security above the prevailing market price and purchases another security from the buyer of the first security at a corresponding price above the prevailing market price to offset the overpayment in the first transaction.” OIP at ¶ II.B. This definition is consistent with Utica Mut. Ins. Co. v. Fireman’s Fund Ins. Cos., 748 F.2d 118, 120 (2d Cir. 1984) (describing as adjusted trading the sale of a large number of bonds to a broker-dealer at prices substantially above market rates and the purchase of another group of bonds of equal value from the same broker-dealer at prices also above market rates). See also National Association of Securities Dealers, NASD Policy on Adjusted Trading, Educational Circular 87-15 (Nov. 10, 1987) (warning that adjusted trading may violate the antifraud provisions and other provisions).<sup>23</sup>

The Division requests sanctions pursuant to Sections 15(b)(6) and 21B of the Exchange Act. The Commission must find willful violations to impose sanctions under Sections 15(b) and 21B of the Exchange Act. A finding of willfulness does not require an intent to violate, but merely an intent to do the act which constitutes a violation. See Wonsover v. SEC, 205 F.3d 408, 413-15 (D.C. Cir. 2000); see also Steadman v. SEC, 603 F.2d 1126, 1135 (5th Cir. 1979); Arthur Lipper Corp. v. SEC, 547 F.2d 171, 180 (2d Cir. 1976); Tager v. SEC, 344 F.2d 5, 8 (2d Cir. 1965).

## **B. Antifraud Violations**

The three-legged program trade at issue consisted of First Union’s (1) buying \$100 million of corporate bonds from a group of ARM accounts; (2) selling the same bonds back to a different group of ARM accounts shortly thereafter at a \$1.376 million loss, a price change that was inconsistent with market conditions; and (3) selling to ARM accounts bonds that were marked up sufficiently to reimburse First Union for the \$1.376 million loss, as well as for the \$1.156 million nonexistent loss on the nonexistent hedge. The program, thus, was a scheme to defraud in the form of adjusted trading and a violation of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

Although Rubinstein proposed the scheme, it was brought to fruition through the collective actions of Rubinstein, Arouh, and Mauney. Arouh’s role was integral to the program – he brought Rubinstein’s proposal to Mauney, and he negotiated with Rubinstein over details of

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<sup>23</sup> The National Association of Securities Dealers NASD Policy on Adjusted Trading may be found at Ex. 32 in the record.

the first and second leg. He was aware from at least March 30, that Mauney expected a \$2 million to \$3 million loss on the first and second legs and expected to make that loss back on the third leg. The second leg proceeded with Arouh's full cooperation despite his awareness of the markedly inconsistent prices. The third leg, which he understood was to make back the losses that Mauney told him First Union had incurred on the first and second legs, also proceeded with his full cooperation. Arouh negotiated with Rubinstein the identity and prices of the third-leg bonds until he had negotiated sufficient transactions to make back the losses.

The record shows Arouh's scienter: He was fully aware of Rubinstein's plan to sell bonds out of customer accounts, repurchase the same bonds at lower prices into different accounts, and make up the loss to First Union via a third set of trades; he fully cooperated in the execution of the program. His conduct was reckless – highly unreasonable and an extreme departure from the standards of ordinary care. Arouh argues that he relied on Mauney's greater experience, knowledge of bond prices, and authority to set prices and decide whether a trade would take place. Mauney's position at the firm vis-à-vis Arouh does not, however, excuse Arouh from the consequences of his participation in the trades. See Nicholas P. Howard, 79 SEC Docket 2332, 2338-39 (Feb. 12, 2003), appeal pending, No. 03-1098 (D.C. Cir.);<sup>24</sup> see also Charles K. Seavey, 79 SEC Docket 3455, 3462-64 (Mar. 27, 2003), appeal pending, No. 03-71565 (9th Cir.);<sup>25</sup> Sharon M. Graham, 53 S.E.C. 1072, 1084-86 (1998), aff'd, 222 F.3d 994 (D.C. Cir. 2000);<sup>26</sup> cf. James J. Pasztor, 70 SEC Docket 2611, 2624 (Oct. 14, 1999).<sup>27</sup>

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<sup>24</sup> In Howard, the Commission held a broker-dealer's vice president in charge of marketing liable for aiding and abetting the fraudulent closing of a part-or-none offering. He had relied on the broker-dealer's corporation finance and compliance departments and on outside legal counsel for compliance with the securities laws. The Commission rejected this defense, stating that a securities professional has an ongoing obligation to familiarize himself with pertinent legal requirements to protect investors from illegality. 79 SEC Docket at 2338-39.

<sup>25</sup> In Seavey, the Commission held an associated person of an investment adviser liable for aiding and abetting antifraud violations based on his participation in a letter to hedge fund investors that misrepresented the fund's assets by including assets that the fund purchased from sellers who fraudulently failed to deliver. The Commission recognized that the associated person diligently attempted to obtain delivery and urged, albeit unsuccessfully, the investment adviser to inform the investors and to initiate civil and criminal proceedings against the fraudulent sellers. The Commission took these factors into account in ordering sanctions but emphasized that they did not excuse liability. 79 SEC Docket at 3462-64.

<sup>26</sup> In Graham, the Commission held a registered representative liable for aiding and abetting a customer's antifraud violations despite direction and assurance from the broker-dealer's branch manager and owner that the trades were legal. The Commission emphasized the registered representative's responsibility to comply with the law. 53 S.E.C. 1084-86; accord, Adrian C. Havill, 53 S.E.C. 1060, 1068-70 (1998).

<sup>27</sup> In Pasztor, the Commission held that a branch manager failed reasonably to supervise a registered representative who aided and abetted a customer's antifraud violations. The branch manager tried to stop the violative trades but was overruled by the broker-dealer's owner. In

In sum, it is concluded that Arouh willfully violated Securities Act Section 17(a) and Exchange Act Section 10(b) and Rule 10b-5. His actions were clearly intentional. Thus, his violations were willful.

#### **IV. SANCTIONS**

The Division requests that Arouh be ordered to pay a third-tier civil money penalty of \$2,530,000 and be barred from association with a broker-dealer. Arouh argues that no sanctions are warranted. For the reasons discussed below, these sanctions will be ordered: a civil penalty of \$330,000 and a ninety-day suspension from association with a broker-dealer.

##### **A. Sanction Considerations**

When the Commission determines administrative sanctions, it considers:

[T]he egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations.

Steadman v. SEC, 603 F.2d at 1140 (quoting SEC v. Blatt, 583 F.2d 1325, 1334 n.29 (5th Cir. 1978)).

The Commission determines sanctions pursuant to a public interest standard.<sup>28</sup> Thus, in addition to issues related to the violator, it “weigh[s] the effect of [its] action or inaction on the welfare of investors as a class and on standards of conduct in the securities business generally.” Arthur Lipper Corp., 46 S.E.C. 78, 100 (1975); see also Richard C. Spangler, Inc., 46 S.E.C. 238, 254 n.67 (1976). The amount of a sanction depends on the facts of each case and the value of the sanction in preventing a recurrence. See Berko v. SEC, 316 F.2d 137, 141 (2d Cir. 1963); see also Leo Glassman, 46 S.E.C. 209, 211-12 (1975).

##### **B. Sanctions**

###### **1. Civil Money Penalty**

Section 21B of the Exchange Act authorizes the Commission to impose civil money penalties for willful violations of the Exchange Act. In considering whether a penalty is in the public interest, the Commission may consider six factors: (1) fraud; (2) harm to others; (3) unjust

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finding his efforts insufficient, the Commission emphasized the branch manager's responsibility despite his superior's role in the violations. 70 SEC Docket at 2624-25.

<sup>28</sup> See Sections 15(b)(6) and 21B(c) of the Exchange Act.

enrichment; (4) previous violations; (5) deterrence; and (6) such other matters as justice may require. See Section 21B(c) of the Exchange Act; see also New Allied Dev. Corp., 52 S.E.C. 1119, 1130 n.33 (1996); Jay Houston Meadows, 52 S.E.C. 778, 787-88, aff'd, 119 F.3d 1219 (5th Cir. 1997); Consolidated Inv. Servs., Inc., 52 S.E.C. 582, 590-91 (1996); First Sec. Transfer Sys., Inc., 52 S.E.C. 392, 395-96 (1995).

Arouh violated the antifraud provisions, so his violative actions “involved fraud” within the meaning of Section 21B(c) of the Exchange Act. Arouh, however, was not unjustly enriched; to the contrary, First Union withheld commissions that he might have earned, not only from the violative transactions, but from unrelated transactions as well. Concerning harm to others, First Union reimbursed ARM for inappropriate pricing of the third leg while leaving ARM in possession of profits from the above-market prices of the first leg. First Union retained Arouh’s commissions that exceeded its actual loss from the violative trading – the \$1.376 million difference between the prices of the first and second legs.<sup>29</sup>

A penalty, in addition to suspension, is necessary for the purpose of deterrence and is in the public interest. See Section 21B(c)(5) of the Exchange Act; see also H.R. Rep. No. 101-616 (1990). A third-tier penalty, as the Division requests, is appropriate because the violative acts involved fraud, reckless disregard of a regulatory requirement, and created a risk of substantial losses to other persons. See Section 21B(b)(3) of the Exchange Act. Such losses would have occurred had the trading gone unnoticed by First Union.

The maximum third-tier penalty applicable in this case for each act or omission is \$110,000 for a natural person.<sup>30</sup> Section 21B of the Exchange Act, like most civil penalty statutes, leaves the precise unit of violation undefined. See Colin S. Diver, The Assessment and Mitigation of Civil Money Penalties by Federal Administrative Agencies, 79 Colum. L. Rev. 1435, 1440-41 (1979). The Division requests a \$110,000 third-tier penalty for each of the twenty-three transactions that it describes as clearly fraudulent, for a total penalty amount of \$2,530,000. The requested total penalty amount is excessive. Instead, each of the three legs of the program trade at issue will be considered as one course of action resulting in three units of violation. Arouh will be ordered to pay a third-tier penalty of \$330,000. In the circumstances of this case, this sum is sufficient for deterrence and other purposes of the penalty statutes.

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<sup>29</sup> First Union’s repricing of the third leg, including its \$1.875 million payment to ARM to reprice trades that had already settled, was not an additional loss to First Union. First Union had concluded that the trades’ original prices were excessive and lowered them to what it concluded were appropriate market levels.

<sup>30</sup> The Commission increased the \$100,000 value set in Section 21B(b)(3) of the Exchange Act for violations occurring after December 9, 1996, and, again, for violations occurring after February 2, 2001. See 17 C.F.R. §§ 201.1001 (1996 adjustment), .1002 (2001 adjustment). The 1996 and 2001 adjustments to the civil penalty amounts are pursuant to the Federal Civil Penalties Inflation Adjustment Act of 1990, as amended by the Debt Collection Improvement Act of 1996. Each federal agency is required to adopt regulations at least once every four years adjusting for inflation the maximum civil penalties under the statutes that it administers.

## 2. Suspension

The Division requests, pursuant to Section 15(b)(6) of the Exchange Act, that Arouh be barred from association with a broker-dealer. Based on the Steadman factors, a ninety-day suspension is in the public interest. Arouh's violation was serious, but not egregious. It was isolated in that it pertained to one series of transactions over a period of a few days, but the transactions were in notional amounts of hundreds of millions of dollars and caused a \$1.376 million loss to First Union. Concerning scienter, Arouh was reckless. Consistent with a vigorous defense of the charges against him, Arouh has not affirmatively acknowledged the wrongful nature of his conduct. He is currently employed in the securities industry, and his occupation will present the opportunity for future violations. The fact that Arouh increased the extent of his violation because he was misled about the losses is a mitigating factor. Because of Mauney's misrepresentation about the hedge, Arouh almost doubled the price adjustments on the third leg that he negotiated with Rubinstein. A ninety-day suspension, combined with a civil money penalty, is an appropriate remedy and deterrent and is consistent with Commission precedent.<sup>31</sup> Accordingly, a ninety-day suspension will be ordered.

## V. RECORD CERTIFICATION

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), it is certified that the record includes the items set forth in the record index issued by the Secretary of the Commission on August 1, 2003.

## VI. ORDER

Based on the findings and conclusions set forth above:

IT IS ORDERED that, pursuant to Section 15(b)(6) of the Securities Exchange Act of 1934, 15 U.S.C. § 78o(b)(6), Leslie A. Arouh IS SUSPENDED from association with any broker or dealer for ninety days, effective on the first business day following the date when this Order becomes effective.

IT IS FURTHER ORDERED that, pursuant to Section 21B of the Securities Exchange Act of 1934, 15 U.S.C. § 78u-2, Leslie A. Arouh PAY A CIVIL MONEY PENALTY of \$330,000.

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<sup>31</sup> See, e.g., Monetta Fin. Servs., Inc., 80 SEC Docket 1437, 1459-60 (June 9, 2003) (imposing a ninety-day suspension, cease-and-desist order, and \$100,000 penalty on the president of an investment adviser and investment companies, who aided and abetted the investment adviser's antifraud violations by failing to disclose that the investment adviser was allocating shares of initial public offerings to accounts of certain investment company directors and trustees. The investment adviser was sanctioned with a censure, cease-and-desist order, and \$200,000 penalty.); see also Howard, 79 SEC Docket at 2343 (imposing a three-month suspension, cease-and-desist order, and \$50,000 penalty on a broker-dealer salesman who aided and abetted the fraudulent closing of a part-or-none offering by failing to disclose material information to investors.).



Payment of the money penalty shall be made on the first business day following the day this Order becomes effective by certified check, U.S. Postal money order, bank cashier's check, or bank money order payable to the Securities and Exchange Commission. The check and a cover letter identifying the Respondent and Administrative Proceeding No. 3-10884, shall be delivered by hand or courier to the Comptroller, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, Virginia 22312. A copy of the cover letter shall be sent to the Commission's Division of Enforcement at the same address.

This Order shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that rule, a petition for review of this Initial Decision may be filed within twenty-one days after service of the decision. It shall become the final decision of the Commission as to each party who has not filed a petition for review pursuant to Rule 360(d)(1) within twenty-one days after service of the Initial Decision upon such party, unless the Commission, pursuant to Rule 360(b)(1), determines on its own initiative to review this Initial Decision as to any party. If a party timely files a petition for review, or the Commission acts to review as to a party, the Initial Decision shall not become final as to that party.

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Carol Fox Foelak  
Administrative Law Judge