MUNICIPAL SECURITIES
Cases and Materials

Supplemental Text

Office of the Municipal Securities
Division of Market Regulation

U.S. Securities and Exchange Commission
Washington, DC

January 2001

Martha Mahan Haines
Office Chief

Mary N. Simpkins
Senior Special Counsel

Stephen J. Weinstein
Attorney-Fellow

Andrea Bellaire
Senior Counsel

Conal Denion
Attorney-Adviser

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This compilation was prepared by the Office of Municipal Securities in the Division of Market Regulation of the Securities and Exchange Commission and supplements the Municipal Securities Cases and Materials Text that was issued in April 1999. It contains the full text of certain Commission orders/opinions, administrative law judge decisions, and litigation releases, as well as federal court decisions, involving participants in municipal securities transactions. In some instances, the document is a determination of fact and law following a hearing; in others, findings made by the Commission in a settled proceeding in which the named party has neither admitted nor denied the findings, but consented to entry of the order. In still other instances, such as a complaint, the document may consist of allegations.

The compilation organizes enforcement actions by relevant participants to municipal securities transactions or topics. However, inclusion under a particular heading does not limit in any manner the relevance of the document to other participants or topics.

While this compilation provides an extensive review of Commission activity in the municipal securities market, it does not purport to be exhaustive. It also does not include actions by private parties under the federal securities laws arising from municipal securities transactions, or Commission and private actions under the antifraud and other sections of the federal securities law arising from transactions not involving municipal securities. Such materials may also be useful to the reader.

The reader is encouraged to consult the web site maintained by the Commission at www.sec.gov for future releases.

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ISSUERS

COMMISSION ORDERS – SETTLED ADMINISTRATIVE PROCEEDINGS

<u>In the Matter of the City of Anaheim, City of Irvine, Irvine Unified School District, North Orange County Community College District and Orange County Board of Education,</u> Securities Act Release No. 7590, A.P. File No. 3-9739 (September 29, 1998).

The Securities and Exchange Commission ("Commission") announced that on September 29, 1998, it issued an Order Instituting Public Administrative Cease-and-Desist Proceeding Pursuant to Section 8A of the Securities Act of 1933 ("Order") against five California municipal entities: City of Anaheim, City of Irvine, Irvine Unified School District, North Orange County Community College District, and Orange County Board of Education. The Commission's Order alleges that these entities issued over $400 million in municipal securities in eight taxable note offerings in 1993 and 1994. The Order further alleges that these entities failed to disclose to investors that the proceeds of the debt offerings would be invested in the Orange County Investment Pools (the "Pools"). The Order also alleges that the municipal issuers failed to disclose information about the Pools' investment strategy, the risks of that strategy, and the Pools' declining performance in 1994.

A hearing will be scheduled to take evidence on the staff's allegations and to afford the Respondents an opportunity to present any defenses thereto. The purpose of the hearing is to determine whether the allegations are true and whether any remedial action should be ordered by the Commission.

<u>In the Matter of the City of Anaheim, City of Irvine, Irvine Unified School District, Orange County Board of Education,</u> Securities Act Release No. 7696, A.P. File No. 3-9739 (July 1, 1999).

I.

In this public administrative cease-and-desist proceeding ordered pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"),[1] Respondents City of Anaheim, City of Irvine (the "Cities"), Irvine Unified School District, and Orange County Board of Education (the latter two collectively, the "Districts") (collectively, the "Issuers" or the "Respondents") have submitted Offers of Settlement ("Offers") which the Commission has determined to accept. Solely for the purpose of this proceeding and any other proceedings brought by or on behalf of the Commission or in which the Commission is a party, and without admitting or denying the findings contained herein, except that the Respondents admit the jurisdiction of the Commission over them and the subject matter of this proceeding, the Respondents, by their Offers, consent to the entry of the findings and the cease-and-desist order set forth below in this Order Making Findings and Imposing Cease-and-Desist Order ("Order").

II.

On the basis of this Order, the Order Instituting Public Administrative Cease-and-Desist Proceeding Pursuant to Section 8A of the Securities Act of 1933, and the Offers submitted by the Respondents, the Commission finds that:[2]

A. City of Anaheim, California ("Anaheim") is a chartered city organized under the constitution and laws of the State of California. Anaheim is the second most populous city in Orange County, California, with over 285,000 residents and an annual budget of over $245 million during the relevant period. Anaheim possesses the power to sue and be sued, and to issue debt. Anaheim conducted three taxable note offerings that are the subject of this Order.

B. City of Irvine, California ("Irvine") is a chartered city organized under the constitution and laws of the State of California. Irvine is among the largest cities in Orange County, California, with over 117,000 residents and an annual budget exceeding $56 million during the relevant period. Irvine possesses the power to sue and be sued, and to issue debt. Irvine conducted two of the taxable offerings that are the subject of this Order.

C. Irvine Unified School District ("Irvine USD") is a school district organized under the constitution and laws of the State of California. Irvine USD operates public schools in and around Irvine, California, serving over 21,000 students. Irvine USD's annual budget exceeded $96 million during the relevant period. Irvine USD possesses the power to sue and be sued, and to issue debt. Irvine USD conducted one of the offerings that are the subject of this Order.

D. Orange County Board of Education ("OC Board") is a county board of education organized under the constitution and laws of the State of California. OC Board provides a variety of educational and administrative support services for local educational districts in Orange County, California. OC Board's annual budget exceeded $88 million during the relevant period. OC Board conducted one of the offerings that are the subject of this Order.

The Orange County Investment Pools

E. The Orange County Investment Pools (the "Pools") operated as an investment fund managed by the Orange County Treasurer-Tax Collector (the "County Treasurer"). The Pools consisted of the Commingled Pool, the Bond Pool, and certain specific investments, in which the County and various local governments or districts (the "Pool Participants") deposited public funds. As Orange County educational districts, the Districts were mandatory Pool Participants because state law required them to deposit their funds with the County Treasurer. The Cities, as cities located in Orange County, were voluntary Pool Participants.

F. As of December 6, 1994 (the date the County and the Pools filed bankruptcy petitions), the Pools held approximately $7.6 billion in Pool Participant deposits, which the County Treasurer had leveraged to an investment portfolio with a book value of over $20.6 billion. The Commingled Pool was the principal investment pool and consisted of $6.126 billion in Pool Participant deposits. The proceeds from the offerings that are the subject of this Order were deposited into the Commingled Pool.

The Pools' Investment Strategy

G. The Pools' investment policy as stated by the County Treasurer to the Pool Participants was, in order of importance: (1) preservation of investment capital; (2) liquidity; and (3) investment yield. Contrary to that policy, the County Treasurer caused the Pools to engage in a risky investment strategy. This strategy involved using a high degree of leverage by obtaining funds through reverse repurchase agreements on a short-term basis (less than 180 days), and investing in securities with a longer maturity (generally two to five years), many of which were derivative securities known as inverse floaters.

H. The Pools' investment return was to result principally from the interest received on the securities in the Pools. Leverage enabled the Pools to purchase more securities to generate increased interest income. This strategy was profitable as long as the Pools were able to maintain a positive spread between the long-term interest rate received on the securities and the short-term interest rate paid on the funds obtained through reverse repurchase agreements.

The Commingled Pool's Portfolio

I. During 1993 and 1994, the County Treasurer, using reverse repurchase agreements, leveraged the Participants' deposits in the Commingled Pool to amounts ranging from 110% to 280%. The County Treasurer then typically invested the Participants' deposits and the funds obtained through reverse repurchase agreements in debt securities issued by the United States Treasury or United States government sponsored enterprises.

J. Many of these securities were derivative securities, comprising from 31% to 53% of the Commingled Pool's portfolio. In particular, the Commingled Pool was heavily invested in derivative instruments known as inverse floaters, which paid interest rates inversely related to the prevailing market interest rate. From January 1993 through November 1994, 24% to 52% of the Commingled Pool's total portfolio consisted of inverse floaters. Inverse floaters are negatively affected by a rise in interest rates.

The Rise in Interest Rates During 1994 and its Effect on the Commingled Pool

K. The composition of the Commingled Pool's portfolio made it highly sensitive to interest rate changes. As interest rates rose, the market value of the Commingled Pool's securities fell, and the interest received on the Commingled Pool's inverse floaters also dropped. Thus, the County Treasurer's investment strategy was profitable so long as interest rates, including the cost of borrowing through reverse repurchase agreements, remained low and the market value of the Commingled Pool's securities remained stable. Indeed, the County Treasurer's 1992-93 Financial Statement for the Pools stated that the investment strategy was "predicated on interest rates to continue to remain low for a minimum of the next three years."

L. During 1993, interest rates remained low and relatively stable. Due to the low interest rates and the County Treasurer's investment strategy, the Commingled Pool paid a relatively high yield of approximately 8% during 1993. Beginning in February 1994, interest rates began to rise. This rise in interest rates caused the Commingled Pool's yield to decrease, the reverse repurchase costs to increase, the interest income on inverse floaters to decrease, and the market value of the Commingled Pool's debt securities to decline. Month-end reports generated by the County Treasurer reflected that the securities marked-to-market for all of the Pools experienced a sharp drop in value, ranging from over $26 million in January 1994 (or 0.45% loss in value), to over $443 million in June 1994 (or 5.24% loss in value).

M. The rising interest rates and the declining value of the Commingled Pool's securities caused the Commingled Pool to suffer corresponding losses through collateral calls and reductions in the amounts loaned under reverse repurchase agreements. From January through June 1994, the County's Pools suffered collateral calls and reductions in loan amounts totaling over $873 million.

The Municipal Securities Offerings

N. In 1993 and 1994, Respondent Anaheim made three offerings of municipal securities in the form of taxable notes for the purpose of investing the proceeds in the Pools. These three offerings were: the 1993 $66 Million Notes, issued on March 31, 1993, and delivered on April 8, 1993; the 1993 Series B $25 Million Notes, issued on June 24, 1993, and delivered on July 8, 1993; and the 1994 $95 Million Notes, issued on March 23, 1994, and delivered on April 5, 1994. Anaheim paid these notes in full and on time.

O. In 1993 and 1994, Respondent Irvine made two offerings of municipal securities in the form of taxable notes for the purpose of investing the proceeds in the Pools. Irvine's two offerings were: the 1993 $60 Million Notes, issued on April 28, 1993, and delivered on May 6, 1993; and the 1994 $62.455 Million Notes, issued on July 21, 1994, and delivered on July 27, 1994. Irvine paid these notes in full and on time.

P. In 1994, Respondent Irvine USD issued municipal securities in the form of taxable notes for the purpose of investing the proceeds. Irvine USD's securities offering was the 1994 $54.575 Million Notes, issued on June 10, 1994, and delivered on June 14, 1994. The proceeds of this offering were invested in the Commingled Pool. Irvine USD paid these notes in full and on time.

Q. In 1994, Respondent OC Board issued municipal securities in the form of taxable notes for the purpose of investing the proceeds. OC Board's securities offering was the 1994 $42.18 Million Notes, issued on June 10, 1994, and delivered on June 14, 1994. The proceeds of the 1994 offering were invested in the Commingled Pool. OC Board paid these notes in full and on time.

R. Each offer of securities described above was made through an underwriter. The underwriter for each transaction purchased the total amount of securities offered, and then offered and sold the securities to investors. At the time each offering of securities was made, each Issuer knew that the underwriter would offer and sell some or all of the securities to others.

The Omissions Regarding Investment of the Proceeds

S. In connection with the issuance of the securities described above, each Issuer approved for distribution a written offering document called an "Official Statement," which described to potential purchasers certain information about the Issuer's note offering. Each Official Statement was then distributed to potential purchasers by the underwriter for the transaction. In addition to officials at each Issuer, the Issuer's outside financial advisor, bond counsel, counsel to the underwriter, and the underwriter participated in the preparation of the Official Statements, which each Issuer reviewed and approved before issuing the notes.

T. Each Official Statement contained a section entitled "Purpose of Issue," in which each Issuer described the purpose of each offering. This section of the Official Statements for Anaheim's offerings and Irvine's 1993 offering represented that the offerings were to provide funds to meet each issuer's current fiscal year expenditures, including current expenses, capital expenditures, and the discharge of other obligations or indebtedness of the issuer. This section of the Official Statements for Irvine's 1994 offering and the Districts' offerings represented that the offerings were to provide funds to meet each issuer's current fiscal year expenditures, including current expenses, capital expenditures, investment and reinvestment, and the discharge of other obligations or indebtedness of the issuer.

U. The disclosure in the Issuers' Official Statements was misleading because it omitted material information that the intended purpose of the debt offerings was to invest the note proceeds into the Commingled Pool for profit. Furthermore, the Official Statements misleadingly retained information typically used in tax and revenue anticipation note offerings, which is another type of municipal securities offering, such as statements that

the taxable notes were issued "in anticipation of the receipt of taxes, revenue and other moneys" to be received by the issuer.

V. The Issuers failed to disclose in the Official Statements any information about the investment of the note proceeds in the Commingled Pool. Accordingly, the Official Statements failed to disclose that the Commingled Pool's investment strategy: (i) was predicated upon the assumption that prevailing interest rates would remain at relatively low levels; (ii) involved a high degree of leverage through the use of reverse repurchase agreements; (iii) involved a substantial investment in derivative securities, including inverse floaters, that are negatively affected by a rise in interest rates; and (iv) was sensitive to changes in the prevailing interest rate because of the combined effect of the derivative securities and leverage.

W. The Official Statements for these offerings further omitted to disclose the risks of the Commingled Pool's investment strategy. In particular, the Official Statements omitted to disclose that rising interest rates would have a substantial negative impact on the Commingled Pool in several respects: (i) the Commingled Pool's cost of borrowing on the substantial reverse repurchase position would increase; (ii) the interest income on the Commingled Pool's substantial investment in inverse floaters would decrease; (iii) the Commingled Pool's securities would decline in market value; (iv) as the value of the securities fell, the Commingled Pool would suffer collateral calls and reductions in amounts obtained under reverse repurchase agreements; (v) as a result of the above effects of a rise in interest rates, the Commingled Pool's earnings would decrease; and (vi) the Commingled Pool would suffer losses of principal at certain interest rate levels.

X. Finally, the Official Statements for the Issuers' 1994 offerings omitted to disclose certain material information concerning the Commingled Pool's investment results. In particular, the Official Statements omitted to disclose that, as a result of rising interest rates in early 1994: (i) the Commingled Pool's cost of borrowing had increased while the income earned from inverse floaters had decreased; (ii) the Commingled Pool had suffered substantial market losses in the overall value of the portfolio; and (iii) the Commingled Pool had suffered losses on the reverse repurchase transactions through collateral calls and reductions in amounts obtained under reverse repurchase agreements, which in turn, had a negative impact on liquidity.

Y. The Issuers knew that the purpose of the offerings was to invest the proceeds in the Commingled Pool. Moreover, the Issuers knew or should have known of certain information regarding the investment strategy of the Commingled Pool and, in 1994, the declining performance of the Commingled Pool. The Issuers should have known of certain related risks of the Commingled Pool's investment strategy. The Issuers received this information about the Pools from, and held meetings with representatives of, the County Treasurer, who managed the Pools. In addition, the Cities received reports which listed the Commingled Pool's portfolio holdings on a monthly basis in 1993 and 1994.

Anaheim, Irvine, Irvine USD, and OC Board Violated Sections 17(a)(2) and (3) of the Securities Act Through Negligent Conduct in the Offer and Sale of the Taxable Notes

Z. Sections 17(a)(2) and (3) of the Securities Act prohibit any person, directly or indirectly, by the use of the means or instruments of transportation or communication in interstate commerce or the mails, in the offer or sale of any security from obtaining money or property by means of any untrue statement of material fact or by omitting to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, and to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser. Scienter is not required to prove violations of Sections 17(a)(2) and (3) of the Securities Act. Aaron v. SEC, 446 U.S. 680, 697 (1980). Violations of these sections may be established by a showing of negligence. SEC v. Hughes Capital Corp., 124 F.3d 449, 453-54 (3d Cir. 1997); SEC v. Steadman, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992). Accordingly, Anaheim, Irvine, Irvine USD, and OC Board, through negligent conduct, violated Sections 17(a)(2) and (3) of the Securities Act in the offer and sale of the taxable notes.

III.

The Issuers have submitted Offers of Settlement in which, without admitting or denying the findings herein, each consents to the Commission's entry of this Order, which makes findings, as set forth above, and orders the Issuers to cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and (3) of the Securities Act. As set forth in the Offers of Settlement, the Issuers each undertake to cooperate with the Commission staff in preparing for and presenting any civil litigation or administrative proceedings concerning the transactions that are the subject of this Order.

IV.

In view of the foregoing, the Commission deems it appropriate to accept the Offers submitted by the Issuers and impose the cease-and-desist order specified in the Offer.

Accordingly, IT IS HEREBY ORDERED that, pursuant to Section 8A of the Securities Act:

1. Anaheim, Irvine, Irvine USD, and OC Board shall cease and desist from committing or causing any violation and any future violation of Sections 17(a)(2) and (3) of the Securities Act.

2. Anaheim, Irvine, Irvine USD, and OC Board shall each comply with the undertaking described in Section III. above.

By the Commission.
Jonathan G. Katz
Secretary

Footnotes

-[1]-The Order Instituting Public Administrative Cease-and-Desist Proceeding Pursuant to Section 8A of the Securities Act of 1933 in this matter was instituted on September 29, 1998. See Securities Act Release No. 7590.
-[2]- The findings herein are made pursuant to the Respondents' Offers and are not binding on any other person or entity named as a respondent in this or any other proceeding.

COMMISSION ORDERS – DISMISSED ACTION

In the Matter of North Orange County Community College District, Securities Act Release No. 7794, A.P. File No. 3-9739 (January 31, 2000).

Upon the recommendation of the Division of Enforcement with the agreement of Respondent North Orange County Community College District and after full consideration,

IT IS ORDERED this matter be, and hereby is, Dismissed Without Prejudice.

The parties have agreed that the dismissal of this proceeding and its reinstitution shall not be used against either of the parties for any purpose in this matter, including the application of any limitations period. Therefore,

It is FURTHER ORDERED that the Division is authorized to reinstitute this Proceeding upon resolution of the Commission's Appeal in SEC v. Dain Rauscher, Inc., Kenneth D. Ough, and Virginia L. Horler, Civil Action No. SA CV 98-639 (ANx)(C.D. Cal.) (9th Cir. Docket No. 99-56828).

By the Commission.

PUBLIC OFFICIALS

SETTLED INJUNCTIVE PROCEEDING

SEC v. David W. McConnell, Civ. Action No. 00CV-2261 (E.D. Penn.), Litigation Release No. 16534, AAE Release No. 1254 (May 2, 2000).

The Securities and Exchange Commission announced today that it filed a complaint in the United States District Court for the Eastern District of Pennsylvania against David W. McConnell, the former chief financial officer of Allegheny Health Education and Research Foundation ("AHERF"), and Charles P. Morrison, the former chief financial officer of AHERF's Delaware Valley region and an AHERF senior vice president, charging them with securities fraud. The Commission's Complaint alleges that McConnell and Morrison violated Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 by, among other things, creating, reviewing and approving false financial statements of AHERF and a group of its subsidiaries collectively known as the Delaware Valley Obligated Group ("Delaware Valley"), thereby masking, from at least December 1996 through July 1998, AHERF's severely deteriorating financial condition. Specifically, the Commission's Complaint alleges that the financial statements overstated: (a) the 1996 income of Delaware Valley by, approximately, $40 million; (b) the 1997 income of AHERF by approximately $114.3 million; and (c) the 1997 income of Delaware Valley by approximately $59.6 million, in documents issued to the public in December 1996 and February 1998.

Simultaneously with the filing of the Complaint, McConnell consented, without admitting or denying the allegations of the Complaint, to a permanent injunction enjoining him from violating Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and ordering him to pay a civil monetary penalty of $40,000.

AHERF is a Pennsylvania nonprofit healthcare organization. On July 21, 1998, AHERF filed for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code on behalf of itself and four of its subsidiaries in the U.S. District Court for the Western District of Pennsylvania. By the time of its bankruptcy filing in 1998, groups of one or more of AHERF's subsidiaries ("obligated groups") were responsible for repaying at least thirteen bond issues issued by or for the benefit of these obligated groups, totaling more than $900 million (the "AHERF Bonds").

On behalf of the obligated groups, AHERF provided to nationally recognized municipal securities information repositories annual Secondary Market Disclosure Reports which contained a section explaining the financial health of the reporting entity(ies), debt service coverage ratios, and which attached audited financial statements. The Disclosure Reports were made available to the public through these repositories and were the most easily accessible source of information for investors and potential investors in AHERF bonds.

According to the complaint, between December 12, 1996 and January 7, 1997, AHERF sent Delaware Valley's 1996 Disclosure Report and audited financial statements to the repositories and numerous other third parties. The Complaint alleges that Delaware

Valley's audited financial statements for the year ended June 30, 1996 were materially false and misleading, and failed to comply with Generally Accepted Accounting Principles ("GAAP"), because they materially overstated Delaware Valley's 1996 income by, approximately, $40 million and misrepresented the condition of Delaware Valley accounts receivable. The complaint further alleges that Delaware Valley's 1996 Disclosure Report was materially false and misleading in that it mirrored the numerical misstatements in the 1996 financial statements and it materially misrepresented the condition of Delaware Valley accounts receivable.

The complaint further alleges that, in February 1998, AHERF distributed its 1997 audited consolidated financial statements with consolidating schedules and consolidated Disclosure Report to the repositories and numerous other third parties. According to the Complaint, AHERF's audited consolidated financial statements with consolidating schedules for the year ended June 30, 1997, which purported to be prepared in accordance with GAAP, were materially false and misleading and failed to comply with GAAP in that they materially overstated AHERF's 1997 consolidated net income by, approximately, $114.3 million and they materially overstated the 1997 net income of Delaware Valley by, approximately, $59.6 million. AHERF's 1997 consolidated Disclosure Report allegedly was materially false and misleading in that it: (1) mirrored the numerical misstatements in the AHERF 1997 audited consolidated financial statements and consolidating schedules; (2) misrepresented the condition of Delaware Valley accounts receivable; and (3) misrepresented the financial condition of another AHERF obligated group, namely the Centennial obligated group ("Centennial").

The Commission also entered two administrative orders related to this case. Without admitting or denying the Commission's findings, two other members of AHERF's senior management agreed to orders to cease and desist from committing or causing any violation and any future violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and barring them pursuant to Rule 102(e) of the Commission's Rules of Practice from appearing or practicing before the Commission as an accountant, with the right to reapply after three years. See In the Matter of Albert Adamczak, CPA, Exchange Act Release No.42743, dated May 2, 2000; In the Matter of Stephen H. Spargo, CPA, Exchange Act Release No. 42742 , dated May 2, 2000.

In the Matter of the City of Miami, Florida, Cesar Odio and Manohar Surana, Securities Act Release No. 7741, Exchange Act Release No. 41896, A.P. File No. 3-10022 (September 22, 1999).
See "ISSUERS" Section.

In the Matter of Manohar Surana, Securities Act Release No. 7895, Exchange Act Release No. 43325, A.P. File No. 3-10022 (September 22, 2000).

I.

The Securities and Exchange Commission ("Commission") instituted public cease-and-desist proceedings pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Respondent Manohar Surana ("Surana") on September 22, 1999.

II.

Respondent Surana has submitted an Offer of Settlement ("Offer") to the Commission, which the Commission has determined to accept. Solely for the purpose of this proceeding and any other proceeding brought by or on behalf of the Commission, or in which the Commission is a party, and without admitting or denying the findings herein, except as to the jurisdiction of the Commission over Respondent and over the subject matter of this proceeding and as to Section III.A., which are admitted, Respondent Surana by his Offer consents to the entry of findings and the cease-and-desist order set forth below.

III.

On the basis of this Order Making Findings and Imposing Cease-and-Desist Order ("Order") and the Offer submitted by Respondent Surana the Commission finds n1 that:

- - - - - - - - - - - - - - - - - -FOOTNOTES- - - - - - - - - - - - - - - - - -

n1 The findings herein are not binding on anyone other than Surana.

- - - - - - - - - - - - - - - - -END FOOTNOTES- - - - - - - - - - - - - - - - -

A. At all relevant times, the City of Miami ("the City") was the largest municipality in Miami-Dade County, Florida. The City was governed by a five member commission and run by a chief administrative officer, known as the City Manager, who reported to the commission.

B. At all relevant times, Surana was the City's Director of Finance and Assistant City Manager. In that capacity, he oversaw the Finance Department, which was responsible

for, among other things, accounting and budget. Surana had direct involvement in and responsibility for the preparation of the City's fiscal year 1995 financial statements and the fiscal year 1995 Budget.

C. In June 1995, the City offered and sold, on a competitive bid basis, $22.5 million in general obligation bonds to pay for the cost of certain sanitary sewer improvements (the "Sewer Bond Offering" or "Sewer Bonds"). In August 1995, the City offered and sold, on a negotiated basis, $ 22 million in on-ad valorem revenue bonds to principally finance the City's acquisition of a new administration building, and to acquire and to pay for certain capital improvements to a City park (the "FPL Offering" or "FPL Bonds"). In December 1995, the City offered and sold, on a negotiated basis, $ 72 million in non-ad valorem revenue bonds to pay for certain of its annual pension and employee compensated absences obligations (the "Pension Bond Offering" or "Pension Bonds").

D. The Official Statements for all three offerings (collectively referred to as the "Bond Offerings") contained the City's fiscal year 1994 audited general purpose financial statements. Also contained in the Official Statements, by incorporation, was a certification located in the Closing Documents (the “anti-fraud certification") stating that the Official Statements were free of misstatements and omissions of material fact, and that there had been no material adverse change in the City's financial condition since the close of the prior fiscal year. Surana executed the anti-fraud certifications for the Pension Bond Offering. Contained in the Sewer and FPL Offering Official Statements was the adopted fiscal year 1995 general fund budget.

E. On or about September 1995, the City mailed its Comprehensive Annual Financial Report for fiscal year 1994 ("1994 CAFR") to broad segments of the investing public. In mailing the 1994 CAFR, the City targeted the investment community, including government and municipal securities dealers, investment banking firms, credit rating agencies, bond insurers and individuals. The City also provided the 1994 CAFR to federal, state and local governments, as well as to public and university libraries. The 1994 CAFR contained a Letter of Transmittal dated February 28, 1995. The 1994 CAFR also contained the City's fiscal year 1994 audited general purpose financial statements.

F. The City's financial condition began to materially decline after the close of fiscal year 1994 and continued to worsen through December 1995. Specifically, the City's cash position had deteriorated to the point where the City faced the prospect of being unable to meet its operating expenses through fiscal year 1995. Surana was aware of the City's dire economic situation.

G. The Official Statements failed to disclose the City's financial condition to investors at the time of the Bond Offerings. Specifically, the City omitted to state that its cash position had materially declined since the close of fiscal year 1994 and that serious consequences could result, including being unable to pay its operating expenses and debt service in fiscal year 1995, if its cash position did not significantly improve. The Official Statements also failed to disclose that Operation Right-Size, a program designed to

significantly reduce City expenditures, while necessary, might not have been sufficient to remedy the City's immediate economic problems. In addition, the Pension Bond Offering Official Statement failed to disclose that the Pension Bonds were issued in order to address the City's "immediate cash flow requirements." Absent these disclosures, the Official Statements did not reveal the City's true financial condition to investors.

H. The statements made in the anti-fraud certifications contained in the Closing Documents, and by incorporation, in the Official Statements, that no material adverse change in the City's finances had occurred since the close of the prior fiscal year, and that the Official Statements contained no omissions or misrepresentations of material fact, are false in light of the City's true financial situation at the time of the Bond Offerings.

I. The only discussion in the Official Statements, which even alludes to the City's cash problems, is found in a footnote to the financial statements. That footnote states that as of September 30, 1994 the City "experienced cash deficits in several of its operating funds which were temporarily remedied by loans from other funds", and that the City intended to replenish these cash deficits through the anticipated savings to be generated by Operation Right-Size. The footnote also states that "the implementation of the [Operation Right-Size] proposals ... are expected to strengthen the City's financial condition." This footnote, located in a section principally addressing the City's proprietary funds, does not sufficiently disclose to investors the nature and gravity of the City's financial situation. Specifically, it omits to state that: (a) the City's cash position had materially declined since the close of fiscal year 1994, (b) the City faced the prospect of being unable to meet its operating expenses in fiscal year 1995 absent significant improvement in its cash position and (c) Operation Right-Size -- a direct result of the City's deteriorating finances -- although necessary, may have been insufficient to remedy the City's immediate cash flow problems.

J. The City's 1994 CAFR also failed to disclose the City's deteriorating financial condition to the market place about previously issued City debt. Besides the same footnote to the financial statements, which was also contained in the Official Statements, the only disclosure contained in the 1994 CAFR that arguably addresses the City's financial problems is found in the Letter of Transmittal. In the Letter of Transmittal, the City merely repeats verbatim that portion of the footnote, which discusses Operation Right-Size and its anticipated savings. Like the footnote contained in the financial statements, the Letter of Transmittal does not disclose the true nature and gravity of the City's financial situation.

K. In formulating its fiscal year 1995 budget in the summer of 1994, the City included approximately $ 9 million in revenues from the Violent Crime Control and Law Enforcement Act of 1994 (the "Crime Bill"), federal legislation which authorized funding to local, state and federal governments to fight crime. The City's approximate $ 9 million Crime Bill revenue projection was based upon a municipal lobbying group report issued in May of 1994 indicating that Miami could expect to receive $ 9,003,862 from the Local Partnership Act, a block grant provision of the Crime Bill. At that time, the Crime Bill

legislation being considered by Congress provided that all the block grant monies under the Local Partnership Act would be paid in a lump sum in fiscal year 1995. However, the final version of the Crime Bill, signed into law by the President on September 13, 1994, reduced funding under the Local Partnership Act and provided that payments would be made over five years commencing in fiscal year 1996. Notwithstanding these material changes which made it certain that the City would not receive the $ 9 million in fiscal year 1995, the City passed the fiscal year 1995 budget, which included the $ 9 million in Crime Bill revenues, on September 22, 1994, nine days after the President had signed the Crime Bill into law.

L. Surana was reckless in not knowing, prior to the City's adoption of the fiscal year 1995 budget, that the block grant funding provisions of the Crime Bill had changed and, as a consequence, the City would not receive the $ 9 million in fiscal year 1995 and therefore did not have a balanced budget. The Crime Bill projected revenues were included in the general fund budget figures (breakdown of revenues and expenditures) contained in the Official Statements in both the Sewer and FPL Offerings, which were provided to investors. Thus, the Sewer and FPL Offering Official Statements falsely represented that the City had achieved a balanced budget for fiscal year 1995.

M. Surana, acting through the City, recklessly failed to disclose the City's deteriorating financial condition in the Official Statements. Surana was aware that the City's cash position had materially declined from the close of the prior fiscal year and that there was a possibility that the City would not meet its operating expenses in fiscal year 1995, yet approved the Pension Bond Official Statement which failed to disclose this fact. Surana was reckless in not knowing that the anti-fraud certification for the Pension Bond Offering was false when he executed it.

N. Based upon the aforesaid conduct, Surana caused violations of Sections 17(a)(1), 17(a)(2) and 17(a)(3) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

IV.

In view of the foregoing, the Commission deems it appropriate to accept the Offer submitted by Surana and impose the following cease-and-desist order:

IT IS ORDERED, pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act that Respondent cease and desist from committing or causing any violation and any future violation of Sections 17(a)(1), 17(a)(2) and 17(a)(3) of the Securities Act and Section 10(b) of the Exchange Act, and Rule 10b-5, thereunder.

By the Commission.

In the Matter Cesar Odio, Securities Act Release No. 7851, Exchange Act Release No. 42690, AAE Release No. 1248, A.P. File No. 10022 (April 14, 2000).

I.

The Securities and Exchange Commission ("Commission") instituted public cease-and-desist proceedings pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Respondent Cesar Odio ("Odio") on September 22, 1999.

II.

Respondent Odio has submitted an Offer of Settlement ("Offer") to the Commission, which the Commission has determined to accept. Solely for the purpose of this proceeding and any other proceeding brought by or on behalf of the Commission, or in which the Commission is a party, and without admitting or denying the findings herein, except as to the jurisdiction of the Commission over Respondent and over the subject matter of this proceeding and as to Section III.A., which is admitted, Respondent Odio by his Offer consents to the entry of findings and cease-and-desist order set forth below.

III.

On the basis of this Order Making Findings and Imposing Cease-and-Desist Order ("Order") and the Offer submitted by Respondent Odio the Commission finds[1] that:

A. At all relevant times, the City of Miami ("the City") was the largest municipality in Miami-Dade County, Florida. The City was governed by a five member commission and run by a chief administrative officer, known as the City Manager, who reported to the commission.

B. At all relevant times, Odio was the City Manager. As City Manager, Odio had full authority over the City's financial operations and the preparation of its annual budget.

The Fraudulent Offer and Sale of the Bonds

C. In June 1995, the City offered and sold, on a competitive bid basis, $22.5 million in general obligation bonds to pay for the cost of certain sanitary sewer improvements (the "Sewer Bond Offering" or "Sewer Bonds"). In August 1995, the City offered and sold, on a negotiated basis, $22 million in non-ad valorem revenue bonds to principally finance the City's acquisition of a new administration building, and to acquire and to pay for certain capital improvements to a City park (the "FPL Offering" or "FPL Bonds"). In December 1995, the City offered and sold, on a negotiated basis, $72 million in non-ad valorem revenue bonds to pay for certain of its annual pension and employee compensated absences obligations (the "Pension Bond Offering" or "Pension Bonds").

D. The Official Statements for all three offerings (collectively referred to as the "Bond Offerings") contained the City's fiscal year 1994 audited general purpose financial statements. Also contained in the Official Statements, by incorporation, was a certification located in the Closing Documents (the "anti-fraud certification") stating that the Official Statements were free of misstatements and omissions of material fact, and

that there had been no material adverse change in the City's financial condition since the close of the prior fiscal year. Odio executed the anti-fraud certifications for the Sewer, FPL, and Pension Bond Offerings. Contained in the Sewer and FPL Offering Official Statements was the adopted fiscal year 1995 general fund budget.

E. On or about September 1995, the City mailed its Comprehensive Annual Financial Report for fiscal year 1994 ("1994 CAFR") to broad segments of the investing public. In mailing the 1994 CAFR, the City targeted the investment community, including government and municipal securities dealers, investment banking firms, credit rating agencies, bond insurers and individuals. The City also provided the 1994 CAFR to federal, state and local governments, as well as to public and university libraries. The 1994 CAFR contained a Letter of Transmittal dated February 28, 1995, which was signed by Odio. The 1994 CAFR also contained the City's fiscal year 1994 audited general purpose financial statements.

F. The City's financial condition began to materially decline after the close of fiscal year 1994 and continued to worsen through December 1995. Specifically, the City's cash position had deteriorated to the point where the City faced the very credible prospect of being unable to meet its operating expenses through fiscal year 1995. Odio was keenly aware of the City's dire economic situation.

G. The Official Statements failed to disclose the City's financial condition to investors at the time of the Bond Offerings. Specifically, the City omitted to state that its cash position had materially declined since the close of fiscal year 1994 and that serious consequences could result, including being unable to pay its operating expenses and debt service in fiscal year 1995, if its cash position did not significantly improve. The Official Statements also failed to disclose that Operation Right-Size, a program designed to significantly reduce City expenditures, while necessary, might not have been sufficient to remedy the City's immediate economic problems. In addition, the Pension Bond Offering Official Statement failed to disclose that the Pension Bonds were issued in order to address the City's "immediate cash flow requirements." Absent these disclosures, the Official Statements did not reveal the City's true financial condition to investors.

H. The statements made in the anti-fraud certifications contained in the Closing Documents, and by incorporation, in the Official Statements, that no material adverse change in the City's finances had occurred since the close of the prior fiscal year, and that the Official Statements contained no omissions or misrepresentations of material fact, are false in light of the City's true financial situation at the time of the Bond Offerings.

I. The only discussion in the Official Statements, which even alludes to the City's cash problems, is found in a footnote to the financial statements. That footnote states that as of September 30, 1994 the City "experienced cash deficits in several of its operating funds which were temporarily remedied by loans from other funds", and that the City intended to replenish these cash deficits through the anticipated savings to be generated by Operation Right-Size. The footnote also states that "[t]he implementation of the [Operation Right-Size] proposals ... are expected to strengthen the City's financial condition." This footnote, located in a section principally addressing the City's proprietary funds, does not sufficiently disclose to investors the nature and gravity of the

City's financial situation. Specifically, it omits to state that: (a) the City's cash position had materially declined since the close of fiscal year 1994, (b) the City faced the prospect of being unable to meet its operating expenses in fiscal year 1995 absent significant improvement in its cash position and (c) Operation Right-Size -- a direct result of the City's deteriorating finances -- although necessary, may have been insufficient to remedy the City's immediate cash flow problems.

J. The City's 1994 CAFR also failed to disclose the City's deteriorating financial condition to the market place about previously issued City debt. Besides the same footnote to the financial statements, which was also contained in the Official Statements, the only disclosure contained in the 1994 CAFR that arguably addresses the City's financial problems is found in the Letter of Transmittal. In the Letter of Transmittal, the City merely repeats verbatim that portion of the footnote, which discusses Operation Right-Size and its anticipated savings. Like the footnote contained in the financial statements, the Letter of Transmittal does not disclose the true nature and gravity of the City's financial situation.

The Fiscal Year 1995 Budget Fraud

K. In formulating its fiscal year 1995 budget in the summer of 1994, the City faced a $15.8 million general fund budget deficit. Through increases in property taxes, and additional revenues from licenses and permits and the sale of landfill, the City was able to reduce partially the budget deficit by $6.8 million. However, not having sufficient revenues to solve the remaining $9 million budget deficit, and not wanting to take the politically unpopular move of cutting expenses, the City, through Odio, balanced the fiscal year 1995 budget by including approximately $9 million in revenues from the Violent Crime Control and Law Enforcement Act of 1994 (the "Crime Bill"), federal legislation which authorized funding to local, state and federal governments to fight crime. The City's approximate $9 million Crime Bill revenue projection was based upon a municipal lobbying group report issued in May of 1994 indicating that Miami could expect to receive $9,003,862 from the Local Partnership Act, a block grant provision of the Crime Bill. At that time, the Crime Bill legislation being considered by Congress provided that all the block grant monies under the Local Partnership Act would be paid in a lump sum in fiscal year 1995. However, the final version of the Crime Bill, signed into law by the President on September 13, 1994, reduced funding under the Local Partnership Act and provided that payments would be made over five years commencing in fiscal year 1996. Notwithstanding these material changes which made it certain that the City would not receive the $9 million in fiscal year 1995, the City passed the fiscal year 1995 budget, which included the $9 million in Crime Bill revenues, on September 22, 1994, <u>nine days after</u> the President had signed the Crime Bill into law.

L. Odio knew, or was reckless in not knowing, prior to the City's adoption of the fiscal year 1995 budget, that the block grant funding provisions of the Crime Bill had changed and, as a consequence, the City would not receive the $9 million -- representing approximately 57% of the $15.8 million general fund budget deficit -- in fiscal year 1995 and therefore did not have a balanced budget. The Crime Bill projected revenues were included in the general fund budget figures (breakdown of revenues and expenditures) contained in the Official Statements in both the Sewer and FPL Offerings, which were

provided to investors. Thus, the Sewer and FPL Offering Official Statements falsely represented that the City had achieved a balanced budget for fiscal year 1995.

Odio's Participation in the Fraudulent Bond Offerings

M. Odio, acting through the City, knowingly and/or recklessly failed to disclose the City's deteriorating financial condition in the Official Statements. Odio knew that the City's cash position had materially declined from the close of the prior fiscal year and that there was a very credible possibility that the City would not meet its operating expenses in fiscal year 1995, yet approved the Official Statements which failed to disclose this fact. Odio also knew that the anti-fraud certifications he executed were false. Further, Odio signed the Letter of Transmittal contained in the 1994 CAFR which failed to disclose the City's true financial condition. Moreover, Odio knew or should have known prior to the passage of the proposed fiscal year 1995 budget that the City would not receive the $9 million from the Crime Bill in fiscal year 1995 and thus did not have a balanced budget.

Violations

N. Based upon the aforesaid conduct, Odio committed or caused, violations of, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, in that, in connection with the purchase and sale of certain securities, namely the Sewer Bonds, FPL Bonds and Pension Bonds, as well as the City's other previously issued and outstanding bonds, by use of the means and instrumentalities of interstate commerce and by use of the mails, Odio, directly and indirectly, employed devices, schemes, and artifices to defraud; made untrue statements of material facts and omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; and engaged in acts, practices and a course of business which would and did operate as a fraud and deceit.

O. Based upon the aforesaid conduct, Odio committed or caused, violations of, Section 17(a)(1) of the Securities Act, in that, in the offer and sale of certain securities, namely the Sewer Bonds, FPL Bonds and Pension Bonds, by the use of the means and instruments of transportation and communication in interstate commerce and by use of the mails, Odio, directly and indirectly, employed devices, schemes and artifices to defraud.

P. Based upon the aforesaid conduct, Odio committed or caused, violations of, Sections 17(a)(2) and 17(a)(3) of the Securities Act, in that, in the offer and sale of certain securities, namely the Sewer Bonds, FPL Bonds and Pension Bonds, by the use of the means and instruments of transportation and communication in interstate commerce and by use of the mails, Odio, directly and indirectly, obtained money or property by means of untrue statements of material facts and omissions to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; and engaged in transactions, practices and a course of business which would and did operate as a fraud and deceit upon the purchasers and prospective purchasers of such securities.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to accept the Offer submitted by Odio and impose the following cease-and-desist order:

IT IS ORDERED, pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") that Respondent cease and desist from committing or causing any violation and any future violation of Sections 17(a)(1), 17(a)(2) and 17(a)(3) of the Securities Act and Section 10(b) of the Exchange Act, and Rule 10b-5, thereunder.

For the Commission, by its Secretary, pursuant to delegated authority.

Jonathan G. Katz
Secretary

Footnotes

1 The findings herein are not binding on anyone other than Odio.

OBLIGATED PERSONS

COMMISSION ORDERS – SETTLED ADMINISTRATIVE PROCEEDING

In the Matter of Allegheny Health, Education and Research Foundation, Exchange Act Release No. 42992, AAE Release No. 1283, A.P. File No. 3-10245 (June 30, 2000).

I.

The Securities and Exchange Commission deems it appropriate that cease-and-desist proceedings be instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Allegheny Health, Education and Research Foundation ("AHERF").

II.

In anticipation of the institution of these proceedings, AHERF has submitted an Offer of settlement that the Commission has determined to accept. Solely for the purpose of these proceedings, and any other proceedings brought by or on behalf of the Commission or in which the Commission is a party, AHERF, without admitting or denying the findings contained herein, except that it admits to the jurisdiction of the Commission over it and over the subject matter of these proceedings, consents to the entry of the findings and the issuance of this Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing Cease-And-Desist Order.

Accordingly, IT IS ORDERED that proceedings against AHERF be, and hereby are, instituted.

III.

On the basis of this Order and the Offer submitted by AHERF, the Commission finds that:[1]

A. Respondent

AHERF. AHERF is a Pennsylvania nonprofit healthcare organization formed in 1983. AHERF was the parent holding company and sole member or owner of numerous subsidiaries.[2] On July 21, 1998, AHERF instituted bankruptcy proceedings under Chapter 11 of the United States Bankruptcy Code on behalf of itself and four of these subsidiaries in the U.S. District Court for the Western District of Pennsylvania.

B. Facts

1. Summary

This matter involves actions by senior executives at AHERF, at its height the largest nonprofit health care organization in Pennsylvania, to grossly overstate the income of AHERF and some of its subsidiaries, thereby masking the enterprise's deteriorating financial condition. On July 21, 1998, AHERF and four of its subsidiaries filed for protection under Chapter 11 of the U.S. Bankruptcy Code. However, from at least December 1996 through February 1998, AHERF and some of its subsidiaries collectively known as the Delaware Valley Obligated Group ("Delaware Valley") issued annual financial statements and municipal securities disclosure reports that materially misrepresented, among other things, AHERF's and Delaware Valley's net income. AHERF, through certain members of its senior management and in violation of Generally Accepted Accounting Principles ("GAAP"): (i) overstated Delaware Valley's 1996 net income before extraordinary item and change in accounting principle by approximately $40 million by failing to adjust Delaware Valley's bad debt reserves to account for uncollectible accounts receivable; (ii) overstated Delaware Valley's and its own 1997 net income through the inappropriate transfers of approximately $99.6 million in reserves that were utilized to address the bad debt reserve shortfall not addressed in 1996, as well as an additional shortfall in 1997; and (iii) overstated its 1997 net income by misclassifying certain restricted trust funds. The misclassification of the restricted funds and the transfers resulted in the overstatement of AHERF's consolidated net income for the period ended June 30, 1997 by approximately $114.3 million. Significantly, both Delaware Valley and AHERF would have posted substantial net losses for fiscal year 1997 without the fraudulent activity.[3] Among the victims were investors holding more than $550 million of publicly offered bonds issued by or on behalf of three of the bankrupt subsidiaries.

2. Background

Before its bankruptcy in July 1998, AHERF was a Pittsburgh-based collection of non-profit acute-care hospitals, a medical university, physician practice groups, and numerous other affiliated entities. From 1987 to 1997, AHERF expanded rapidly, acquiring other non-profit healthcare organizations, including several in the Philadelphia metropolitan area: the Medical College of Pennsylvania, United Hospitals, Inc., Hahnemann University Hospital and the Graduate Health System ("Graduate"). Acquired entities became direct or indirect subsidiaries of AHERF. As an umbrella holding company, AHERF managed and provided centralized corporate support services for the acquired entities, but did not assume liability for their pre-existing debt. The obligation to repay debt within AHERF was placed on collections of one or more of its non-profit subsidiaries known as "obligated groups." Each subsidiary within an obligated group was jointly and severally liable for the debt of that obligated group. By 1997, AHERF had five obligated groups**:** Allegheny General Hospital ("Allegheny General"), Allegheny University Medical Centers, Delaware Valley, Allegheny Hospitals, Centennial ("Centennial"), and Allegheny Hospitals, New Jersey.

On July 21, 1998, AHERF filed for protection under Chapter 11 of the U.S. Bankruptcy Code in U.S. District Court for the Western District of Pennsylvania on behalf of itself, the Delaware Valley hospitals and university, the Centennial hospitals and the Allegheny University Medical Practices. According to the bankruptcy petition and supporting documents, AHERF and these subsidiaries accumulated $1.3 billion in outstanding debt. The outstanding debt included approximately $396 million of publicly offered bonds issued by or on behalf of Delaware Valley and $154.3 million of publicly offered bonds issued on behalf of Graduate and assumed by the Centennial Hospitals. On September 2, 1998, following substantial media coverage about the bankruptcy, AHERF issued a press release in which it acknowledged that its audited financial statements for 1997 were inaccurate. In the release, AHERF stated that "[n]o further reliance should be placed on the financial statements" or upon the accompanying report prepared by AHERF's independent auditor.

3. AHERF's Continuing Disclosure Obligations

By the time of the bankruptcy in July 1998, AHERF's obligated groups were responsible for at least thirteen bond issues, with outstanding debt of more than $900 million.[4] The individual issues ranged from $12.7 million to $306 million, the latter incurred on behalf of Delaware Valley in a 1996 refinancing of its older bonds (the "Delaware Valley refinancing"). At least $400 million of AHERF bonds were not credit enhanced, meaning that they were not supported by a letter of credit or bond insurance. The obligated groups, through AHERF as their agent, provided to nationally recognized repositories annual Secondary Market Disclosure Reports ("Disclosure Reports") containing audited financial statements, debt coverage ratios and other information with respect to certain of its obligated groups.[5] These Disclosure Reports were made available to the public through these repositories and were the most easily accessible source of information for investors and potential investors in AHERF bonds. The obligated groups also were required by contract to periodically disclose financial information to, among others, credit enhancers and bond trustees, and some of the agreements required certifications by company officers as to the accuracy of the submitted information.

4. Misrepresentations in Financial Statements and Disclosure Documents

AHERF's rapid growth and consequent debt left it with significant pressures to maintain stable financial results and positive net income. It was in this environment that AHERF, through certain of its senior officers and in violation of applicable accounting principles, misstated its financial statements and schedules to overstate the 1996 and 1997 net income of AHERF, including that of some of its subsidiaries, in materials disseminated to the public, including investors and potential investors in the various AHERF bonds.

a. AHERF's Financial Reporting Function

At all relevant times, AHERF's financial reporting function, including the initial preparation of financial statements, was primarily handled by AHERF's Corporate Support Services Department (the "Accounting Department"). This department was under the control of AHERF's Chief Financial Officer, who reported to AHERF's Chief Executive Officer. Significant aspects of the financial reporting function also were the

responsibility of other departments or entities within AHERF. For example, separate AHERF entities each had their own Chief Executive Officers and Chief Financial Officers. These individuals also participated, to varying degrees, in AHERF's financial reporting.

b. The 1996 $40,000,000 Overstatement

In October 1996 AHERF decided to write off approximately $81 million in Delaware Valley uncollectible accounts receivable. This decision was made more than two months prior to AHERF's issuance of Delaware Valley's 1996 financial statements and was based on information that indicated that the accounts receivable were impaired as of Delaware Valley's June 30, 1996 balance sheet date. This write off would have necessitated an approximately $40 million increase to Delaware Valley's bad debt reserve and bad debt expense. Despite this, and in violation of GAAP, AHERF failed to adjust Delaware Valley's bad debt reserve as of June 30, 1996, resulting in a $40 million overstatement of Delaware Valley's net income before extraordinary item and change in accounting principle and corresponding misstatements in the 1996 Delaware Valley Disclosure Report.

During fiscal year 1996, AHERF senior management was aware of substantial increases in, and collection problems with, Delaware Valley's patient accounts receivable. They attempted to diagnose and address this issue through, among other things, changes in management and internal meetings. By early fall 1996 AHERF decided to write off approximately $81 million in Delaware Valley patient accounts receivable.[6] It then implemented a plan by which to write those accounts off in quarterly installments, beginning in October 1996. Although Delaware Valley's reserve for bad debts was insufficient at June 30, 1996, AHERF made no effort to adjust the 1996 financial statements, which were being finalized contemporaneously with this decision to write off $81 million. Under GAAP, Delaware Valley should have increased its bad debt reserve.[7] AHERF ultimately determined that the bad debt reserve shortfall as of June 30, 1996 was approximately $40 million. This shortfall calculation was based upon the $81 million write off and its effect on Delaware Valley's bad debt reserve, using Delaware Valley's methodology for computing its bad debt reserve.

Between December 12, 1996 and January 7, 1997, AHERF distributed Delaware Valley audited financial statements and 1996 Disclosure Report to the public. Appropriately adjusting Delaware Valley's bad debt reserve would have, among other things, reduced its reported net income of $27 million before extraordinary item and change in accounting principle by approximately $40 million and similarly reduced its reported net accounts receivable figure of $253 million by approximately $40 million. Moreover, the management discussion and analysis ("MD&A") portion of the Disclosure Report implied that the $72.2 million increase in Delaware Valley accounts receivable during fiscal year 1996 was a temporary phenomenon that would resolve itself upon completion of Patient Billing department consolidation and conversion. In addition, the referenced patient accounts receivable figure, taken from the Delaware Valley balance sheet, should have represented amounts that, in the judgment of AHERF, were still collectible. However, months before the date of the Disclosure Report, AHERF knew or was reckless in not knowing that accounts receivable were overstated by, at least, $40 million, and that

the primary cause of the increase in net accounts receivable was, in fact, the failure of AHERF to adequately increase Delaware Valley's bad debt reserve. Increasing the bad debt reserve would have, in turn, decreased the Delaware Valley net accounts receivable figure on its balance sheet. Despite this knowledge, AHERF did not correct the misstatement and, by not doing so, hid the misstatements contained in the Delaware Valley fiscal 1996 audited financial statements and the financial information contained within the Disclosure Report.

c. The 1997 $114,300,000 Overstatement

The AHERF consolidated financial statements and consolidating schedules for fiscal year 1997 overstated both AHERF and Delaware Valley net income through AHERF's inappropriate transfer of $99.6 million from the Graduate Hospitals to the Delaware Valley and its misclassification of $54.7 million in trust funds. Correcting both misstatements, AHERF's reported consolidated net income was overstated by approximately $114.3 million. Moreover, AHERF's 1997 Disclosure Report included misstatements pertaining to the decrease in Delaware Valley accounts, as well as misleading narrative information about intercompany account balances and restructuring expenses.

i) The Transfer of $99.6 Million in Reserves

The failure to address the accounts receivable problems described above in fiscal year 1996 and the continued deterioration of accounts receivable in fiscal year 1997 resulted in approximately $111 million of write offs of uncollectible accounts receivable by June 30, 1997. However, Delaware Valley did not have sufficient bad debt reserves in fiscal year 1997 to absorb $111 million in write offs and still maintain an adequate bad debt reserve under GAAP for its remaining accounts receivable. Proper accounting treatment under GAAP required increasing these reserves through bad debt expense, thereby decreasing Delaware Valley's net income.[8] In violation of GAAP, AHERF increased Delaware Valley's reserves without recognizing the corresponding charge to income. Specifically, during the third and fourth quarters of fiscal 1997, AHERF, through a series of intercompany transactions, transferred to Delaware Valley $99.6 million of reserves from various Graduate hospitals.[9] Although AHERF did this to address Delaware Valley's bad debt reserve shortfall, $40 million of that shortfall properly was attributable to fiscal year 1996. During the time the transferred reserves were established, the Graduate hospitals were held in a separate company controlled by AHERF that was not included in the AHERF consolidated financial statements.[10] As a result, AHERF and Delaware Valley avoided the negative earnings impact of establishing the reserves required under GAAP.

By virtue of the transfer of reserves from the Graduate hospitals to Delaware Valley to cover bad debt, the AHERF 1997 audited consolidated financial statements, distributed to the public on or about February 6, 1998, overstated reported net income of $21.9 million by, approximately, $59.6 million.[11] Similarly, Delaware Valley 1997 reported net income of $23.7 million, reflected on the consolidating schedules, was overstated by, approximately, $59.6 million. Moreover, as part of the bond agreements, AHERF

certified to bond trustees and others that, among other things, the 1997 financial statements were prepared in conformity with GAAP.

The 1997 Disclosure Report, also distributed to the public on or about February 6,1998, mirrored the numbers contained in the 1997 financial statements, thereby repeating the misstatements described above. Moreover, the MD&A discussion for Delaware Valley attributed a $50.7 million decrease in patient accounts receivable to enhanced patient accounts receivable collection and more cost effective billing and accounts receivable management. In fact, accounts receivable decreased in 1997 by virtue of the transfers from the Graduate reserves, not an improved collection process.

Moreover, Centennial was portrayed more negatively than its financial condition warranted.[12] The MD&A discussion for the Centennial Hospitals attributed $46.1 million in restructuring costs to "the recognition of reserves for patient accounts receivable third-party reimbursement issues, inventory obsolescence, pension costs and self insurance reserves for malpractice and workers' compensation claims." In fact, at least $28.4 million of these reserves were considered excess at June 30, 1997 and were utilized for a different, undisclosed purpose - covering Delaware Valley's bad debt reserve shortfall.[13] Moreover, the MD&A section attributes a change from a $48.8 million receivable to a $100.2 million payable position in Centennial intercompany account balances to the inclusion of the intercompany balances of two new entities in the obligated group, intercompany charges for corporate support services and borrowings for operating and cash flow requirements, and the transfer of pension and self insurance liabilities from Centennial's balance sheet to AHERF. Unmentioned are the reserve transfers to Delaware Valley, which for accounting purposes were treated from Centennial's perspective as an intercompany account payable.

ii) The Misclassification of Trust Funds

In fiscal year 1996, AHERF, through senior management, misclassified five irrevocable trusts held by an independent trustee known collectively as the "Lockhart Trusts," with a market value as of June 30, 1996 of $87.3 million.[14] Applicable state law and the trust documents provided that the capital gains attributable to the Lockhart Trusts were part of the corpus of the trust and accordingly inaccessible to AHERF.

In adopting FAS 116,[15] AHERF misclassified the Lockhart funds by treating permanently restricted funds in the Lockhart Trusts as available to AHERF. However, by early fiscal 1997 AHERF senior management had received notice that its classification of the Lockhart Trusts was incorrect. In November 1996, AHERF senior management received and reviewed written notice from the independent trustee to the effect that the Lockhart Trust documentation explicitly provided that only income (and not capital gains) was available to AHERF. In response, AHERF senior management discussed, but did not modify, the Lockhart Trust classification. In addition, for fiscal year 1997, AHERF improperly recognized $54.7 million from the Lockhart Trust assets as income. [16] As a result, without considering the impact of the Delaware Valley fraud described above, AHERF overstated its reported net income in its consolidated audited financial statements for 1997 by $54.7 million.

C. Legal Discussion: AHERF Violated Section 10(b) of the Exchange Act and Rule 10b-5 Thereunder

Section 10(b) of the Exchange Act and Rule 10b-5 thereunder make it unlawful to make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. Any issuer that releases information to the public that is reasonably expected to reach investors and trading markets will be subject to the antifraud provisions. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied sub nom, Coates v. SEC, 394 U.S. 976 (1969). The antifraud provisions are equally applicable to disclosures in the secondary market for municipal securities. See Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, Exchange Act Rel. No. 33-7049, 1994 SEC LEXIS 700 (March 9, 1994).

AHERF, through certain of its senior officers, violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. As described above, AHERF materially overstated Delaware Valley's net income before extraordinary item and change in accounting principle by, approximately, $40 million, in the 1996 Delaware Valley audited financial statements and Disclosure Report. It further overstated its consolidated net income by $114.3 million and Delaware Valley's net income by $59.6 million in the 1997 AHERF audited consolidated financial statements and consolidating schedules and the 1997 Disclosure Report. In both Disclosure Reports, AHERF hid its true financial condition from the public through its misleading disclosures and omissions as to Delaware Valley accounts receivable, the transactions related to its transfer of $99.6 million from Graduate and its misclassification of the Lockhart Trusts. Finally, its statements to trustees and others permitted AHERF to continue unchecked in its conduct.

IV.

In view of the foregoing, the Commission deems it appropriate to accept the Offer submitted by AHERF and accordingly:

IT IS ORDERED pursuant to Section 21C of the Exchange Act that AHERF cease and desist from committing or causing any violations and any future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

By the Commission.

Jonathan G. Katz
Secretary

Footnotes

[1] The findings herein are made pursuant to AHERF's Offer and are not binding on any other person or entity in this or any other proceeding.

[2] AHERF's underlying entities are referred to as "subsidiaries," although technically AHERF was their sole "member", not a shareholder.

[3] A reference to fiscal year 19xx is from July 1 of the previous year through June 30, 19xx.

[4] In order to take advantage of lower tax-exempt interest rates, the obligated groups generally borrowed money through various conduit public authorities. The public authorities issued publicly offered tax-exempt municipal bonds on behalf of the obligated group. The obligated group in turn assumed responsibility for repaying that debt. For convenience this order refers to the bonds as if the responsible obligated group, not the conduit public authority, issued them. Approximately 41% of this debt was issued by or on behalf of Delaware Valley, 28% by or on behalf of Allegheny General, and 22% by or on behalf of Centennial and Allegheny Hospitals, New Jersey. The remaining 9% was issued by or on behalf of Allegheny University Medical Centers and Canonsburg Hospital, the latter of which joined AHERF in fiscal year 1998.

[5] See Exchange Act Rule 15c2-12, which generally prohibits broker-dealers from underwriting primary offerings of municipal securities after July 1995 unless the issuer and/or an entity obligated to repay the debt contractually agrees to submit to national repositories annual Disclosure Reports as well as timely information concerning events, if material, such as principal and interest payment delinquencies, non-payment related defaults and rating changes. AHERF provided annual Disclosure Reports for all of its obligated groups.

[6] Although this decision was made in the fall of 1996, the factors leading to this decision existed as of June 30, 1996.

[7] Pursuant to Statement of Financial Accounting Standards ("FAS") 5, an entity's bad debt reserve should reflect, at a given point in time, the estimated probable loss inherent in the entity's accounts receivable. On the balance sheet, the reserve is deducted from total accounts receivable (an asset of the entity) so that the resulting figure represents the net realizable value (i.e., the amount estimated to be collectible). On the income statement, periodic increases in the reserve are reflected as charges against earnings. FAS No. 5 further provides that events that occur subsequent to the balance sheet date (here, June 30, 1996) but prior to the issuance of the financial statements, provide additional evidence with respect to conditions that existed on the balance sheet date and affect the estimates inherent in the process of preparing financial statements.

[8] See discussion of FAS 5 in note 6, above.

[9] The Graduate hospitals in Pennsylvania joined AHERF as members of Centennial. The

Graduate hospital in New Jersey became a separate subsidiary of AHERF known as Allegheny Hospitals, New Jersey. Of the $99.6 million transferred, $50 million was created as part of the purchase price computation and $29.9 million through charges and restructuring reserves. The precise source of the remainder is unclear from the available records but it derived from some combination of purchase price adjustments, restructuring reserves and pre-existing Graduate reserves.

[10] AHERF used this separate entity to temporarily hold assets of acquired entities pending a determination whether to incorporate them into the AHERF system.

[11] Because $40 million of the $99.6 million shortfall should have been offset against Delaware Valley 1996 net income before extraordinary item and change in accounting principle, AHERF consolidated and Delaware Valley 1997 net income are only overstated by $59.6 million.

[12] In contrast to AHERF's 1997 consolidated audited financial statements, which included only two months of operations for Centennial, the 1997 Disclosure Report provided a full twelve months of financial results for Centennial, albeit on an unaudited basis.

[13] As stated above, $29.9 million of the reserves derived from Graduate restructuring reserves-$28.4 million from the Philadelphia hospitals (Centennial) and $1.5 million from the New Jersey hospital (Allegheny Hospitals, New Jersey). Of course, any Graduate reserves deemed to be excess should have been eliminated by adjustments to Graduate's income statement or balance sheet, depending on whether those reserves were originally restructuring charges or part of the purchase price.

[14] Notwithstanding the misclassification described below, the investments held by the independent trustee were never actually liquidated or transferred.

[15] This standard required AHERF to reclassify all of its net assets as unrestricted, temporarily restricted, or permanently restricted. Under FAS 116, permanently restricted net assets result from donor contributions whose use by AHERF is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by actions of the organization. Temporarily restricted net assets result from donor contributions whose use by AHERF is limited by donor-imposed stipulations that either expire by passage of time or can be fulfilled and removed by actions of the organization pursuant to those stipulations. Unrestricted net assets are those assets without donor-imposed stipulations.

[16] Under GAAP, the income statement for a non-profit entity includes as income funds released from restriction and used for operations. Net income or loss is then shown to increase or decrease unrestricted net assets, as appropriate.

UNDERWRITERS

COMMISSION ORDERS – SETTLED ADMINISTRATIVE PROCEEDINGS

YIELD BURNING CASES

In the Matter of Rauscher Pierce Refsnes, Inc., Dain Rauscher Inc., and James R. Feltham, Securities Act Release No. 7844, Exchange Act Release No. 42644, A.P. File No. 3-10182 (April 6, 2000).

I.

The Commission deems it appropriate and in the public interest that public administrative proceedings be, and they hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Sections 15(b)(4) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Sections 203(e) and (k) of the Investment Advisers Act of 1940 ("Advisers Act") against Rauscher Pierce Refsnes, Inc. ("Rauscher") and Dain Rauscher Incorporated ("Dain Rauscher") and pursuant to Section 8A of the Securities Act and Section 203(k) of the Advisers Act against James R. Feltham ("Feltham").

In anticipation of the institution of these proceedings, Dain Rauscher and Feltham have submitted offers of settlement, which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceeding brought by or on behalf of the Commission or in which the Commission is a party, and prior to a hearing pursuant to the Commission's Rules of Practice, 17 C.F.R. 201.100, *et seq.*, Dain Rauscher and Feltham, without admitting or denying the findings contained herein, except that they admit to the jurisdiction of the Commission over them and over the subject matter of these proceedings, consent to the entry of the findings, the issuance of the cease-and-desist orders, and the imposition of the remedial sanctions set forth below.

II.

Based on the foregoing, the Commission finds as follows:

A. Respondents

At all relevant times, Rauscher Pierce Refsnes, Inc. was a Delaware corporation with its principal place of business in Dallas, Texas. At all relevant times, Rauscher was registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Exchange Act, and as an investment adviser pursuant to Section 203(c) of the Advisers Act. At all relevant times, Rauscher's Phoenix, Arizona office had primary responsibility for the municipal finance transaction in which Rauscher's client, the Department of Administration of the State of Arizona (the "DOA"), issued $129,640,000 of Series 1992B Refunding Certificates of Participation (the "1992B COPS").

Dain Rauscher Incorporated is the corporate successor to Rauscher. Rauscher and Dain Bosworth Incorporated were merged to form Dain Rauscher on January 2, 1998. Dain Rauscher is a Minnesota corporation with its registered office in Minneapolis, Minnesota. Dain Rauscher is registered with the Commission as a broker-dealer pursuant to Section

15(b) of the Exchange Act, and as an investment adviser pursuant to Section 203(c) of the Advisers Act.

Feltham, at all relevant times, was a Senior Vice President of Rauscher and was the individual at Rauscher with primary responsibility for Rauscher's engagement on the 1992B COPS transaction.

B. Summary

Rauscher breached its fiduciary duties to its financial advisory client, the DOA, in connection with DOA's issuance of the 1992B COPS. As part of the 1992B COPs offering, Rauscher charged DOA an excessive undisclosed markup on the sale of certain United States Treasury securities (the "escrow securities") to the DOA. Rauscher breached its fiduciary duties to DOA by failing to inform its client, among other things, that it was taking a $707,037 profit on the sale of the escrow securities. In addition, Rauscher issued a tax certification (the "Certification"), which Feltham signed, in connection with the sale of the escrow securities which falsely stated that Rauscher's sale prices for the escrow securities equaled their "fair market value" and that Rauscher's sale of the securities was an "arm's length transaction without regard to any amount paid to reduce the yield on the securities."

C. Background: Advance Refundings

When interest rates fall, state and local governments often seek to reduce their borrowing costs by paying off outstanding bonds through the issuance of new bonds paying lower interest rates. When the old bonds cannot be paid off until a future call date, the municipality can still obtain a benefit from lower interest rates through an advance refunding. An advance refunding can lock in current interest rates and ensure that the municipality will realize debt service savings over the life of the new bonds. In an advance refunding, the municipality issues new "refunding" bonds and immediately invests the proceeds in a portfolio of U.S. Treasury or agency securities structured to pay the principal and interest obligations on the old bonds until the call date and then to pay off the outstanding principal and any call premium. The portfolio of government securities is normally placed in a defeasance escrow to guarantee repayment of the old bonds.

Defeasance escrow portfolios are subject to Internal Revenue Code provisions and Treasury regulations that prohibit the issuer of tax-exempt refunding bonds from earning tax arbitrage (that is, a profit from the rate differential between the taxable and tax-exempt markets). I.R.C. § 148; Treas. Reg. §§1.148-0, *et seq*. The regulations provide that the issuer cannot receive a yield on the securities held in escrow that exceeds the yield it pays on the refunding bonds. In addition, to prevent an issuer from diverting tax arbitrage to the seller of the escrow securities by paying artificially high prices, the regulations provide, in effect, that the price paid by refunding bond issuers for escrow securities purchased in the secondary market (known as "open market securities") cannot exceed the fair market value or market price of the securities as defined in those regulations.

When the yield on the investments in the escrow, if purchased at fair market value, would be above the yield on the refunding bonds, the transaction is said to be in "positive arbitrage." In a "positive arbitrage" situation "when the yield on open market securities purchased at fair market value would exceed the yield on the refunding bonds," overcharging by dealers for open market escrow securities diverts tax arbitrage to the dealers at the expense of the U.S. Treasury. This diversion, known colloquially as "yield burning," violated IRS regulations. If yield burning occurs, the Internal Revenue Service can declare interest paid on the refunding bonds taxable. See Harbor Bancorp & Subsidiaries v. Commissioner, 115 F.3d 722 (9th Cir. 1997), cert. denied, 118 S. Ct. 1035 (1998).

In contrast, a "negative arbitrage" situation occurs when the yield on open market securities purchased at fair market value would be *below* the yield on the refunding bonds. In a negative arbitrage transaction, overcharging by a dealer for open market escrow securities takes money away from the municipality rather than the Treasury by reducing, dollar for dollar, the present value savings the municipality obtains through the advance refunding.

D. Background to the Issuance of the 1992B COPS

In 1988, DOA issued $121,830,000 of tax-exempt certificates of participation (the 1988 COPS") to finance the construction of six buildings for the State of Arizona. The 1988 COPS bore an average interest rate of 7.55% and could not be called until July 1998.

In 1990, Rauscher became DOA's financial advisor. By May 1992, prevailing interest rates had fallen to a point substantially below the 7.55% DOA was paying on its 1988 COPs. Rauscher and Feltham therefore recommended that DOA take advantage of this decline in rates by "advance refunding" the 1988 COPs. Rauscher and Feltham recommended transactions in which DOA would issue new tax-exempt COPs bearing an interest rate lower than that of the 1988 COPs and invest most of the proceeds of the offering in United States Treasury securities, which would be held in a defeasance escrow account and used to make debt service payments on the 1988 COPs until they could be redeemed in July 1998.

Rauscher and Feltham knew, were reckless in not knowing, or should have known that an essential feature of the 1992B COPs was the tax-exempt status of the interest component to be paid to investors. For the interest component on a refunding issue such as the 1992B COPs to be exempt from federal income taxes, the applicable provisions of the Internal Revenue Code and the IRS regulations thereunder required that the aggregate yield on the escrow securities not materially exceed the yield on the 1992B COPs themselves.

In order to prevent yield burning, applicable provisions of the federal tax laws in effect at the time of the 1992B COPS transaction required that escrow investments be purchased at market price. In particular, under the applicable yield restriction regulations, U.S. Treasury securities had to be priced at the "mean of the bid and offered prices on an established market" where such securities were traded. A price exceeding the mean market price qualified as a market price only if the issuer "acquired [the security] in an

arm's length transaction without regard to any amount paid to reduce the yield" on the acquired security.

E. The 1992B COPs Offering

As DOA's financial adviser in connection with the 1992B COPs offering, Rauscher assumed substantial responsibility for structuring the offering, preparing the necessary documentation and advising DOA regarding the allocation and investment of issue proceeds. In addition, Rauscher assumed the responsibility of selling the escrow securities to the defeasance escrow. Although numerous other dealers were regularly engaged in the business of selling Treasury securities and could have been approached about selling the securities to DOA through competitive bid or negotiation, Rauscher did not consider assigning that responsibility to another party during the course of the 1992B COPs offering process.[1]

The underwriters of the 1992B COPs offering priced the 1992B COPs on June 10, 1992. That same day, acting as a principal for its own account, Rauscher purchased the escrow securities and priced them for delivery at the June 16, 1992 closing of the offering. At the time Rauscher priced the escrow securities, a positive arbitrage situation existed. At the closing on June 16, 1992, Rauscher delivered a portfolio of securities to the escrow trustee, adding an aggregate undisclosed markup of $707,037.

F. Rauscher Failed to Disclose Material Information to its Client

Rauscher's financial advisory contract with DOA required Rauscher to provide unbiased advice and assistance in all aspects of the issuance of the 1992B COPs. That duty was particularly important because, as Rauscher knew, the DOA personnel responsible for the 1992B COPs offering had virtually no experience with advance refunding transactions and, therefore, relied heavily on Rauscher's advice. As a result, Rauscher stood in a fiduciary or similar relationship of trust and confidence with DOA. Rauscher also stood in a fiduciary or similar relationship of trust and confidence with DOA because it acted as an investment adviser to DOA.

As a result of its fiduciary or similar relationships of trust and confidence with DOA, Rauscher was under a duty to DOA to disclose all information material to the 1992B COPs issue, including all facts material to DOA's purchase of the escrow securities.

Prior to the closing of the 1992B COPs transaction, Rauscher did not disclose to DOA or its representatives the following material facts: (1) that Rauscher, acting as a principal, would make a substantial profit from the sale; (2) the amount of the undisclosed profit; (3) that the escrow securities could be purchased for a lower price from other dealers; (4) that the prices DOA was charged exceeded the mean of the bid and offered prices for the securities on an established market; and (5) that the profit received by Rauscher could jeopardize the tax-exempt status of the 1992B COPs.

Rauscher violated its fiduciary duties to DOA by failing to disclose the above matters and by failing to disclose the conflict inherent in Rauscher's taking an undisclosed profit of $707,037 on transactions with DOA while at the same time purporting to give DOA independent investment advice.

G. Rauscher Charged Excessive Markups

The prices charged DOA for the escrow securities were excessive in that the prices were not reasonably related to prevailing market prices, and Rauscher's $707,037 profit from the sale of such securities was unreasonable in light of the circumstances surrounding the sale. The markups Rauscher charged on the escrow securities averaged approximately .55 percent (or just over one half of one percent) of the prevailing interdealer market prices of the Treasury securities sold to DOA. At the time, other dealers generally charged materially lower markups on escrow securities when the prices were determined through competition or bona fide arm's length negotiation. Under the facts and circumstances, Rauscher's prices were above fair market value as defined by federal tax laws.

H. Rauscher Issued the Certification

As a prerequisite to the issuance of their respective opinions that the interest to be paid on the 1992B COPs would be exempt from federal income taxation, DOA and its bond counsel required Rauscher to certify that it had sold the escrow securities at fair market value and in compliance with applicable tax laws. Accordingly, on June 16, 1992, Feltham, on Rauscher's behalf, signed the Certification. Rauscher and Feltham knew, were reckless in not knowing, or should have known that DOA and its bond counsel would rely on the Certification in making their respective representations that the interest component of the 1992B COPs was exempt from federal income taxes.

The Certification was materially false and misleading in that, contrary to the representations in the Certification, Rauscher's prices for the escrow securities did not equal the "fair market value" of those securities and those prices had not been determined in an "arm's length transaction without regard to any amount paid to reduce the yield on the securities."

III.

Section 10(b) of the Exchange Act and Rule 10b-5 thereunder proscribe materially false and misleading statements "in connection with the purchase or sale of any security." Section 17(a) of the Securities Act similarly prohibits the making of such statements in connection with the "offer or sale" of securities. In addition, Sections 206(1) and (2) of the Advisers Act prohibit investment advisers from making materially false and misleading statements.[2] A statement is material if there is a substantial likelihood that, under all the circumstances, it would have assumed actual significance in the deliberations of a reasonable investor. Basic, Inc. v. Levinson, 485 U.S. 224, 231-32 (1988).

Material omissions are also actionable under Section 10(b), Section 17(a) and Sections 206(1) and 206(2), but only when a duty to disclose exists. Chiarella v. United States, 445 U.S. 222, 235 (1980)("When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak"). A fiduciary or other relationship of trust and confidence gives rise to a duty to disclose material information. Chiarella, 445 U.S. at 228; Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-55 (1972).

Finally, proof of scienter is necessary to establish violations of Section 10(b), Section 17(a)(1) and Section 206(1). In this context, scienter means "a mental state embracing intent to deceive, manipulate or defraud," Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1976), and includes recklessness. See, e.g., Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-69 (9th Cir. 1990); SEC v. Blavin, 760 F.2d 706, 711 (6th Cir. 1985); SEC v. Falstaff Brewing Corp., 629 F.2d 62, 77 (D.C. Cir.), cert. denied, 449 U.S. 1012 (1980); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir.), cert. denied, 439 U.S. 1039 (1978). Proof of scienter is not necessary to establish a violation of Sections 17(a)(2) and (3) of the Securities Act, Aaron v. SEC, 446 U.S. 680, 697 (1980), or Section 206(2) of the Advisers Act. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

A. Material Omissions and Misrepresentations by Rauscher

Rauscher violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Section 17(a) of the Securities Act and Section 206(1) and 206(2) of the Advisers Act by knowingly or recklessly failing to inform DOA that Rauscher was taking a $707,037 profit on the sale of the escrow securities and by failing to disclose the conflict inherent in Rauscher's taking an undisclosed profit of $707,037 on transactions with DOA while at the same time purporting to give DOA independent investment advice. Rauscher also violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Section 17(a) of the Securities Act and Section 206(1) and 206(2) of the Advisers Act by knowingly or recklessly issuing the materially false and misleading Certification to DOA and its bond counsel.

Rauscher also violated Section 206(3) of the Advisers Act[3] by knowingly effecting the sale of the escrow securities for the account of its client, DOA, without disclosing its capacity as principal to DOA in writing before completion of the transaction and obtaining DOA's consent to the transaction.

B. Excessive Undisclosed Markups

Rauscher violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Section 17(a) of the Securities Act and Section 206(1) and 206(2) of the Advisers Act by effecting the sales of the escrow securities to DOA at prices not reasonably related to the current wholesale market prices for the securities under the particular facts and circumstances, including the pertinent tax regulations. See, e.g., Grandon v. Merrill Lynch & Co., 147 F.3d 184, 192 (2d Cir. 1998) (under the shingle theory, a broker-dealer has a duty to disclose excessive markups); In re Lehman Bros. Inc., 62 SEC Dkt. at 2330-31; In re Duker & Duker, 6 S.E.C. 386, 389 (1939). Rauscher's markups on the sales of the escrow securities averaged just over one half of one percent of the prevailing interdealer market prices of the Treasury securities sold to DOA. Based on all the relevant facts and circumstances, Rauscher knew, was reckless with respect to whether, or should have known that the prices it charged DOA were not reasonably related to the prevailing wholesale market prices of the securities.

Before 1995, in addition to the DOA, Dain Rauscher sold portfolios of U.S. Treasury securities for defeasance escrows at excessive, undisclosed markups to a number of other municipal bond issuers in connection with advance refundings. At the time, as compared with the markups Dain Rauscher charged in these transactions, dealers generally charged materially lower markups on escrow securities when the prices were determined through competition or bona fide arm's length negotiation.

In connection with these other advance refunding transactions, Dain Rauscher violated Sections 17(a)(2) and 17(a)(3) of the Securities Act by effecting defeasance escrow transactions with municipalities at prices not reasonably related to the current wholesale market prices for the securities under the particular facts and circumstances, including the pertinent tax regulations. Based on all the relevant facts and circumstances, Dain Rauscher knew or should have known that the prices it charged were not reasonably related to the prevailing wholesale market prices of the securities. The excessive markups also violated Sections 17(a)(2) and 17(a)(3) of the Securities Act because the excessive markups jeopardized the tax-exempt status of the municipalities' refunding bonds and diverted money from the U.S. Treasury to Dain Rauscher when the transaction was in positive arbitrage, or reduced the savings available to the municipalities from the refundings when the transaction was in negative arbitrage.

C. Feltham Was a Cause of Certain of Rauscher's Violations

Feltham was the individual at Rauscher with primary responsibility for Rauscher's engagement on the 1992B COPS transaction. He was the senior person at Rauscher assigned to coordinate Rauscher's work on the 1992B COPS transaction. Feltham was aware of the markups charged by Rauscher on the 1992B COPS transaction and knew or should have known that the markups had not been adequately disclosed to the DOA.

Feltham signed the Certification on Rauscher's behalf. Feltham was a cause of Rauscher's violations of Sections 17(a)(2) and (3) of the Securities Act and Sections 206(2) and (3) of the Advisers Act relating to the 1992B COPS transaction, due to acts or omissions he knew or should have known would contribute to such violations.[4]

IV.

Based on the above, the Commission finds that:

A. Dain Rauscher willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Section 17(a) of the Securities Act and Sections 206(1), (2) and (3) of the Advisers Act; and

B. Feltham was a cause of Dain Rauscher's violations of Section 17(a)(2) and (3) of the Securities Act and Sections 206(2) and (3) of the Advisers Act relating to the 1992B COPS transaction.

V.

Accordingly, IT IS ORDERED, that:

A. Dain Rauscher:

1. Be, and hereby is, censured;

2. Pursuant to Section 8A of the Securities Act, Section 21C of the Exchange Act and Section 203(k) of the Advisers Act, cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Section 206 of the Advisers Act;

3. Pursuant to Section 21B of the Exchange Act, pay a civil penalty of $100,000, in connection with sales of defeasance escrow securities to the DOA in the 1992B COPS transaction, within ten (10) business days of the entry of this Order by wire transfer in accordance with instructions furnished by the Commission staff, or by a postal or bank money order, certified check or bank cashier's check, to the United States Treasury;

4. Comply with its undertaking to pay disgorgement of $347,631 and prejudgment interest of $299,856, in connection with sales of defeasance escrow securities to the DOA in the 1992B COPS transaction, to the United States Treasury in accordance with the terms of an agreement simultaneously entered into among Dain Rauscher, the Internal Revenue Service and the United States Attorney for the Southern District of New York;

5. Comply with its undertaking to pay $10,586,081.59 to the United States Treasury, related to sales of defeasance escrow securities in connection with advance refunding transactions in positive arbitrage (other than the 1992B COPS transaction) in accordance with the terms of an agreement simultaneously entered into among Dain Rauscher, the Internal Revenue Service and the United States Attorney for the Southern District of New York;

6. Within ten (10) business days of the entry of this Order, comply with its undertaking to make certain payments totaling $1,607,623.38 related to sales of defeasance escrow securities to certain municipal issuers in connection with advance refundings in negative arbitrage, as follows:

i. $12,253.52 to Carbondale, Illinois in connection with the refunding that settled on November 5, 1992;

ii. $13,067.76 to Poudre School District No. R-1, Colorado in connection with the refunding that settled on May 28, 1993;

iii. $117,525.78 to Montgomery County, Iowa in connection with the refunding that settled on August 19, 1993;

iv. $35,600.96 to St. Louis County, Missouri in connection with the refunding that settled on August 31, 1993;

v. $412,334.30 to the St. Louis Park, Minnesota Health System in connection with the refunding that settled on September 30, 1993;

vi. $76,081.24 to the Community School Corp. of S. Hancock County, Indiana in connection with the refunding that settled on December 21, 1993;

vii. $64,160.66 to the Eastern Howard School Building Corporation, Indiana in connection with the refunding that settled on December 29, 1993;

viii. $113,060.29 to Denver School District No. 1, Colorado in connection with the refunding that settled on February 22, 1994;

ix. $21,677.71 to Aurora, Colorado in connection with the refunding that settled on June 14, 1994;

x. $10,682.91 to the Indiana Bond Bank in connection with the refunding that settled on September 8, 1994;

xi. $26,999.54 to the City of Tucson, Arizona in connection with the refunding that settled on June 5, 1990;

xii. $24,032.36 to the Humble Independent School District connection with the refunding that settled on December 1, 1992;

xiii. $55,050.50 to the City of Cupertino in connection with the refunding that settled on December 16, 1993;

xiv. $55,942.59 to the Paradise Valley Unified School District No. 69, Maricopa County, Arizona in connection with the refunding that settled on February 23, 1993;

xv. $119,354.55 to the City of Cupertino in connection with the refunding that settled on April 6, 1993;

xvi. $34,495.01 to the City of Bedford in connection with the refunding that settled on April 20, 1993;

xvii. $24,461.64 to the City of Scottsdale Municipal Property Corp. in connection with the refunding that settled on April 22, 1992;

xviii. $71,446.07 to the City of Nevada in connection with the refunding that settled on April 22, 1993;

xix. $16,710.30 to the Alamo Community College District in connection with the refunding that settled on April 28, 1993;

xx. $13,271.81 to the Clear Creek Independence School District in connection with the refunding that settled on May 18, 1993;

xxi. $14,243.07 to the Katy Independence School District in connection with the refunding that settled on May 26, 1993;

xxii. $37,165.94 to the City of Santa Clara, California in connection with the refunding that settled on August 25, 1993;

xxiii. $185,902.39 to the San Mateo County Transit District in connection with the refunding that settled on June 3, 1993;

xxiv. $25,501.89 to the Midland County Hospital District in connection with the refunding that settled on August 25, 1993; and

xxv. $26,600.59 to the Tyler Junior College District in connection with the refunding that settled on June 29, 1994; and

7. Send copies of payments made as described in sub-paragraphs 3, 4, 5 and 6 above and any cover letters accompanying them to Gregory Bruch, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0703.

B. Feltham:

1. Pursuant to Section 8A of the Securities Act and Section 203(k) of the Advisers Act, cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and (3) of the Securities Act and Sections 206(2) and (3) of the Advisers Act.

By the Commission.

Jonathan G. Katz
Secretary

Footnotes

[1] In addition to selling the escrow securities to DOA, Rauscher advised DOA to structure the defeasance escrow to include a forward supply contract, a separate security designed to maximize the interest earned on the funds held in the defeasance escrow by selling certain rights to invest those funds periodically in the future in exchange for an up front payment. Rauscher also received a separate fee for acting as co-broker in the procurement and sale of a Guaranteed Investment Contract ("GIC") in which a portion of the offering proceeds was invested.
[2] Rauscher acted as an investment adviser within the meaning of Section 202(a)(11) of the Advisers Act, 15 U.S.C. Section 80b-2(a)(11), in connection with the 1992B COPS offering because, for compensation, Rauscher was in the business of advising DOA as to the advisability of investing in, purchasing, or selling securities. Because Rauscher's advice was not limited to Treasury securities or other government securities as described in Section 202(a)(11)(E), that provision did not operate to exclude Rauscher from the definition of investment adviser. See O'Brien Partners, Inc., Investment Advisers Act Release No. 1772 (Oct. 27, 1998).
[3] Section 206(3) of the Advisers Act prohibits an investment adviser, acting as principal, from knowingly selling a security to a client without disclosing to the client, in writing before the completion of the transaction, the capacity in which he is acting and obtaining the client's consent to the transaction.
[4] The Commission makes no allegations that Feltham was involved in any of Rauscher's or Dain Rauscher's advance refunding transactions other than the 1992B COPS transaction.

In the Matter of Morgan Stanley & Co., Inc., Securities Act Release No. 7841, Exchange Act Release No. 42642, A.P. File No. 3-10181 (April 6, 2000).

I.

The Commission deems it appropriate and in the public interest that public administrative proceedings be, and they hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 15(b)(4) of the Securities Exchange Act of 1934 ("Exchange Act") against Morgan Stanley & Co. Incorporated ("Morgan Stanley").

In anticipation of the institution of these proceedings, Morgan Stanley has submitted an offer of settlement, which the Commission has determined to accept. Solely for the

purpose of these proceedings and any other proceeding brought by or on behalf of the Commission or in which the Commission is a party, and prior to a hearing pursuant to the Commission's Rules of Practice, 17 C.F.R. 201.100 *et seq.*, Morgan Stanley, without admitting or denying the findings contained herein, except that it admits to the jurisdiction of the Commission over it and over the subject matter of these proceedings, consents to the entry of the findings, the issuance of the cease-and-desist order, and the imposition of the remedial sanctions set forth below.

II.

Based on the foregoing, the Commission finds as follows:

A. Respondent

Morgan Stanley is a Delaware corporation with its principal place of business in New York. At all relevant times, Morgan Stanley was registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Exchange Act.

B. Background

This is a municipal finance case involving Morgan Stanley's sale of U.S. Treasury securities to municipal bond issuers at excessive, undisclosed markups in connection with certain advance refunding transactions.

When interest rates fall, state and local governments often seek to reduce their borrowing costs by paying off outstanding bonds through the issuance of new bonds at lower interest rates. When the old bonds cannot be paid off until a future call date, the municipality can still obtain a benefit from lower interest rates through an advance refunding. An advance refunding can lock in current interest rates and ensure that the municipality will realize debt service savings over the life of the new bonds. In an advance refunding, the municipality issues new "refunding" bonds and immediately invests the proceeds in a portfolio of U.S. Treasury or agency securities structured to pay the principal and interest obligations on the old bonds until the call date and then to pay off the outstanding principal and any call premium. The portfolio of government securities is normally placed in a defeasance escrow to guarantee repayment of the old bonds.

Defeasance escrow portfolios are subject to Internal Revenue Code provisions and Treasury regulations that prohibit the issuer of tax-exempt refunding bonds from earning tax arbitrage (that is, a profit from the rate differential between the taxable and tax-exempt markets). I.R.C. § 148; Treas. Reg. § § 1.148-0 *et seq*. The regulations provide that the issuer cannot receive a yield on the securities held in escrow that exceeds the yield it pays on the refunding bonds. In addition, to prevent an issuer from diverting tax arbitrage to the seller of the escrow securities by paying artificially high prices, the regulations provide, in effect, that the price paid by refunding bond issuers for escrow securities purchased in the secondary market (known as "open market securities") cannot exceed the fair market value or market price of the securities as defined in those regulations.

When the yield on the investments in the escrow, if purchased at fair market value, would exceed the yield on the refunding bonds, the transaction is said to be in "positive arbitrage." Overcharging by dealers for open market escrow securities in positive arbitrage situations diverts tax arbitrage to the dealers at the expense of the U.S. Treasury. This diversion of money-known colloquially as "yield burning"-violates IRS regulations. If yield burning occurs, the IRS can declare interest paid on the refunding bonds taxable. *See* Harbor Bancorp & Subsidiaries v. Commissioner, 115 F.3d 722 (9th Cir. 1997), *cert. denied*, 118 S. Ct. 1035 (1998).

C. Facts and Legal Analysis

Before 1995, Morgan Stanley sold portfolios of U.S. Treasury securities for defeasance escrows at excessive, undisclosed markups to certain municipalities in connection with advance refundings. For example, in 1994, Morgan Stanley sold a portfolio of $41.8 million in Treasury securities to a municipality. Morgan Stanley's markup and carry on that portfolio was .45 percent of the prevailing interdealer market prices of the Treasury securities sold to the municipality.[1] At the time, dealers generally charged materially lower markups on escrow securities when the prices were determined through competition or bona fide arm's length negotiation.

Morgan Stanley violated Sections 17(a)(2) and 17(a)(3) of the Securities Act by effecting defeasance escrow transactions with municipalities at prices not reasonably related to the current wholesale market prices for the securities under the particular facts and circumstances, including the pertinent tax regulations. Based on all the relevant facts and circumstances, Morgan Stanley knew or should have known that the prices it charged were not reasonably related to the prevailing wholesale market prices of the securities. The excessive markups also violated Sections 17(a)(2) and 17(a)(3) of the Securities Act because the excessive markups jeopardized the tax-exempt status of those municipalities' refunding bonds and diverted money from the U.S. Treasury to Morgan Stanley.

III.

By reason of the foregoing, Morgan Stanley willfully violated Sections 17(a)(2) and 17(a)(3) of the Securities Act.

IV.

Accordingly, IT IS ORDERED, pursuant to Section 8A of the Securities Act and Section 15(b)(4) of the Exchange Act, that:

A. Morgan Stanley is censured;

B. Morgan Stanley shall cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act;

C. Morgan Stanley shall comply with its undertaking to pay $2,453,219.92 to the United States Treasury under an agreement simultaneously entered into among Morgan Stanley, the Internal Revenue Service and the United States Attorney for the Southern District of New York; and

D. At the time the payment is made to the United States Treasury as described in sub-paragraph C above, a copy of the payment and any cover letter accompanying it shall be sent by Morgan Stanley to Lawrence A. West, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0807.

By the Commission.

Jonathan G. Katz
Secretary

Footnotes

1 Profit on open market escrow securities generally has two components: markup and carry. Markup is the difference between the price that the dealer charges the issuer and the prevailing wholesale market price. In re Lehman Bros. Inc., Exchange Act Release No. 37673 (Sept. 12, 1996). Carry is the difference between (a) the interest and accretion produced by the escrow securities between the sale date and closing date and (b) the cost of financing those securities during that period. *See* Board of Governors of the Federal Reserve System, Trading Activities Manual, Part 2 at 2-8 (March 1994).

In the Matter of Merrill Lynch, Pierce, Fenner & Smith Inc., Securities Act Release No. 7838, Exchange Act Release No. 42640, A.P. File No. 3-10180 (April 6, 2000).

I.

The Commission deems it appropriate and in the public interest that public administrative proceedings be, and they hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 15(b)(4) of the Securities Exchange Act of 1934 ("Exchange Act") against Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch").

In anticipation of the institution of these proceedings, Merrill Lynch has submitted an offer of settlement, which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceeding brought by or on behalf of the Commission or in which the Commission is a party, and prior to a hearing pursuant to the Commission's Rules of Practice, 17 C.F.R. 201.100 *et seq.*, Merrill Lynch, without admitting or denying the findings contained herein, except that it admits to the jurisdiction of the Commission over it and over the subject matter of these proceedings, consents to the entry of the findings, the issuance of the cease-and-desist order, and the imposition of the remedial sanctions set forth below.

II.

Based on the foregoing, the Commission finds as follows:

A. Respondent

Merrill Lynch is a Delaware corporation with its principal place of business in New York. At all relevant times, Merrill Lynch was registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Exchange Act.

B. Background

This is a municipal finance case involving Merrill Lynch's sale of U.S. Treasury securities to municipal bond issuers at excessive, undisclosed markups in connection with certain advance refunding transactions.

When interest rates fall, state and local governments often seek to reduce their borrowing costs by paying off outstanding bonds through the issuance of new bonds at lower interest rates. When the old bonds cannot be paid off until a future call date, the municipality can still obtain a benefit from lower interest rates through an advance refunding. An advance refunding can lock in current interest rates and ensure that the municipality will realize debt service savings over the life of the new bonds. In an advance refunding, the municipality issues new "refunding" bonds and immediately invests the proceeds in a portfolio of U.S. Treasury or agency securities structured to pay the principal and interest obligations on the old bonds until the call date and then to pay off the outstanding principal and any call premium. The portfolio of government securities is normally placed in a defeasance escrow to guarantee repayment of the old bonds.

Defeasance escrow portfolios are subject to Internal Revenue Code provisions and Treasury regulations that prohibit the issuer of tax-exempt refunding bonds from earning tax arbitrage (that is, a profit from the rate differential between the taxable and tax-exempt markets). I.R.C. § 148; Treas. Reg. §§1.148-0 *et seq*. The regulations provide that the issuer cannot receive a yield on the securities held in escrow that exceeds the yield it pays on the refunding bonds. In addition, to prevent an issuer from diverting tax arbitrage to the seller of the escrow securities by paying artificially high prices, the regulations provide, in effect, that the price paid by refunding bond issuers for escrow securities purchased in the secondary market (known as "open market securities") cannot exceed the fair market value or market price of the securities as defined in those regulations.

When the yield on the investments in the escrow, if purchased at fair market value, would exceed the yield on the refunding bonds, the transaction is said to be in "positive arbitrage." Overcharging by dealers for open market escrow securities in positive arbitrage situations diverts tax arbitrage to the dealers at the expense of the U.S. Treasury. This diversion of money-known colloquially as "yield burning"-violates IRS regulations. If yield burning occurs, the IRS can declare interest paid on the refunding bonds taxable. *See* Harbor Bancorp & Subsidiaries v. Commissioner, 115 F.3d 722 (9th Cir. 1997), *cert. denied*, 118 S. Ct. 1035 (1998).

In contrast, a "negative arbitrage" situation occurs when the yield on open market securities purchased at fair market value would be *below* the yield on the refunding bonds. In a negative arbitrage transaction, overcharging by a dealer for open market escrow securities takes money away from the municipality rather than the Treasury by reducing, dollar for dollar, the present value savings the municipality obtains through the advance refunding.

C. Facts And Legal Analysis

Before 1995, Merrill Lynch sold portfolios of U.S. Treasury securities for defeasance escrows at excessive, undisclosed markups to certain municipalities in connection with advance refundings. For example, in 1994, Merrill Lynch sold a portfolio of $10.5 million in Treasury securities to a municipality. Merrill Lynch's markup and carry on that portfolio was .48 percent of the prevailing interdealer market prices of the Treasury securities sold to the municipality.[1] At the time, dealers generally charged materially lower markups on escrow securities when the prices were determined through competition or bona fide arm's length negotiation.

Merrill Lynch violated Sections 17(a)(2) and 17(a)(3) of the Securities Act by effecting defeasance escrow transactions with municipalities at prices not reasonably related to the current wholesale market prices for the securities under the particular facts and circumstances, including the pertinent tax regulations. Based on all the relevant facts and circumstances, Merrill Lynch knew or should have known that the prices it charged were not reasonably related to the prevailing wholesale market prices of the securities. The excessive markups also violated Sections 17(a)(2) and 17(a)(3) of the Securities Act because the excessive markups jeopardized the tax-exempt status of those municipalities' refunding bonds and diverted money from the U.S. Treasury to Merrill Lynch when the transaction was in positive arbitrage, or reduced the savings available to the municipalities from the refundings when the transaction was in negative arbitrage.

III.

By reason of the foregoing, Merrill Lynch willfully violated Sections 17(a)(2) and 17(a)(3) of the Securities Act.

IV.

Accordingly, IT IS ORDERED, pursuant to Section 8A of the Securities Act and Section 15(b)(4) of the Exchange Act, that:

A. Merrill Lynch is censured;

B. Merrill Lynch shall cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act;

C. Within ten days of the entry of this order, Merrill Lynch shall comply with its undertaking to make certain payments totaling $972,481.58 related to sales of defeasance escrow securities to certain municipal issuers in connection with advance refundings in negative arbitrage, as set forth in Merrill Lynch's offer of settlement;

D. Merrill Lynch shall comply with its undertaking to pay $4,614,868.76 to the United States Treasury under an agreement simultaneously entered into among Merrill Lynch, the Internal Revenue Service and the United States Attorney for the Southern District of New York; and

E. At the time the payments are made to the municipalities and the United States Treasury as described in sub-paragraphs C and D above, copies of the payments and any cover letters accompanying them shall be sent by Merrill Lynch to Lawrence A. West, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0807.

By the Commission.

Jonathan G. Katz
Secretary

Footnotes

1 Profit on open market escrow securities generally has two components: markup and carry. Markup is the difference between the price that the dealer charges the issuer and the prevailing wholesale market price. In re Lehman Bros. Inc., Exchange Act Release No. 37673 (Sept. 12, 1996). Carry is the difference between (a) the interest and accretion produced by the escrow securities between the sale date and closing date and (b) the cost of financing those securities during that period. *See* Board of Governors of the Federal Reserve System, Trading Activities Manual, Part 2 at 2-8 (March 1994).

In the Matter of Lehman Brothers Inc., Securities Act Release No. 7835, Exchange Act Release No. 42638, A.P. File No. 3-10179 (April 6, 2000).

I.

The Commission deems it appropriate and in the public interest that public administrative proceedings be, and they hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 15(b)(4) of the Securities Exchange Act of 1934 ("Exchange Act") against Lehman Brothers Inc. ("Lehman Brothers").

In anticipation of the institution of these proceedings, Lehman Brothers has submitted an offer of settlement, which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceeding brought by or on behalf of the Commission or in which the Commission is a party, and prior to a hearing pursuant to the Commission's Rules of Practice, 17 C.F.R. 201.100 *et seq.*, Lehman Brothers, without admitting or denying the findings contained herein, except that it admits to the jurisdiction of the Commission over it and over the subject matter of these proceedings, consents to the entry of the findings, the issuance of the cease-and-desist order, and the imposition of the remedial sanctions set forth below.

II.

Based on the foregoing, the Commission finds as follows:

A. Respondent

Lehman Brothers is a Delaware corporation with its principal place of business in New York. At all relevant times, Lehman Brothers was registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Exchange Act.

B. Background

This is a municipal finance case involving Lehman Brothers' sale of U.S. Treasury securities to municipal bond issuers at excessive, undisclosed markups in connection with certain advance refunding transactions.

When interest rates fall, state and local governments often seek to reduce their borrowing costs by paying off outstanding bonds through the issuance of new bonds at lower interest rates. When the old bonds cannot be paid off until a future call date, the municipality can still obtain a benefit from lower interest rates through an advance refunding. An advance refunding can lock in current interest rates and ensure that the municipality will realize debt service savings over the life of the new bonds. In an advance refunding, the municipality issues new "refunding" bonds and immediately invests the proceeds in a portfolio of U.S. Treasury or agency securities structured to pay the principal and interest obligations on the old bonds until the call date and then to pay off the outstanding principal and any call premium. The portfolio of government securities is normally placed in a defeasance escrow to guarantee repayment of the old bonds.

Defeasance escrow portfolios are subject to Internal Revenue Code provisions and Treasury regulations that prohibit the issuer of tax-exempt refunding bonds from earning tax arbitrage (that is, a profit from the rate differential between the taxable and tax-exempt markets). I.R.C. § 148; Treas. Reg. §§1.148-0 *et seq*. The regulations provide that the issuer cannot receive a yield on the securities held in escrow that exceeds the yield it pays on the refunding bonds. In addition, to prevent an issuer from diverting tax arbitrage to the seller of the escrow securities by paying artificially high prices, the regulations provide, in effect, that the price paid by refunding bond issuers for escrow securities purchased in the secondary market (known as "open market securities") cannot exceed the fair market value or market price of the securities as defined in those regulations.

When the yield on the investments in the escrow, if purchased at fair market value, would exceed the yield on the refunding bonds, the transaction is said to be in "positive arbitrage." Overcharging by dealers for open market escrow securities in positive arbitrage situations diverts tax arbitrage to the dealers at the expense of the U.S. Treasury. This diversion of money-known colloquially as "yield burning"-violates IRS regulations. If yield burning occurs, the IRS can declare interest paid on the refunding bonds taxable. *See* Harbor Bancorp & Subsidiaries v. Commissioner, 115 F.3d 722 (9th Cir. 1997), *cert. denied*, 118 S. Ct. 1035 (1998).

In contrast, a "negative arbitrage" situation occurs when the yield on open market securities purchased at fair market value would be *below* the yield on the refunding bonds. In a negative arbitrage transaction, overcharging by a dealer for open market escrow securities takes money away from the municipality rather than the Treasury by reducing, dollar for dollar, the present value savings the municipality obtains through the advance refunding.

C. Facts And Legal Analysis

Before 1995, Lehman Brothers sold portfolios of U.S. Treasury securities for defeasance escrows at excessive, undisclosed markups to certain municipalities in connection with advance refundings. For example, in 1994, Lehman Brothers sold a portfolio of $15.8 million in Treasury securities to a municipality. Lehman Brothers' markup and carry on that portfolio was .42 percent of the prevailing interdealer market prices of the Treasury securities sold to the municipality.[1] At the time, dealers generally charged materially lower markups on escrow securities when the prices were determined through competition or bona fide arm's length negotiation.

Lehman Brothers violated Sections 17(a)(2) and 17(a)(3) of the Securities Act by effecting defeasance escrow transactions with municipalities at prices not reasonably related to the current wholesale market prices for the securities under the particular facts and circumstances, including the pertinent tax regulations. Based on all the relevant facts and circumstances, Lehman Brothers knew or should have known that the prices it charged were not reasonably related to the prevailing wholesale market prices of the securities. The excessive markups also violated Sections 17(a)(2) and 17(a)(3) of the Securities Act because the excessive markups jeopardized the tax-exempt status of those municipalities' refunding bonds and diverted money from the U.S. Treasury to Lehman Brothers when the transaction was in positive arbitrage, or reduced the savings available to the municipalities from the refundings when the transaction was in negative arbitrage.

III.

By reason of the foregoing, Lehman Brothers willfully violated Sections 17(a)(2) and 17(a)(3) of the Securities Act.

IV.

Accordingly, IT IS ORDERED, pursuant to Section 8A of the Securities Act and Section 15(b)(4) of the Exchange Act, that:

A. Lehman Brothers is censured;

B. Lehman Brothers shall cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act;

C. Within ten days of the entry of this order, Lehman Brothers shall comply with its undertaking to make certain payments totaling $450,151.62 related to sales of defeasance escrow securities to certain municipal issuers in connection with advance refundings in negative arbitrage, as set forth in Lehman Brothers' offer of settlement;

D. Lehman Brothers shall comply with its undertaking to pay $4,520,857.29 to the United States Treasury under an agreement simultaneously entered into among Lehman Brothers, the Internal Revenue Service and the United States Attorney for the Southern District of New York; and

E. At the time the payments are made to the municipalities and the United States Treasury as described in sub-paragraphs C and D above, copies of the payments and any cover letters accompanying them shall be sent by Lehman Brothers to Lawrence A. West,

Assistant Director, Division of Enforcement, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0807.

By the Commission.

Jonathan G. Katz
Secretary

Footnotes

1 Profit on open market escrow securities generally has two components: markup and carry. Markup is the difference between the price that the dealer charges the issuer and the prevailing wholesale market price. In re Lehman Bros. Inc., Exchange Act Release No. 37673 (Sept. 12, 1996). Carry is the difference between (a) the interest and accretion produced by the escrow securities between the sale date and closing date and (b) the cost of financing those securities during that period. *See* Board of Governors of the Federal Reserve System, Trading Activities Manual, Part 2 at 2-8 (March 1994).

<u>In the Matter of Goldman, Sachs & Co.,</u> Securities Act Release No. 7832, Exchange Act Release No. 42636, A.P. File No. 3-10178 (April 6, 2000).

I.

The Commission deems it appropriate and in the public interest that public administrative proceedings be, and they hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 15(b)(4) of the Securities Exchange Act of 1934 ("Exchange Act") against Goldman, Sachs & Co. ("Goldman Sachs").

In anticipation of the institution of these proceedings, Goldman Sachs has submitted an offer of settlement, which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceeding brought by or on behalf of the Commission or in which the Commission is a party, and prior to a hearing pursuant to the Commission's Rules of Practice, 17 C.F.R. 201.100 *et seq.*, Goldman Sachs, without admitting or denying the findings contained herein, except that it admits to the jurisdiction of the Commission over it and over the subject matter of these proceedings, consents to the entry of the findings, the issuance of the cease-and-desist order, and the imposition of the remedial sanctions set forth below.

II.

Based on the foregoing, the Commission finds as follows:

A. Respondent

Goldman Sachs is a New York partnership with its principal place of business in New York. At all relevant times, Goldman Sachs was registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Exchange Act.

B. Background

This is a municipal finance case involving Goldman Sachs' sale of U.S. Treasury securities to municipal bond issuers at excessive, undisclosed markups in connection with certain advance refunding transactions.

When interest rates fall, state and local governments often seek to reduce their borrowing costs by paying off outstanding bonds through the issuance of new bonds at lower interest rates. When the old bonds cannot be paid off until a future call date, the municipality can still obtain a benefit from lower interest rates through an advance refunding. An advance refunding can lock in current interest rates and ensure that the municipality will realize debt service savings over the life of the new bonds. In an advance refunding, the municipality issues new "refunding" bonds and immediately invests the proceeds in a portfolio of U.S. Treasury or agency securities structured to pay the principal and interest obligations on the old bonds until the call date and then to pay off the outstanding principal and any call premium. The portfolio of government securities is normally placed in a defeasance escrow to guarantee repayment of the old bonds.

Defeasance escrow portfolios are subject to Internal Revenue Code provisions and Treasury regulations that prohibit the issuer of tax-exempt refunding bonds from earning

tax arbitrage (that is, a profit from the rate differential between the taxable and tax-exempt markets). I.R.C. § 148; Treas. Reg. §§1.148-0 *et seq*. The regulations provide that the issuer cannot receive a yield on the securities held in escrow that exceeds the yield it pays on the refunding bonds. In addition, to prevent an issuer from diverting tax arbitrage to the seller of the escrow securities by paying artificially high prices, the regulations provide, in effect, that the price paid by refunding bond issuers for escrow securities purchased in the secondary market (known as "open market securities") cannot exceed the fair market value or market price of the securities as defined in those regulations.

When the yield on the investments in the escrow, if purchased at fair market value, would exceed the yield on the refunding bonds, the transaction is said to be in "positive arbitrage." Overcharging by dealers for open market escrow securities in positive arbitrage situations diverts tax arbitrage to the dealers at the expense of the U.S. Treasury. This diversion of money-known colloquially as "yield burning"-violates IRS regulations. If yield burning occurs, the IRS can declare interest paid on the refunding bonds taxable. *See* Harbor Bancorp & Subsidiaries v. Commissioner, 115 F.3d 722 (9th Cir. 1997), *cert. denied*, 118 S. Ct. 1035 (1998).

In contrast, a "negative arbitrage" situation occurs when the yield on open market securities purchased at fair market value would be *below* the yield on the refunding bonds. In a negative arbitrage transaction, overcharging by a dealer for open market escrow securities takes money away from the municipality rather than the Treasury by reducing, dollar for dollar, the present value savings the municipality obtains through the advance refunding.

C. Facts And Legal Analysis

Before 1994, Goldman Sachs sold portfolios of U.S. Treasury securities for defeasance escrows at excessive, undisclosed markups to certain municipalities in connection with advance refundings. For example, in 1993, Goldman Sachs sold a portfolio of $122 million in Treasury securities to a municipality. Goldman Sachs' markup and carry on that portfolio was .38 percent of the prevailing interdealer market prices of the Treasury securities sold to the municipality.[1] At the time, dealers generally charged materially lower markups on escrow securities when the prices were determined through competition or bona fide arm's length negotiation.

Goldman Sachs violated Sections 17(a)(2) and 17(a)(3) of the Securities Act by effecting defeasance escrow transactions with municipalities at prices not reasonably related to the current wholesale market prices for the securities under the particular facts and circumstances, including the pertinent tax regulations. Based on all the relevant facts and circumstances, Goldman Sachs knew or should have known that the prices it charged were not reasonably related to the prevailing wholesale market prices of the securities. The excessive markups also violated Sections 17(a)(2) and 17(a)(3) of the Securities Act because the excessive markups jeopardized the tax-exempt status of those municipalities' refunding bonds and diverted money from the U.S. Treasury to Goldman Sachs when the transaction was in positive arbitrage, or reduced the savings available to the municipalities from the refundings when the transaction was in negative arbitrage.

III.

By reason of the foregoing, Goldman Sachs willfully violated Sections 17(a)(2) and 17(a)(3) of the Securities Act.

IV.

Accordingly, IT IS ORDERED, pursuant to Section 8A of the Securities Act and Section 15(b)(4) of the Exchange Act, that:

A. Goldman Sachs is censured;

B. Goldman Sachs shall cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act;

C. Within ten days of the entry of this order, Goldman Sachs shall comply with its undertaking to make certain payments totaling $104,444.11 related to sales of defeasance escrow securities to certain municipal issuers or obligors in connection with advance refundings in negative arbitrage, as set forth in Goldman Sachs' offer of settlement;

D. Goldman Sachs shall comply with its undertaking to pay $5,110,446.16 to the United States Treasury under an agreement simultaneously entered into among Goldman Sachs, the Internal Revenue Service and the United States Attorney for the Southern District of New York; and

E. At the time the payments are made to the municipalities or obligors and the United States Treasury as described in sub-paragraphs C and D above, copies of the payments and any cover letters accompanying them shall be sent by Goldman Sachs to Lawrence A. West, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0807.

By the Commission.

Jonathan G. Katz
Secretary

Footnotes

1 Profit on open market escrow securities generally has two components: markup and carry. Markup is the difference between the price that the dealer charges the issuer and the prevailing wholesale market price. In re Lehman Bros. Inc., Exchange Act Release No. 37673 (Sept. 12, 1996). Carry is the difference between (a) the interest and accretion produced by the escrow securities between the sale date and closing date and (b) the cost of financing those securities during that period. *See* Board of Governors of the Federal Reserve System, Trading Activities Manual, Part 2 at 2-8 (March 1994).

In the Matter of Salomon Smith Barney Inc., Securities Act Release No. 7829, Exchange Act Release No. 42634, A.P. File No. 3-10177 (April 6, 2000).

I.

The Commission deems it appropriate and in the public interest that public administrative proceedings be, and they hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 15(b)(4) of the Securities Exchange Act of 1934 ("Exchange Act") against Salomon Smith Barney Inc. ("Salomon Smith Barney"), as the successor to Smith Barney Inc. ("Smith Barney").

In anticipation of the institution of these proceedings, Salomon Smith Barney has submitted an offer of settlement, which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceeding brought by or on behalf of the Commission or in which the Commission is a party, and prior to a hearing pursuant to the Commission's Rules of Practice, 17 C.F.R. 201.100 *et seq.*, Salomon Smith Barney, without admitting or denying the findings contained herein, except that it admits to the jurisdiction of the Commission over it and over the subject matter of these proceedings, consents to the entry of the findings, the issuance of the cease-and-desist order, and the imposition of the remedial sanctions set forth below.

II.

Based on the foregoing, the Commission finds as follows:

A. Respondent

Salomon Smith Barney, a New York corporation, with its principal place of business in New York, is registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Exchange Act. During the period relevant to this matter, Salomon Smith Barney's predecessor, Smith Barney, was registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Exchange Act.

B. Background

This is a municipal finance case involving Smith Barney's sale of U.S. Treasury securities to municipal bond issuers at excessive, undisclosed markups in connection with certain advance refunding transactions.

When interest rates fall, state and local governments often seek to reduce their borrowing costs by paying off outstanding bonds through the issuance of new bonds at lower interest rates. When the old bonds cannot be paid off until a future call date, the municipality can still obtain a benefit from lower interest rates through an advance refunding. An advance refunding can lock in current interest rates and ensure that the municipality will realize debt service savings over the life of the new bonds. In an advance refunding, the municipality issues new "refunding" bonds and immediately invests the proceeds in a portfolio of U.S. Treasury or agency securities structured to pay the principal and interest obligations on the old bonds until the call date and then to pay off the outstanding principal and any call premium. The portfolio of government securities is normally placed in a defeasance escrow to guarantee repayment of the old bonds.

Defeasance escrow portfolios are subject to Internal Revenue Code provisions and Treasury regulations that prohibit the issuer of tax-exempt refunding bonds from earning tax arbitrage (that is, a profit from the rate differential between the taxable and tax-exempt markets). I.R.C. § 148; Treas. Reg. §§1.148-0 *et seq*. The regulations provide that the issuer cannot receive a yield on the securities held in escrow that exceeds the yield it pays on the refunding bonds. In addition, to prevent an issuer from diverting tax arbitrage to the seller of the escrow securities by paying artificially high prices, the regulations provide, in effect, that the price paid by refunding bond issuers for escrow securities purchased in the secondary market (known as "open market securities") cannot exceed the fair market value or market price of the securities as defined in those regulations.

When the yield on the investments in the escrow, if purchased at fair market value, would exceed the yield on the refunding bonds, the transaction is said to be in "positive arbitrage." Overcharging by dealers for open market escrow securities in positive arbitrage situations diverts tax arbitrage to the dealers at the expense of the U.S. Treasury. This diversion of money-known colloquially as "yield burning"-violates IRS regulations. If yield burning occurs, the IRS can declare interest paid on the refunding bonds taxable. *See* Harbor Bancorp & Subsidiaries v. Commissioner, 115 F.3d 722 (9th Cir. 1997), *cert. denied*, 118 S. Ct. 1035 (1998).

In contrast, a "negative arbitrage" situation occurs when the yield on open market securities purchased at fair market value would be *below* the yield on the refunding bonds. In a negative arbitrage transaction, overcharging by a dealer for open market escrow securities takes money away from the municipality rather than the Treasury by reducing, dollar for dollar, the present value savings the municipality obtains through the advance refunding.

C. Facts And Legal Analysis

Before 1995, Smith Barney sold portfolios of U.S. Treasury securities for defeasance escrows at excessive, undisclosed markups to certain municipalities in connection with advance refundings. For example, in 1994, Smith Barney sold a portfolio of $26.7 million in Treasury securities to a municipality. Smith Barney's markup and carry on that portfolio was .43 percent of the prevailing interdealer market prices of the Treasury securities sold to the municipality.[1] At the time, dealers generally charged materially lower markups on escrow securities when the prices were determined through competition or bona fide arm's length negotiation.

Smith Barney violated Sections 17(a)(2) and 17(a)(3) of the Securities Act by effecting defeasance escrow transactions with municipalities at prices not reasonably related to the current wholesale market prices for the securities under the particular facts and circumstances, including the pertinent tax regulations. Based on all the relevant facts and circumstances, Smith Barney knew or should have known that the prices it charged were not reasonably related to the prevailing wholesale market prices of the securities. The excessive markups also violated Sections 17(a)(2) and 17(a)(3) of the Securities Act because the excessive markups jeopardized the tax-exempt status of those municipalities' refunding bonds and diverted money from the U.S. Treasury to Smith Barney when the transaction was in positive arbitrage, or reduced the savings available to the municipalities from the refundings when the transaction was in negative arbitrage.

III.

By reason of the foregoing, Smith Barney willfully violated Sections 17(a)(2) and 17(a)(3) of the Securities Act.

IV.

Accordingly, IT IS ORDERED, pursuant to Section 8A of the Securities Act and Section 15(b)(4) of the Exchange Act, that:

A. Salomon Smith Barney is censured;

B. Salomon Smith Barney shall cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act;

C. Within ten days of the entry of this order, Salomon Smith Barney shall comply with its undertaking to make certain payments totaling $6,977,739.84 related to sales of defeasance escrow securities to certain municipal issuers or obligors in connection with advance refundings in negative arbitrage, as set forth in Salomon Smith Barney's offer of settlement;

D. Salomon Smith Barney shall comply with its undertaking to pay $38,004,103.16 to the United States Treasury under an agreement simultaneously entered into among Salomon Smith Barney, the Internal Revenue Service and the United States Attorney for the Southern District of New York; and

E. At the time the payments are made to the municipalities or obligors and the United States Treasury as described in sub-paragraphs C and D above, copies of the payments and any cover letters accompanying them shall be sent by Salomon Smith Barney to Lawrence A. West, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, DC 20549-0807.

By the Commission.

Jonathan G. Katz
Secretary

Footnote

1 Profit on open market escrow securities generally has two components: markup and carry. Markup is the difference between the price that the dealer charges the issuer and the prevailing wholesale market price. In re Lehman Bros. Inc., Exchange Act Release No. 37673 (Sept. 12, 1996). Carry is the difference between (a) the interest and accretion produced by the escrow securities between the sale date and closing date and (b) the cost of financing those securities during that period. *See* Board of Governors of the Federal Reserve System, Trading Activities Manual, Part 2 at 2-8 (March 1994).

In the Matter of William R. Hough & Co., Securities Act Release No. 7826, Exchange Act Release No. 42632, A.P. File No. 3-10176 (April 6, 2000).

I.

The Commission deems it appropriate and in the public interest that public administrative proceedings be, and they hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Sections 15(b)(4) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against William R. Hough & Co. ("Hough").

In anticipation of the institution of these proceedings, Hough has submitted an offer of settlement, which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission or in which the Commission is a party, Hough, without admitting or denying the findings contained herein, except that it admits to the jurisdiction of the Commission over it and over the subject matter of these proceedings, consents to the entry of the findings, the issuance of the cease-and-desist order, and the imposition of the remedial sanctions set forth below.

II.

Based on the foregoing, the Commission finds as follows:

A. Respondent

William R. Hough & Co. ("Hough") is a financial services firm with its principal place of business in St. Petersburg, Florida. At all relevant times, Hough was registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Exchange Act.

B. Summary

This is a municipal finance case involving the breach of Hough's fiduciary duty to the Canaveral Port Authority, one of its financial advisory clients in Florida. The breach of duty involved Hough's failure to make necessary disclosures in a 1992 advance refunding transaction in which it served as the Port Authority's financial advisor and also sold Treasury securities to the Port Authority as principal. This case also involves Hough's sale of the Treasury securities to the Port Authority at excessive, undisclosed markups.

In addition, in connection with a 1992 refunding in Florida by the City of Boynton Beach, Hough certified the fairness of the price paid to Boynton Beach by the provider of a forward supply contract. The certification was materially misleading because it failed to disclose that at the same time that Hough was certifying the fairness of this price, Hough was seeking a $300,000 payment from the provider of the forward supply contract, which Hough contends was for work on a separate project.

C. Background

1. Advance Refundings

When interest rates fall, state and local governments often seek to reduce their borrowing costs by paying off outstanding bonds through the issuance of new bonds paying lower interest rates. When the old bonds cannot be paid off until a future call date, the municipality can still obtain a benefit from lower interest rates through an advance refunding. An advance refunding can lock in current interest rates and ensure that the municipality will realize debt service savings over the life of the new bonds.

In an advance refunding, the municipality issues new "refunding" bonds and immediately invests the proceeds in a portfolio of U.S. Treasury or agency securities structured to pay the principal and interest obligations on the old bonds until the call date and then to pay off the outstanding principal and any call premium. The portfolio of government securities is normally placed in a defeasance escrow to guarantee repayment of the old bonds.

Defeasance escrow portfolios are subject to Internal Revenue Code provisions and Treasury regulations that prohibit the issuer of tax-exempt refunding bonds from earning tax arbitrage (that is, a profit from the rate differential between the taxable and tax-exempt markets). I.R.C. § 148; Treas. Reg. §§1.148-0 *et seq*. The regulations provide that the issuer cannot receive a yield on the securities held in escrow that exceeds the yield it

pays on the refunding bonds. In addition, to prevent an issuer from diverting tax arbitrage to the seller of the escrow securities by paying artificially high prices, the regulations provide, in effect, that the price paid by refunding bond issuers for escrow securities purchased in the secondary market (known as "open market securities") cannot exceed the fair market value or market price of the securities as defined in those regulations.

When the yield on the investments in the escrow, if purchased at fair market value, would exceed the yield on the refunding bonds, the transaction is said to be in "positive arbitrage." Overcharging by dealers for open market escrow securities in a positive arbitrage situation diverts tax arbitrage to the dealers at the expense of the U.S. Treasury.[1] This diversion, known colloquially as "yield burning," is illegal. If yield burning occurs, the IRS can declare interest paid on the refunding bonds taxable. *See* Harbor Bancorp & Subsidiaries v. Commissioner, 115 F.3d 722 (9th Cir. 1997), *cert. denied*, 118 S. Ct. 1035 (1998).[2]

2. Forward Supply Contracts

When an open market defeasance escrow for an advance refunding is structured to contain securities that will mature before their cash flow is needed to make debt service payments on the refunded bonds, the refunding bond issuer often enters into a forward supply contract. In a forward supply contract, the issuer gives the provider of the contract the right to receive the cash from the early-maturing securities. In return, the provider must supply securities to the escrow to replace the cash, so that the escrow continues to satisfy the refunded bonds' debt service requirements. In addition, because the substituted securities will predictably cost the provider less than the cash it will receive, the provider agrees to pay the issuer an initial sum of money, sometimes called the "facility fee," which is the yield of the forward supply contract to the issuer.

Because the facility fee increases the escrow's yield, federal tax regulations require the issuer to include the amount of the facility fee in the escrow's yield calculation. *See* Treas. Reg. §1.148-5(b)(1). Moreover, like any escrow investment, a forward supply contract must be priced at fair market value for purposes of calculating escrow yield. *See* Treas. Reg. §1.148-5(d)(6)(i). Pricing a forward supply contract below fair market value artificially depresses the escrow's yield. A forward supply contract provider that underpays an issuer in a positive arbitrage situation engages in yield burning, because the transaction diverts tax arbitrage to the provider at the expense of the U.S. Treasury.

D. Hough Failed to Make Required Disclosures to the Canaveral Port Authority

The Canaveral Port Authority (the "Port Authority") priced a $46,315,000 refunding bond issue on October 6, 1992. Hough served as the Port Authority's financial advisor for the refunding pursuant to a written financial advisory agreement. The refunding required the Port Authority to purchase for the defeasance escrow a portfolio of Treasury securities costing over $29 million. Hough and the senior managing underwriter agreed to share the risk and profits from the sale of the defeasance escrow securities. Hough then sold the defeasance escrow securities to the Port Authority as principal from Hough's own account. Hough did not discuss the prices it charged for the securities with anyone from the Port Authority.

The Port Authority's personnel had no prior experience with refundings. They depended on Hough's expertise in all aspects of the refunding. They believed that Hough was acting on the Port Authority's behalf in purchasing the Treasury securities and believed that the compensation Hough would earn on the refunding would be limited to its fees under the financial advisory agreement. The Port Authority also relied on Hough to advise the Authority regarding the prices that the senior manager and other underwriters would pay the Port Authority for the refunding bonds.[3]

On the refunding's closing date, October 20, 1992, Hough provided a certificate stating that it had acted as the seller of the securities for the escrow and that "the prices quoted for the U.S. Treasury Securities resulted in yields on such Securities to the Authority at least as high as the yield offered on similar securities in the secondary market for trades which have similar complexities...." In turn, the Port Authority certified that "in reliance upon the certifications made [by Hough], the prices for all of such securities were determined in arms-length negotiations, without any intent to reduce yield." Hough failed to disclose to the Port Authority the amount of profit it made on the escrow securities, or that Hough could have arranged for the Port Authority to buy the escrow securities for less than Hough charged. Hough contends that it disclosed to the Port Authority its profit-sharing arrangement with the senior manager and the possibility that Hough would make a substantial profit on the escrow securities, but no one at the Port Authority can recall learning about the profit-sharing arrangement or knowing that there would be a profit. In connection with the October 6 refunding, Hough eventually received a fee of more than $35,000 from the Port Authority for services it performed under the financial advisory agreement.

E. Hough Sold Treasury Securities to the Canaveral Port Authority at Excessive, Undisclosed Markups

Hough's profit from the sale of $30.7 million in escrow securities to the Port Authority was $393,475 from markups charged and carry received.[4] Hough paid 45 percent of this profit to the senior manager pursuant to their agreement to share escrow profits. The total markup and carry on the transaction was approximately 1.29 percent of the prevailing interdealer market prices of the Treasury securities sold to the Port Authority. At the time, other dealers generally charged materially lower markups on escrow securities when the prices were determined through competition or bona fide arm's length negotiation. Under the facts and circumstances, Hough's prices were above fair market value as defined by federal tax laws. Because the Port Authority's refunding was a positive arbitrage transaction, the profit made by Hough and the senior manager on the escrow securities by charging more than their fair market value diverted tax arbitrage to Hough and the senior manager at the expense of the U.S. Treasury.

F. Hough Signed a Materially Misleading Market Price Certificate Concerning a Forward Supply Contract in a City of Boynton Beach Refunding

In late June 1992, Hough served as a co-managing underwriter of a refunding by the City of Boynton Beach, Florida. In addition, Hough assisted in structuring the defeasance escrow and sold the open market Treasury securities to the City for the defeasance escrow. On June 26, the refunding's underwriters and a forward supply contract provider

agreed on the price, terms, and conditions of a forward supply contract that the provider would enter into with the City when the refunding closed. Bond counsel for the refunding did not require-and there is no evidence that the underwriters used-a competitive process to select the provider or to determine the size of the facility fee that the provider would pay to the City for the forward supply contract rights. Bond counsel did, however, discuss with Hough that if the City did not receive fair value for the forward supply contract rights, the defeasance escrow would exceed the permitted yield and, thereby, jeopardize the tax-exempt status of the bond issue.

Before the refunding's closing date, July 22, 1992, Hough certified in writing, at bond counsel's request, on a certificate dated July 22, 1992, that the facility fee of $2,089,935 paid by the provider to the City for the forward supply contract rights "was established at arm's length without any amount being withheld by [the provider] from the Escrow Agent in order to reduce the yield on the Investments in the Escrow Fund." Under the circumstances, if the provider had withheld as little as $4,000 in order to reduce the yield-that is, paid less than fair value for the contract rights-the defeasance escrow would have exceeded the permitted yield and the tax-exempt status of the City's bond issue would have been jeopardized.

On the closing date, Hough sent the provider an invoice for $300,000. The invoice said that the $300,000 was for services that Hough was performing for the provider to develop a "forward supply assignment program." Hough failed to disclose to the issuer, bond counsel, and bond investors, when certifying the fairness of the price paid by the provider for the forward supply contract, that Hough would receive a $300,000 payment from the provider. The day after closing, the provider sent the $300,000 payment to Hough.[5]

III.

Section 17(a) of the Securities Act prohibits materially false or misleading statements, or material omissions when there is a duty to speak, in the offer or sale of any security. Section 17(a)(1) requires a showing of scienter; however, Sections 17(a)(2) and 17(a)(3) do not require such a showing. Aaron v. SEC, 446 U.S. 680, 697 (1980). Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit materially false or misleading statements, or material omissions when there is a duty to speak, made with scienter, in connection with the purchase or sale of any security. Both knowing and reckless conduct satisfy the scienter element. *See, e.g.*, Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-69 (9th Cir. 1990). A duty to speak arises, and material omissions become fraudulent, when a person or entity has information that another is entitled to know because of a fiduciary or similar relationship of trust and confidence. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-55 (1972); Chiarella v. United States, 445 U.S. 222, 228 (1980); In re Arleen W. Hughes, 27 S.E.C. 629 (1948), *aff'd sub nom.* Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949).

A. Material Omissions in Connection with the Sale of Securities to the Canaveral Port Authority

Generally, a municipality's financial advisor owes fiduciary obligations to it in connection with bond financings by the municipality. *See* In re Lazard Freres & Co. LLC,

Securities Act Release No. 41318 (April 21, 1999). In addition, Florida courts have found a fiduciary relationship implied in law when "confidence is reposed by one party and a trust accepted by the other." Capital Bank v. MVB, Inc., 644 So.2d 515, 518 (Fla. 3d DCA 1994). The Port Authority reposed confidence in Hough, and Hough accepted that trust. Therefore, based on the facts and circumstances, Hough had a fiduciary or similar relationship of trust and confidence with the Port Authority.

Courts have imposed on a fiduciary affirmative duties of utmost good faith and full and fair disclosure of all material facts, as well as an affirmative obligation to employ reasonable care to avoid misleading its client. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963); *see also* Capital Bank, 644 So.2d at 520 ("A fiduciary owes to its beneficiary the duty to refrain from self-dealing, the duty of loyalty, the overall duty to not take unfair advantage and to act in the best interest of the other party, and the duty to disclose material facts.") A broker-dealer that seeks to sell securities from its own account, as principal, to a client to whom it owes fiduciary duties must follow well-established standards. Under both common law and federal securities law, the broker-dealer can only deal with its fiduciary client as a principal by making full disclosure-before entering into the transaction-of the nature and extent of any adverse interest that the broker-dealer may have with the client. *See* In re Arleen W. Hughes, 27 S.E.C. at 635-36; Restatement (Second) of Agency § 390 (1958). A broker-dealer subject to fiduciary obligations must disclose all material facts, including any current market price at which the customer could effect the transaction that is better than the price that the dealer intends to provide to the customer. In re Lazard Freres, Securities Act Release No. 41318 (April 21, 1999).

Hough violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder when it failed to obtain the Port Authority's fully informed consent before engaging in the escrow securities transaction as principal. Hough failed to disclose-in a manner that its client would be sure to understand-(1) that it would sell the escrow securities to the Port Authority from Hough's own account, and (2) the nature and extent of its actual and apparent conflicts of interest, including the conflict of interest posed by Hough's profit-sharing agreement with the refunding's senior manager. Under the circumstances, Hough had, at a minimum, an obligation to investigate whether another seller would have provided the escrow securities to the Port Authority at better prices, to disclose to the Port Authority the results of that investigation and to adequately advise the Port Authority that if Hough provided the escrow securities, it would seek to make a profit and would share any profit made with the refunding's senior manager.

B. Material Misrepresentations and Omissions in the Sale of Securities to the Canaveral Port Authority

As to the pricing of the escrow securities sold to the Port Authority, Hough violated Sections 17(a)(2) and 17(a)(3) of the Securities Act by effecting that transaction at prices not reasonably related to the current wholesale market prices for the securities under the particular facts and circumstances, including the pertinent tax regulations, and by representing to the Port Authority that Hough had sold the securities at fair market value. *See, e.g.*, Grandon v. Merrill Lynch & Co., 147 F.3d 184, 192 (2d Cir. 1998) (under the

shingle theory, a broker-dealer has a duty to disclose excessive markups); In re Lazard Freres, Securities Act Release No. 41318 (April 21, 1999). Hough's markup and carry on the transaction was 1.29 percent of the prevailing interdealer market prices of the Treasury securities sold to the Port Authority. Based on all the relevant facts and circumstances, Hough knew or should have known that the prices it charged were not reasonably related to the prevailing wholesale market prices of the securities. The excessive markups operated as a fraud or deceit on the Port Authority because unbeknownst to the Port Authority the excessive markups diverted money from the U.S. Treasury to Hough and thereby jeopardized the tax-exempt status of the Port Authority's refunding bonds.

C. Material Omission in the Market Price Certificate for the Forward Supply Contract in the City of Boynton Beach Refunding

When Hough certified the fairness of the price paid by the provider for the forward supply contract, Hough failed to disclose to the City of Boynton Beach, bond counsel, and bond investors that Hough would receive a substantial payment from the provider. Hough knew or should have known that a reasonable investor (whether the bond issuer or a purchaser of the tax-exempt bonds) would have wanted to know about that apparent conflict of interest. Under the circumstances, the tax-exempt status of the bonds depended on the validity of Hough's certification of the fairness of the facility fee. Disclosure of Hough's conflict would have permitted the issuer and bond counsel to consider whether they should ask another firm to certify the fairness of the fee. If the issuer had decided to proceed with Hough as the certifier, disclosure of the conflict would have permitted bond investors to assess properly the credibility of Hough's certification.[6] By signing a certificate and failing to disclose a material fact, Hough violated Sections 17(a)(2) and 17(a)(3) of the Securities Act.

IV.

On the basis of this Order and the offer of settlement made by Hough, the Commission finds that Hough willfully violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5.

V.

Accordingly, IT IS ORDERED, pursuant to Section 8A of the Securities Act and Sections 15(b)(4) and 21C of the Exchange Act, that:

A. Hough is censured;

B. Hough shall cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder;

C. Within ten days of the entry of the Order, Hough shall, by a postal or bank money order, certified check or bank cashier's check, pay to the United States Treasury disgorgement and prejudgment interest of (1) $241,906.57 in connection with the Canaveral Port Authority refunding that settled on October 20, 1992, and (2) $555,119.26

in connection with the City of Boynton Beach refunding that settled on July 22, 1992. Documentation confirming the wire transfer shall be hand-delivered or mailed to the Comptroller, Securities and Exchange Commission, Operations Center, 6342 General Green Way, Alexandria, VA 22312-0003, under cover of letter identifying the name and number of this administrative proceeding and the name of the Respondent. A copy of the cover letter and wire transfer documentation shall be simultaneously transmitted to Lawrence A. West, Assistant Director, Securities and Exchange Commission, Washington, DC 20549-0807.

D. Within ten days of the entry of this order, Hough shall comply with its undertaking to make certain payments totaling $136,668.94 related to sales of defeasance escrow securities to certain municipal issuers in connection with advance refundings in negative arbitrage, as set forth in Hough's offer of settlement;

E. Hough shall comply with its undertaking to pay $2,329,977.60 to the United States Treasury under an agreement simultaneously entered into among Hough, the Internal Revenue Service and the United States Attorney for the Southern District of New York; and

F. Copies of payments made to the municipalities and the United States Treasury as described in sub-paragraphs D and E above and any cover letters accompanying them shall be sent by Hough to Lawrence A. West, Assistant Director, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0807.

By the Commission.

Jonathan G. Katz
Secretary

Footnotes

[1] In contrast, in a "negative arbitrage" situation-when the yield on open market securities purchased at fair market value would be *below* the yield on the refunding bonds-overcharging by dealers for open market escrow securities takes money away from the municipality rather than the Treasury by reducing, dollar for dollar, the present value savings the municipality obtains through the advance refunding.

[2] There are several lawful methods to limit the yield of the defeasance escrow in a positive arbitrage situation. One method is to purchase from the Bureau of Public Debt at the Department of the Treasury below-market-interest Treasury securities-known as State and Local Government Series securities ("SLGS")-customized to match the yield limitation. Alternatively, the municipality can purchase open market securities of shorter durations than those required to match the escrow requirements; when these securities mature, the cash proceeds are invested for the remaining period of the escrow in non-interest-bearing SLGS. When either of these methods is used, the Treasury obtains a benefit by issuing debt at interest rates lower than those prevailing in the taxable market. In some instances, an all-SLGS escrow can be more expensive for the issuer than an escrow containing open market securities. However, even in those instances, overcharging by the dealer for open market securities still burns yield illegally and can

cause the issuer's refunding bonds to lose their tax exemption.

[3] There is no evidence that the profit-sharing arrangement affected the prices that the senior manager and other underwriters paid the Port Authority for the refunding bonds.

[4] Profit on open market escrow securities generally has two components: markup and carry. Markup is the difference between the price that the dealer charges the issuer and the prevailing wholesale market price. In re Lehman Bros. Inc., Exchange Act Release No. 37673 (Sept. 12, 1996). Carry is the difference between (a) the interest and accretion produced by the escrow securities between the sale date and closing date and (b) the cost of financing those securities during that period. *See* Board of Governors of the Federal Reserve System, Trading Activities Manual, Part 2 at 2-8 (March 1994).

[5] There is no evidence that the $300,000 payment affected either the selection of the forward supply contract provider or the amount of the facility fee paid to Boynton Beach. Confirmation of the terms of the forward supply contract were sent to the senior managing underwriter, not to Hough.

[6] See Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, Securities Act Release No. 7049 (March 9, 1994) ("Information concerning financial and business relationships and arrangements among the parties involved in the issuance of municipal securities may be critical to evaluating an offering....[S]uch information could indicate the existence of actual or potential conflicts of interest, breaches of duty, or less than arms' length transactions. Similarly, these matters may reflect upon the qualifications, level of diligence, and disinterestedness of financial advisers, underwriters, experts and other participants in an offering. Failure to disclose material information concerning such relationships, arrangements or practices may render misleading statements made in connection with the process ....")

In the Matter of Painewebber Inc., Securities Act Release No. 7823, Exchange Act Release No. 42630, A.P. File No. 3-1017 (April 6, 2000).

I.

The Commission deems it appropriate and in the public interest that public administrative proceedings be, and they hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 15(b)(4) of the Securities Exchange Act of 1934 ("Exchange Act") against PaineWebber Incorporated ("PaineWebber").

In anticipation of the institution of these proceedings, PaineWebber has submitted an offer of settlement, which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceeding brought by or on behalf of the Commission or in which the Commission is a party, and prior to a hearing pursuant to the Commission's Rules of Practice, 17 C.F.R. 201.100 *et seq.*, PaineWebber, without admitting or denying the findings contained herein, except that it admits to the jurisdiction of the Commission over it and over the subject matter of these proceedings, consents to the entry of the findings, the issuance of the cease-and-desist order, and the imposition of the remedial sanctions set forth below.

II.

Based on the foregoing, the Commission finds as follows:

A. Respondent

PaineWebber is a Delaware corporation with its principal place of business in New York. At all relevant times, PaineWebber was registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Exchange Act.

B. Background

This is a municipal finance case involving PaineWebber's sale of U.S. Treasury securities to municipal bond issuers at excessive, undisclosed markups in connection with certain advance refunding transactions.

When interest rates fall, state and local governments often seek to reduce their borrowing costs by paying off outstanding bonds through the issuance of new bonds at lower interest rates. When the old bonds cannot be paid off until a future call date, the municipality can still obtain a benefit from lower interest rates through an advance refunding. An advance refunding can lock in current interest rates and ensure that the municipality will realize debt service savings over the life of the new bonds. In an advance refunding, the municipality issues new "refunding" bonds and immediately invests the proceeds in a portfolio of U.S. Treasury or agency securities structured to pay the principal and interest obligations on the old bonds until the call date and then to pay off the outstanding principal and any call premium. The portfolio of government securities is normally placed in a defeasance escrow to guarantee repayment of the old bonds.

Defeasance escrow portfolios are subject to Internal Revenue Code provisions and Treasury regulations that prohibit the issuer of tax-exempt refunding bonds from earning tax arbitrage (that is, a profit from the rate differential between the taxable and tax-exempt markets). I.R.C. § 148; Treas. Reg. §§1.148-0 *et seq*. The regulations provide that the issuer cannot receive a yield on the securities held in escrow that exceeds the yield it pays on the refunding bonds. In addition, to prevent an issuer from diverting tax arbitrage to the seller of the escrow securities by paying artificially high prices, the regulations provide, in effect, that the price paid by refunding bond issuers for escrow securities purchased in the secondary market (known as "open market securities") cannot exceed the fair market value or market price of the securities as defined in those regulations.

When the yield on the investments in the escrow, if purchased at fair market value, would exceed the yield on the refunding bonds, the transaction is said to be in "positive arbitrage." Overcharging by dealers for open market escrow securities in positive arbitrage situations diverts tax arbitrage to the dealers at the expense of the U.S. Treasury. This diversion of money-known colloquially as "yield burning"-violates IRS regulations. If yield burning occurs, the IRS can declare interest paid on the refunding bonds taxable. *See* Harbor Bancorp & Subsidiaries v. Commissioner, 115 F.3d 722 (9th Cir. 1997), *cert. denied*, 118 S. Ct. 1035 (1998).

In contrast, a "negative arbitrage" situation occurs when the yield on open market securities purchased at fair market value would be *below* the yield on the refunding bonds. In a negative arbitrage transaction, overcharging by a dealer for open market

escrow securities takes money away from the municipality rather than the Treasury by reducing, dollar for dollar, the present value savings the municipality obtains through the advance refunding.

C. Facts And Legal Analysis

Before 1995, PaineWebber sold portfolios of U.S. Treasury securities for defeasance escrows at excessive, undisclosed markups to certain municipalities in connection with advance refundings. For example, in 1994, PaineWebber sold a portfolio of $72.8 million in Treasury securities to a municipality. PaineWebber's markup and carry on that portfolio was .39 percent of the prevailing interdealer market prices of the Treasury securities sold to the municipality.[1] At the time, dealers generally charged materially lower markups on escrow securities when the prices were determined through competition or bona fide arm's length negotiation.

PaineWebber violated Sections 17(a)(2) and 17(a)(3) of the Securities Act by effecting defeasance escrow transactions with municipalities at prices not reasonably related to the current wholesale market prices for the securities under the particular facts and circumstances, including the pertinent tax regulations. Based on all the relevant facts and circumstances, PaineWebber knew or should have known that the prices it charged were not reasonably related to the prevailing wholesale market prices of the securities. The excessive markups also violated Sections 17(a)(2) and 17(a)(3) of the Securities Act because the excessive markups jeopardized the tax-exempt status of those municipalities' refunding bonds and diverted money from the U.S. Treasury to PaineWebber when the transaction was in positive arbitrage, or reduced the savings available to the municipalities from the refundings when the transaction was in negative arbitrage.

III.

By reason of the foregoing, PaineWebber willfully violated Sections 17(a)(2) and 17(a)(3) of the Securities Act.

IV.

Accordingly, IT IS ORDERED, pursuant to Section 8A of the Securities Act and Section 15(b)(4) of the Exchange Act, that:

A. PaineWebber is censured;

B. PaineWebber shall cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act;

C. Within ten days of the entry of this order, PaineWebber shall comply with its undertaking to make certain payments totaling $4,608,326.23 related to sales of defeasance escrow securities to certain municipal issuers or obligors in connection with advance refundings in negative arbitrage, as set forth in PaineWebber's offer of settlement;

D. PaineWebber shall comply with its undertaking to pay $21,571,085.72 to the United States Treasury under an agreement simultaneously entered into among PaineWebber, the Internal Revenue Service and the United States Attorney for the Southern District of New York; and

E. At the time the payments are made to the municipalities or obligors and the United States Treasury as described in sub-paragraphs C and D above, copies of the payments and any cover letters accompanying them shall be sent by PaineWebber to Lawrence A. West, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0807.

By the Commission.

Jonathan G. Katz
Secretary

Footnote

1 Profit on open market escrow securities generally has two components: markup and carry. Markup is the difference between the price that the dealer charges the issuer and the prevailing wholesale market price. In re Lehman Bros. Inc., Exchange Act Release No. 37673 (Sept. 12, 1996). Carry is the difference between (a) the interest and accretion produced by the escrow securities between the sale date and closing date and (b) the cost of financing those securities during that period. *See* Board of Governors of the Federal Reserve System, Trading Activities Manual, Part 2 at 2-8 (March 1994).

In the Matter of Warburg Dillon Read LLC, Securities Act Release No. 7820, Exchange Act Release No. 42628, A.P. File No. 3-10174 (April 6, 2000).

I.

The Commission deems it appropriate and in the public interest that public administrative proceedings be, and they hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 15(b)(4) of the Securities Exchange Act of 1934 ("Exchange Act") against Warburg Dillon Read LLC ("Dillon Read").

In anticipation of the institution of these proceedings, Dillon Read has submitted an offer of settlement, which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceeding brought by or on behalf of the Commission or in which the Commission is a party, and prior to a hearing pursuant to the Commission's Rules of Practice, 17 C.F.R. 201.100 *et seq.*, Dillon Read, without admitting or denying the findings contained herein, except that it admits to the jurisdiction of the Commission over it and over the subject matter of these proceedings, consents to the entry of the findings, the issuance of the cease-and-desist order, and the imposition of the remedial sanctions set forth below.

II.

Based on the foregoing, the Commission finds as follows:

A. Respondent

Dillon Read is a Delaware limited liability corporation with its principal place of business in Connecticut. At all relevant times, Dillon Read was registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Exchange Act.

B. Background

This is a municipal finance case involving Dillon Read's sale of U.S. Treasury securities to municipal bond issuers at excessive, undisclosed markups in connection with certain advance refunding transactions.

When interest rates fall, state and local governments often seek to reduce their borrowing costs by paying off outstanding bonds through the issuance of new bonds at lower interest rates. When the old bonds cannot be paid off until a future call date, the municipality can still obtain a benefit from lower interest rates through an advance refunding. An advance refunding can lock in current interest rates and ensure that the municipality will realize debt service savings over the life of the new bonds. In an advance refunding, the municipality issues new "refunding" bonds and immediately invests the proceeds in a portfolio of U.S. Treasury or agency securities structured to pay the principal and interest obligations on the old bonds until the call date and then to pay off the outstanding principal and any call premium. The portfolio of government securities is normally placed in a defeasance escrow to guarantee repayment of the old bonds.

Defeasance escrow portfolios are subject to Internal Revenue Code provisions and Treasury regulations that prohibit the issuer of tax-exempt refunding bonds from earning tax arbitrage (that is, a profit from the rate differential between the taxable and tax-exempt markets). I.R.C. § 148; Treas. Reg. §§1.148-0 *et seq*. The regulations provide that the issuer cannot receive a yield on the securities held in escrow that exceeds the yield it pays on the refunding bonds. In addition, to prevent an issuer from diverting tax arbitrage to the seller of the escrow securities by paying artificially high prices, the regulations provide, in effect, that the price paid by refunding bond issuers for escrow securities purchased in the secondary market (known as "open market securities") cannot exceed the fair market value or market price of the securities as defined in those regulations.

When the yield on the investments in the escrow, if purchased at fair market value, would exceed the yield on the refunding bonds, the transaction is said to be in "positive arbitrage." Overcharging by dealers for open market escrow securities in positive arbitrage situations diverts tax arbitrage to the dealers at the expense of the U.S. Treasury. This diversion of money-known colloquially as "yield burning"-violates IRS regulations. If yield burning occurs, the IRS can declare interest paid on the refunding bonds taxable. *See* Harbor Bancorp & Subsidiaries v. Commissioner, 115 F.3d 722 (9th Cir. 1997), *cert. denied*, 118 S. Ct. 1035 (1998).

In contrast, a "negative arbitrage" situation occurs when the yield on open market securities purchased at fair market value would be *below* the yield on the refunding bonds. In a negative arbitrage transaction, overcharging by a dealer for open market

escrow securities takes money away from the municipality rather than the Treasury by reducing, dollar for dollar, the present value savings the municipality obtains through the advance refunding.

C. Facts And Legal Analysis

Before 1994, Dillon Read sold portfolios of U.S. Treasury securities for defeasance escrows at excessive, undisclosed markups to certain municipalities in connection with advance refundings. For example, in 1993, Dillon Read sold a portfolio of $200 million in Treasury securities to a municipality. Dillon Read's markup and carry on that portfolio was .37 percent of the prevailing interdealer market prices of the Treasury securities sold to the municipality.[1] At the time, dealers generally charged materially lower markups on escrow securities when the prices were determined through competition or bona fide arm's length negotiation.

Dillon Read violated Sections 17(a)(2) and 17(a)(3) of the Securities Act by effecting defeasance escrow transactions with municipalities at prices not reasonably related to the current wholesale market prices for the securities under the particular facts and circumstances, including the pertinent tax regulations. Based on all the relevant facts and circumstances, Dillon Read knew or should have known that the prices it charged were not reasonably related to the prevailing wholesale market prices of the securities. The excessive markups also violated Sections 17(a)(2) and 17(a)(3) of the Securities Act because the excessive markups jeopardized the tax-exempt status of those municipalities' refunding bonds and diverted money from the U.S. Treasury to Dillon Read when the transaction was in positive arbitrage, or reduced the savings available to the municipalities from the refundings when the transaction was in negative arbitrage.

III.

By reason of the foregoing, Dillon Read willfully violated Sections 17(a)(2) and 17(a)(3) of the Securities Act.

IV.

Accordingly, IT IS ORDERED, pursuant to Section 8A of the Securities Act and Section 15(b)(4) of the Exchange Act, that:

A. Dillon Read is censured;

B. Dillon Read shall cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act;

C. Within ten days of the entry of this order, Dillon Read shall comply with its undertaking to make certain payments totaling $380,545.06 related to sales of defeasance escrow securities to certain municipal issuers or obligors in connection with advance refundings in negative arbitrage, as set forth in Dillon Read's offer of settlement;

D. Dillon Read shall comply with its undertaking to pay $6,326,962.18 to the United States Treasury under an agreement simultaneously entered into among Dillon Read, the

Internal Revenue Service and the United States Attorney for the Southern District of New York; and

E. At the time the payments are made to the municipalities or obligors and the United States Treasury as described in sub-paragraphs C and D above, copies of the payments and any cover letters accompanying them shall be sent by Dillon Read to Lawrence A. West, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0807.

By the Commission.

Jonathan G. Katz
Secretary

Footnote

1 Profit on open market escrow securities generally has two components: markup and carry. Markup is the difference between the price that the dealer charges the issuer and the prevailing wholesale market price. In re Lehman Bros. Inc., Exchange Act Release No. 37673 (Sept. 12, 1996). Carry is the difference between (a) the interest and accretion produced by the escrow securities between the sale date and closing date and (b) the cost of financing those securities during that period. *See* Board of Governors of the Federal Reserve System, Trading Activities Manual, Part 2 at 2-8 (March 1994).

In the Matter of Prudential Securities Inc., Securities Act Release No. 7817, Exchange Act Release No. 42626, A.P. File No. 3-10173 (April 6, 2000).

I.

The Commission deems it appropriate and in the public interest that public administrative proceedings be, and they hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 15(b)(4) of the Securities Exchange Act of 1934 ("Exchange Act") against Prudential Securities Incorporated ("PSI").

In anticipation of the institution of these proceedings, PSI has submitted an offer of settlement, which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceeding brought by or on behalf of the Commission or in which the Commission is a party, and prior to a hearing pursuant to the Commission's Rules of Practice, 17 C.F.R. 201.100 *et seq.*, PSI, without admitting or denying the findings contained herein, except that it admits to the jurisdiction of the Commission over it and over the subject matter of these proceedings, consents to the entry of the findings, the issuance of the cease-and-desist order, and the imposition of the remedial sanctions set forth below.

II.

Based on the foregoing, the Commission finds as follows:

A. Respondent

PSI is a Delaware corporation with its principal place of business in New York. At all relevant times, PSI was registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Exchange Act.

B. Background

This is a municipal finance case involving PSI's sale of U.S. Treasury securities to municipal bond issuers at excessive, undisclosed markups in connection with certain advance refunding transactions.

When interest rates fall, state and local governments often seek to reduce their borrowing costs by paying off outstanding bonds through the issuance of new bonds at lower interest rates. When the old bonds cannot be paid off until a future call date, the municipality can still obtain a benefit from lower interest rates through an advance refunding. An advance refunding can lock in current interest rates and ensure that the municipality will realize debt service savings over the life of the new bonds. In an advance refunding, the municipality issues new "refunding" bonds and immediately invests the proceeds in a portfolio of U.S. Treasury or agency securities structured to pay the principal and interest obligations on the old bonds until the call date and then to pay off the outstanding principal and any call premium. The portfolio of government securities is normally placed in a defeasance escrow to guarantee repayment of the old bonds.

Defeasance escrow portfolios are subject to Internal Revenue Code provisions and Treasury regulations that prohibit the issuer of tax-exempt refunding bonds from earning tax arbitrage (that is, a profit from the rate differential between the taxable and tax-exempt markets). I.R.C. § 148; Treas. Reg. §§1.148-0 *et seq*. The regulations provide that the issuer cannot receive a yield on the securities held in escrow that exceeds the yield it pays on the refunding bonds. In addition, to prevent an issuer from diverting tax arbitrage to the seller of the escrow securities by paying artificially high prices, the regulations provide, in effect, that the price paid by refunding bond issuers for escrow securities purchased in the secondary market (known as "open market securities") cannot exceed the fair market value or market price of the securities as defined in those regulations.

When the yield on the investments in the escrow, if purchased at fair market value, would exceed the yield on the refunding bonds, the transaction is said to be in "positive arbitrage." Overcharging by dealers for open market escrow securities in positive arbitrage situations diverts tax arbitrage to the dealers at the expense of the U.S. Treasury. This diversion of money-known colloquially as "yield burning"-violates IRS regulations. If yield burning occurs, the IRS can declare interest paid on the refunding bonds taxable. *See* Harbor Bancorp & Subsidiaries v. Commissioner, 115 F.3d 722 (9th Cir. 1997), *cert. denied*, 118 S. Ct. 1035 (1998).

In contrast, a "negative arbitrage" situation occurs when the yield on open market securities purchased at fair market value would be *below* the yield on the refunding bonds. In a negative arbitrage transaction, overcharging by a dealer for open market escrow securities takes money away from the municipality rather than the Treasury by reducing, dollar for dollar, the present value savings the municipality obtains through the advance refunding.

C. Facts And Legal Analysis

Before 1995, PSI sold portfolios of U.S. Treasury securities for defeasance escrows at excessive, undisclosed markups to certain municipalities in connection with advance refundings. For example, in 1994, PSI sold a portfolio of $28.3 million in Treasury securities to a municipality. PSI's markup and carry on that portfolio was .41 percent of the prevailing interdealer market prices of the Treasury securities sold to the municipality.[1] At the time, dealers generally charged materially lower markups on escrow securities when the prices were determined through competition or bona fide arm's length negotiation.

PSI violated Sections 17(a)(2) and 17(a)(3) of the Securities Act by effecting defeasance escrow transactions with municipalities at prices not reasonably related to the current wholesale market prices for the securities under the particular facts and circumstances, including the pertinent tax regulations. Based on all the relevant facts and circumstances, PSI knew or should have known that the prices it charged were not reasonably related to the prevailing wholesale market prices of the securities. The excessive markups also violated Sections 17(a)(2) and 17(a)(3) of the Securities Act because the excessive markups jeopardized the tax-exempt status of those municipalities' refunding bonds and diverted money from the U.S. Treasury to PSI when the transaction was in positive arbitrage, or reduced the savings available to the municipalities from the refundings when the transaction was in negative arbitrage.

III.

By reason of the foregoing, PSI willfully violated Sections 17(a)(2) and 17(a)(3) of the Securities Act.

IV.

Accordingly, IT IS ORDERED, pursuant to Section 8A of the Securities Act and Section 15(b)(4) of the Exchange Act, that:

A. PSI is censured;

B. PSI shall cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act;

C. Within ten days of the entry of this order, PSI shall comply with its undertaking to make certain payments totaling $54,733.89 related to sales of defeasance escrow securities to certain municipal issuers in connection with advance refundings in negative arbitrage, as set forth in PSI's offer of settlement;

D. PSI shall comply with its undertaking to pay $5,832,805.74 to the United States Treasury under an agreement simultaneously entered into among PSI, the Internal Revenue Service and the United States Attorney for the Southern District of New York; and

E. At the time the payments are made to the municipalities and the United States Treasury as described in sub-paragraphs C and D above, copies of the payments and any cover letters accompanying them shall be sent by PSI to Lawrence A. West, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0807.

By the Commission.
Jonathan G. Katz
Secretary

Footnote

1 Profit on open market escrow securities generally has two components: markup and carry. Markup is the difference between the price that the dealer charges the issuer and the prevailing wholesale market price. In re Lehman Bros. Inc., Exchange Act Release No. 37673 (Sept. 12, 1996). Carry is the difference between (a) the interest and accretion produced by the escrow securities between the sale date and closing date and (b) the cost of financing those securities during that period. *See* Board of Governors of the Federal Reserve System, Trading Activities Manual, Part 2 at 2-8 (March 1994).

In the Matter of BT Alex Brown Incorporated, Securities Act Release No. 7772, Exchange Act Release No. 42145, A..P. File No. 3-10097 (November 17, 1999).

I.

The Commission deems it appropriate and in the public interest that public administrative proceedings be, and they hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 (the "Securities Act") and Sections 15(b)(4) and 21C of the Securities Exchange Act of 1934 (the "Exchange Act") against BT Alex. Brown Incorporated ("BT Alex. Brown").

In anticipation of the institution of these proceedings, BT Alex, Brown has submitted an offer of settlement, which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission or in which the Commission is a party, and prior to a hearing pursuant to the Commission's Rules of Practice, 17 C.F.R. @ 201.100 et seq., BT Alex. Brown, without admitting or denying the findings contained herein, except that it admits to the jurisdiction of the Commission over it and over the subject matter of these proceedings, consents to the entry of the findings, the issuance of the cease-and-desist order, and the imposition of the remedial sanctions set forth below.

II.

Based on the foregoing, the Commission finds n1 as follows:

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n1 The findings herein are not binding on anyone other than the Respondent.

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A. Respondent

BT Alex. Brown is a Delaware corporation with its principal place of business in Baltimore, Maryland. It is the successor by merger, since September 1, 1997, to Alex. Brown and Sons Incorporated ("Alex. Brown"). BT Alex. Brown is a broker-dealer registered with the Commission pursuant to Section 15(b) of the Exchange Act. At all times relevant to the events described herein, Alex. Brown was a registered broker-dealer.

B. Summary

This is a municipal finance case involving misrepresentations and breaches of duty by Alex. Brown in connection with an advance refunding bond issue of the Commonwealth of Pennsylvania. Alex. Brown agreed with the Treasurer's Office of the Commonwealth that Alex. Brown would sell a portfolio of U.S. Treasury securities to the Commonwealth for the refunding at a markup of 4.5 basis points in price. Without effective disclosure, Alex. Brown instead marked the portfolio up 45 basis points. In addition to exceeding the agreed amount, this markup was excessive under all of the facts and circumstances. Alex. Brown also failed to fully disclose the purpose, nature, and extent of a fee-splitting arrangement with the Commonwealth's financial adviser, including the fact that it was sharing fees with the financial adviser in order to obtain the Treasury business.

C. Background: Advance Refundings

When interest rates fall, state and local governments often seek to reduce their borrowing costs by paying off outstanding bonds through the issuance of new bonds paying lower interest rates. When the old bonds cannot be paid off until a future call date, the municipality can still obtain a benefit from lower interest rates through an advance refunding. An advance refunding can lock in current interest rates and ensure that the municipality will realize debt service savings over the life of the new bonds.

In an advance refunding, the municipality issues new "refunding" bonds and immediately invests the proceeds in a portfolio of U.S. Treasury or agency securities structured to pay the principal and interest obligations on the old bonds until the call date and then to pay off the outstanding principal and any call premium. The portfolio of government securities is normally placed in a defeasance escrow to guarantee repayment of the old bonds.

Defeasance escrow portfolios are subject to Internal Revenue Code provisions and Treasury regulations that prohibit the issuer of tax-exempt refunding bonds from earning tax arbitrage (that is, a profit from the rate differential between the taxable and tax-exempt markets). n2 I.R.C. @ 148; Treas. Reg. @@ 1.148-0 et seq. The regulations provide that the issuer cannot receive a yield on the securities held in escrow that exceeds the yield it pays on the refunding bonds. In addition, to prevent an issuer from diverting tax arbitrage to the seller of the escrow securities by paying artificially high prices, the regulations provide, in effect, that the price paid by refunding bond issuers for escrow securities purchased in the secondary market (known as "open market securities") cannot exceed the fair market value or market price of the securities as defined in those regulations. n3

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n2 These provisions and regulations are designed to prevent abuse of the benefit the federal government affords municipalities by not taxing interest paid on municipal bonds. See Joint Comm. on Taxation, 91st Cong., 2d Sess., General Explanation of the Tax Reform Act of 1969, at 185-86 (Comm. Print 1970).

n3 Over time, Treasury regulations provided several definitions of fair market value and market price for purposes of valuing open market government securities for advance refundings. For example, a regulation generally applicable to advance refunding transactions that settled on or before June 30, 1993 defined market price as "die mean of the bid and offered prices on an established market" on the day of pricing: if, however, the price paid by the issuer was higher than the mean of the bid and offered prices, then the higher price could be treated as the market price of the security if the issuer acquired it in an "arm's length transaction without regard to any amount paid to reduce the yield . . . ." Treas. Reg. @ 1.103-13(c)(1)(iii)(B) (1979). Generally, after June 30, 1993 (the period of the Commonwealth of Pennsylvania refundings described here), fair market value was defined as "the price at which a willing buyer would purchase the [security] from a willing seller in a bona fide, arm's length transaction." Treas. Reg. @ 1.148-5(d)(6)(i) (1993).

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When the yield on the investments in the escrow, if purchased at fair market value, would exceed the yield on the refunding bonds, the transaction is said to be in "positive arbitrage." Overcharging by dealers for open market escrow securities in a positive arbitrage situation diverts tax arbitrage to the dealers at the expense of the U.S. Treasury. n4 This diversion, known colloquially as "yield burning," is illegal. If yield burning occurs, the IRS can declare interest paid on the refunding bonds taxable. See Harbor Bancorp & Subsidiaries v. Keith, 115 F.3d 722 (9th Cir. 1997), cert. denied, 118 S. Ct. 1035 (1998). n5

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n4 In contrast, in a "negative arbitrage" situation--when the yield on open market securities purchased at fair market value would be below the yield on the refunding bonds--overcharging by dealers for open market escrow securities takes money away from the municipality rather than the Treasury by reducing, dollar for dollar, the present value savings the municipality obtains through the advance refunding.

n5 There are several lawful methods to limit the yield of the defeasance escrow in a positive arbitrage situation. One method is to purchase from the Bureau of Public Debt at the Department of the Treasury below-market-interest Treasury securities--known as State and Local Government Series securities ("SLGS")--customized to match the yield limitation. Alternatively, the municipality can purchase open market securities of shorter durations (and lower yields) than those required to satisfy the escrow requirements; when these securities mature, the cash proceeds are invested for the remaining period of the escrow in non-interest-bearing SLGS. When either of these methods is used, the Treasury obtains a benefit by issuing debt at interest rates lower than those prevailing in the taxable market.
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There are two significant dates in an advance refunding bond issue. On the pricing date, the price of the refunding bonds is set, the composition of the defeasance escrow is determined, and the escrow securities are priced and sold -- but not delivered -- to the issuer. At the closing, which usually occurs two to three weeks after the pricing date, the refunding bonds are issued and the escrow securities are delivered to the defeasance escrow.

D. The March 1994 Pennsylvania Refunding

In mid-1991, Alex. Brown entered into a relationship with Patrick H. McCarthy, a Philadelphia-based attorney, pursuant to which McCarthy acted as a finder of municipal securities business for Alex. Brown's Public Finance Department. McCarthy had been a senior adviser, fundraiser, and transition chief for the Treasurer of the Commonwealth of Pennsylvania. n6 Although McCarthy held no official title and was not employed by the Treasurer's Office, he was actively involved in the day-to-day operations, decisions and policies of the Treasurer's Office. McCarthy was de facto the most powerful person in the office after the Treasurer and the Executive Deputy Treasurer, with whom McCarthy worked closely.

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n6 The Treasurer served two terms, beginning in January 1989, and ending in January 1997.

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In 1991, McCarthy met with a senior Alex. Brown banker who was then the head of Alex. Brown's Public Finance Department (the "Senior Banker"). McCarthy promoted to the Senior Banker his ability to obtain Public Finance engagements for Alex. Brown from, among others, the Pennsylvania Treasurer's office. Alex. Brown agreed to pay McCarthy's law firm 20 to 25 percent of the gross revenues earned by Alex. Brown's Public Finance Department, and 20 to 25 percent of the net revenues realized by the firm's Sales, Trading, and Underwriting Department on assignments McCarthy provided assistance in securing for Alex. Brown. Under this arrangement, from 1991 through 1994 Alex. Brown paid McCarthy's law firms more than $ 369.000 for various Public Finance engagements which McCarthy directed to Alex. Brown.

In mid-1993, the Treasurer's Office issued a Request for Proposals to solicit the services of a financial adviser. McCarthy successfully pushed to have Alex. Brown appointed, and a Service Purchase Contract was issued to Alex. Brown effective September 15, 1993. This contract incorporated by reference a standard contractor integrity and confidentiality provision which was set forth in the Request for Proposals to which Alex. Brown responded, and which, in part, provided:

The contractor [Alex. Brown] shall maintain the highest standards of integrity in the performance of this agreement and shall take no action in violation of state or federal laws, regulations, or other requirements that govern contracting with the Commonwealth.

Except with the consent of the Commonwealth, neither the contractor nor anyone in privity with him shall accept or agree to accept from, or give or agree to give to, any gratuity from any person in connection with the performance of work under this agreement except as provided therein.

In late 1993, the Commonwealth of Pennsylvania was considering bond refundings totaling over $ 1 billion. The Governor's Budget Office, which was responsible for all Pennsylvania debt issues, appointed Arthurs Lestrange & Company ("Arthurs Lestrange"), a Pittsburgh-based broker dealer, to serve as the Commonwealth's financial adviser for the refundings. (Arthurs Lestrange had proposed the refundings to the Commonwealth.) The Treasurer's Office, which was generally responsible for the investment of Commonwealth funds, was charged with obtaining investments for the escrows for the refundings. Ultimately, two refundings resulted: (1) the Commonwealth of Pennsylvania $ 494,145,000 General Obligation First Series, which closed in March 1994 (the "March Refunding") and (2) the Commonwealth of Pennsylvania $ 469,616, 337.34 General Obligation Bond Second Series 1994, which closed in June 1994.

In January 1994, McCarthy telephoned the Senior Banker about the refundings. McCarthy explained to the Senior Banker that the Commonwealth was planning to issue refunding bonds, but that Arthurs Lestrange was too small to handle the purchase and sale of the escrow securities. McCarthy then offered the Senior Banker the following proposal: Alex. Brown could be named the escrow provider if it would agree (1) to take all of the financial risk associated with the sale of the escrow securities and (2) to pool revenues with Arthurs Lestrange and allocate 60 percent of the total revenues to Arthurs

Lestrange. McCarthy also told the Senior Banker that the Treasurer's Office was dissatisfied with the size of the markup that another broker-dealer had charged for the escrow portfolio on another recent Commonwealth refunding, and indicated that Alex. Brown would have to provide the escrow for a markup in the range of three to five basis points.

The Senior Banker received approval from his superiors at Alex. Brown to provide the escrow securities on the terms that the Senior Banker described to them. Thereafter, the Senior Banker discussed the transaction and the projected markup on the escrow with the then Deputy Treasurer for Finance (the "Deputy Treasurer"), who was the senior official in the Treasurer's Office with direct responsibility for investments. The Senior Banker proposed a markup of 5 basis points in price, emphasizing the risks that Alex. Brown would assume by purchasing the Treasury portfolio on the pricing date and selling it to the Commonwealth for delivery on the closing date, contingent on the refunding closing. The Deputy Treasurer would only agree to a 4 basis point markup, but the Executive Deputy Treasurer and McCarthy overruled him based on the Senior Banker's assertions. The Treasurer's Office thereafter orally agreed to pay Alex. Brown a markup of 4.5 basis points in price on the escrow portfolio for the March Refunding. A basis point is 1/100 of one percent, and a markup of 4.5 basis points is a markup of .045 percent, or .00045.

On or about February 18, 1994, Michael Bova, then senior vice president and head of municipal securities for Arthurs Lestrange, sent a letter to Commonwealth officials concerning the fee-splitting arrangement between Alex. Brown and Arthurs Lestrange. The Senior Banker was provided with a draft of the letter before it was sent. The letter, in its entirety, stated as follows:

This is to inform you that Arthurs Lestrange as Financial Adviser, and Alex. Brown, as Escrow Agent, intend to pool and then mutually apportion their respective compensation for serving as Financial Adviser and Escrow Agent on the upcoming refunding. The efforts so far by each firm have been so inextricably integrated with the other firm that we are, in effect, working as partners on a day-to-day basis.

On a deal this size, with its significant complexity and critical-timing issues, close professional cooperation by the entire Commonwealth team (the issuer's overall financial adviser and the issuer's technical support--the escrow agent) will only serve to maximize benefits for the issuer.

In February 1994, during the planning for the March Refunding, the Senior Banker was working with his staff at Alex. Brown to structure the defeasance escrow for the transaction. The Senior Banker told a quantitative analyst on his staff that the markup on the escrow securities was to be 4.5 basis points in price, and instructed the analyst to calculate the markup using a factor of .0045. The analyst told the Senior Banker that a factor of .0045 resulted in a 45 basis point markup, not a 4.5 basis point markup. The Senior Banker responded by stating that he had an agreement with the Treasurer's Office for a markup using a factor of .0045. In fact, the Senior Banker had agreed to a markup of

4.5 basis point in price, and had never received approval to mark up the securities by a factor of .0045, or 45 basis points.

The March Refunding was priced on March 16, 1994. The Deputy Treasurer attended the pricing at Alex. Brown's offices in Baltimore. An analyst who worked with the Senior Banker on the March Refunding testified that, on the pricing day, the Senior Banker had him show the Deputy Treasurer Alex. Brown's purchase price for the escrow securities, the markup factor of .0045, the sales price to the Commonwealth for the escrow securities, and the resulting dollar amount of the markup. However, the Deputy Treasurer testified that he only learned about the 45 basis point markup the next day, after he had his staff research publicly available pricing information to calculate the markups that Alex. Brown had charged. The Deputy Treasurer then brought this overcharge to the Senior Banker's attention. In response, the Senior Banker falsely claimed that Alex. Brown had charged only the agreed-upon 4.5 basis point markup. The Senior Banker knew, as his staff had told him, that the .0045 markup factor Alex. Brown used was the equivalent of a 45 basis point markup.

The Deputy Treasurer also raised this issue with McCarthy, who pointed out the Senior Banker's credentials and experience in these matters and supported the Senior Banker's assertion that only a 4.5 basis point markup had been charged. McCarthy told the Deputy Treasurer that he was wrong. Despite the overcharge identified by the Deputy Treasurer, the refunding closed on March 30,
1994.

After the March Refunding closed, Alex. Brown and Arthurs Lestrange combined and allocated their pooled fees in accordance with their 60/40 fee-splitting agreement. The total pooled fees from the transaction were $ 2.604,457.10. Arthurs Lestrange contributed $ 210,000 to the pool, which was its fee for serving as the Commonwealth's financial adviser. Alex. Brown contributed $2,394,457.10 ($ 1,782,140.70 from the markup on the escrow securities, $418,316.40 in carry n7, and a forward supply contract brokerage fee of $194,000). In accordance with the split formula. Arthurs Lestrange received $ 1,562,674.26 and Alex. Brown received $ 1,041,782.84 from the transaction.

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n7 Profit on open market escrow securities generally has two components: markup and carry. Markup is the difference between the price that the dealer charges the issuer and the prevailing wholesale market price. In re Lehman Bros. Inc., Exchange Act Release No. 37673 (Sept. 12, 1996), 62 SEC Dkt. 2324, 2330. Carry is the difference between (a) the interest and accretion produced by the escrow securities between the sale date and closing date and (b) the cost of financing those securities during that period. See Board of Governors of the Federal Reserve System. Trading Activities Manual. Part 2 at 2-8 (March 1994).

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The Senior Banker departed Alex. Brown after the March Refunding. Subsequent to the March Refunding, the Deputy Treasurer continued to protest that Alex. Brown had taken a 45 basis point markup on the escrow portfolio. n8 No one at Alex. Brown ever admitted that he was right. In response to the Deputy Treasurer's request to Alex. Brown for pricing information on the March Refunding escrow, on July 12, 1994, Alex. Brown sent the Deputy Treasurer a memorandum which accurately set forth, among other things, the markup on the escrow portfolio in dollars and in decimal terms (.00449). However, the memorandum also falsely stated, "This represents a markup of 4.49 basis points on a per $ 1000 basis."

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n8 During this period, McCarthy defended Alex. Brown against the Deputy Treasurer's protests. McCarthy told the Deputy Treasurer that he (McCarthy) would handle the discussions between the Treasurer's Office and Alex. Brown over the markup dispute. Thereafter, McCarthy and the Executive Deputy Treasurer repeatedly told the Deputy Treasurer that he was wrong about the markup charged by Alex. Brown, that it had actually been 4.5 basis points, and that it was reasonable.

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III.

Section 17(a) of the Securities Act prohibits materially false or misleading statements, or material omissions when there is a duty to speak, in the offer or sale of any security. Section 17(a)(1) requires a showing of scienter, however, Sections 17(a)(2) and 17(a)(3) do not require such a showing. Aaron v. SEC, 446 U.S. 680, 697 (1980). Violations of Sections 17(a)(2) and 17(a)(3) may be established by showing negligence. SEC. v. Hughes Capital Corp., 124 F.3d 449, 453-54 (3rd Cir. 1997); SEC v. Steadman, 967 F.2d 636, 643 n. 5 (D.C. Cir. 1992). Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit materially false or misleading statements, or material omissions when there is a duty to speak, made with scienter, in connection with the purchase or sale of any security. Both knowing and reckless conduct satisfy the scienter element. See, e.g., Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-69 (9th Cir. 1990). A duty to speak arises, and material omissions become fraudulent, when a person or entity has information that another is entitled to know because of a fiduciary or similar relationship of trust and confidence. See Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-55 (1972); Chiarella v. United States, 445 U.S. 222. 228 (1980); In re Arleen W. Hughes, 27 SEC 629 (1948). aff'd sub nom. Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949).

A. Material Misrepresentations and Omissions in Connection with the Sale of Securities to the Commonwealth of Pennsylvania

As financial adviser to the Treasurer's office, Alex. Brown acted as a fiduciary in the Pennsylvania refundings. The Treasurer's office reposed trust in the skill and integrity of Alex. Brown, and placed the Commonwealth's pecuniary interest in Alex. Brown's charge with respect to the refundings. The Treasurer's office also had a "just foundation for

belief" that Alex. Brown was acting in the Commonwealth's best interest. See Antinoph v. Laverell Securities, 703 F.Supp. 1185 (E.D. Pa. 1989); Lazin v. Pavilion Partners. 1995 U.S. Dist. LEXIS 15255, Civ. A. No. 95-601, 1995 WL 614018 (E.D. Pa. Oct. 11, 1995). The express terms of Alex. Brown's financial advisory contract with the Treasurer's Office (which was signed by the Senior Banker) created a relationship of confidence, and bound Alex. Brown to act according to "the highest standards of integrity."

Courts have imposed on a fiduciary affirmative duties of utmost good faith, and full and fair disclosure of all material facts, as well as an affirmative obligation to employ reasonable care to avoid misleading its client, SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963). A broker-dealer that seeks to sell securities from its own account, as principal, to a client to whom it owes fiduciary duties must follow well-established standards. Under both common law and Federal securities law, the broker-dealer can only deal with its fiduciary client as a principal by making full disclosure -- before entering into the transaction -- of the nature and extent of any adverse interest that the broker-dealer may have with the client. See In re Arleen W. Hughes, 27 SEC at 635-36; Restatement (Second) of Agency @ 390 (1958). This standard requires disclosure of more than the fact that the broker-dealer will act as principal in the transaction. See, e.g., In re R.H. Johnson & Co., 36 S.E.C. 467(1955), aff'd. 231 F.2d 523 (D.C. Cir. 1956); Norris & Hirshberg, Inc. v. SEC, 177 F.2d 228, 233 (D.C. Cir. 1949) (holding that a broker-dealer that sent a fiduciary client confirmations stating that it acted as principal in certain transactions nevertheless violated the anti-fraud provisions by failing to disclose its capacity as principal rather than agent at the time of the transaction). A broker-dealer subject to fiduciary obligations must disclose "all material circumstances fully and completely." Arleen W. Hughes, 27 SEC at 636; see also Restatement (Second) of Agency @ 390, comment a.

Alex. Brown violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder in connection with the sale of escrow securities to the Commonwealth of Pennsylvania for the March Refunding. The Treasurer's Office authorized Alex. Brown to mark up the escrow portfolio 4.5 basis points in price, but Alex. Brown instead took a 45 basis point markup. After the pricing and before the closing of the refunding, when the Deputy Treasurer confronted the Senior Banker on the size of the markup, the Senior Banker claimed that Alex. Brown's markup on the portfolio was only 4.5 basis points as had been agreed. n9 Alex. Brown's misrepresentation was material because a reasonable investor in the position of the Commonwealth would have wanted to know that the financial adviser to the Treasurer's Office had unilaterally determined to charge more for the escrow securities than the Commonwealth had agreed to pay, in particular given the Commonwealth's concern at the time over the high markups charged by another broker dealer in a recently completed refunding.

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n9 The conduct of the Senior Banker may be imputed to the firm. See SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1089 n. 3 (2d Cir. 1972); Converse, Inc. v. Norwood Venture Corp., 1997 Fed. Sec.L.Rep. (CCH) @ 90.121 (S.D.N.Y. 1997); Blanchard v. Edgemark Financial Corp., Fed. Sec.L.Rep. (CCH) @ 90.439(N.D. Ill. 1999).

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Alex. Brown acted knowingly or recklessly. Several weeks before the pricing of the issue, the Senior Banker's own staff told him that the markup he wanted them to apply was 45 basis points, and not 4.5 basis points. Further, in the same March Refunding, Alex. Brown also brokered a forward supply contract for a fee of 4.5 basis points in price paid by the contract provider. In that instance, the "4.5 basis points" was calculated correctly using a factor of .00045. A different approach was taken on the refunding escrow, where, notwithstanding the agreement to a markup of 4.5 basis points, the markup was calculated using a factor of .0045 -- ten times the factor used on the forward supply contract. Alex. Brown's subsequent false characterization of the markup on the March Refunding escrow portfolio as "4.49 basis points on a per $ 1000 basis" is further evidence of scienter. If the Alex. Brown analyst showed the Deputy Treasurer the markup factor of .0045 and the resulting dollar amount of the markup on the pricing day, this did not satisfy Alex. Brown's obligation as a fiduciary to make full and complete disclosure of all material facts in the sale of the escrow securities to the Commonwealth, given Alex. Brown's express agreement that the markup would be 4.5 basis points and its assurances after the pricing that the markup had indeed been 4.5 basis points. If Alex. Brown wanted to change the terms of its deal with the Commonwealth, it needed to disclose that fact clearly, and at a time and in a manner calculated to ensure that its client would fully appreciate what Alex. Brown was doing. Cf., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969) (disclosure requires "effective" disclosure).

Alex. Brown also failed to disclose the true purpose, nature, and extent of the fee-splitting arrangement with Arthurs Lestrange. Bova's February 18 letter suggested that the firms had decided to pool their fees because their efforts were "inextricably integrated," and pooling would promote "close professional cooperation" to the benefit of the Commonwealth. The Senior Banker, however, knew that Alex. Brown agreed to the fee-splitting because he understood, based on his discussion with McCarthy, that Alex. Brown needed to do so in order to obtain the escrow business. The Senior Banker further knew that the 60/40 terms of the fee split would disproportionately compensate Arthurs Lestrange given that Arthurs Lestrange's contribution to the pool from its financial advisory fee would be small compared to the revenues related to the escrow trades, and that Arthurs Lestrange would not be involved in structuring or assembling the escrow and would bear no risk on the escrow. The Senior Banker did not disclose any of these facts to the Commonwealth. These facts were material because they affected the integrity of the process by which Alex. Brown was selected to provide the escrow securities. n10 In fact, for his role in helping secure the escrow business for Alex. Brown, McCarthy obtained for his law firm undisclosed compensation out of the pooled Alex.

Brown/Arthurs Lestrange fees in the form of a payment from an Arthurs Lestrange consultant who had originate the idea for the fee split with Arthurs Lestrange. n11

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n10 See Statement of the Commission Regarding Disclosure of Municipal Securities Issuers and Others. Securities Act Release No. 7049 (March 9, 1994) ("Information concerning financial and business arrangements among the parties involved in the issuance of municipal securities may be critical to evaluating an offering...Such information could indicate the existence of actual or potential conflicts of interest, breaches of duty or less than arm's length transactions...Failure to disclose material information concerning such relationships, arrangements or practices may render misleading statements in connection with the process.")

n11 Alex. Brown's Legal Department had previously vetoed paying McCarthy's firm a portion of securities trading revenues pursuant to the existing payment arrangement with McCarthy because of a determination that such revenues could not be paid to unregistered persons. There is no evidence that Alex. Brown knew about the payment by Arthurs Lestrange to its consultant or that either Alex. Brown or Arthurs Lestrange knew about the compensation to McCarthy's law firm.

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B. Excessive Markups

As to the pricing of the escrow securities sold to the Commonwealth, Alex. Brown also violated Sections 17(a)(2) and 17(a)(3) of the Securities Act by effecting that transaction at prices not reasonably related to the current wholesale market prices for the securities under the particular facts and circumstances, including the pertinent tax regulations. See, e.g., Grandon v. Merrill Lynch & Co., 147 F.3d 184, 192 (2d Cir. 1998) (under the shingle theory, a broker-dealer has a duty to disclose excessive markups); In re Lazard Freres, Securities Act Release No. 41318 (April 21, 1999). Alex. Brown's markup and carry on the March Refunding was over one-half of one percent of Alex. Brown's contemporaneous cost for the Treasury securities sold to the Commonwealth. n12 At the time, other dealers generally charged materially lower markups on escrow securities when the prices were determined through competition or bona fide arm's length negotiation. Based on all the relevant facts and circumstances. Alex. Brown knew or should have known that the prices it charged were not reasonably related to the prevailing wholesale market prices of the securities. n13 The excessive markups operated as a fraud or deceit because, unbeknownst to the Commonwealth, the excessive markups diverted money from the U.S. Treasury to Alex. Brown, and thereby jeopardized the tax-exempt status of the Commonwealth's refunding bonds.

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n12 Absent countervailing evidence, the best evidence of prevailing market price for a broker-dealer is the dealer's contemporaneous cost for the security. In the Matter of Alstead, Dempsey & Co., Inc., 47 SEC 1034, 1035 (1984).

n13 In addition to the tax regulations which governed the pricing of escrow securities and the practice of broker-dealers in competitive escrows or arm's length negotiated escrows, the pertinent circumstances here included, among others, the negotiations between Alex. Brown and the Commonwealth's representative on an appropriate escrow markup, and the fee-splitting arrangement with Arthurs Lestrange.

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IV.

On the basis of this Order and BT Alex. Brown's offer of settlement, the Commission finds that BT Alex. Brown willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

V.

In view of the foregoing, the Commission deems it appropriate and in the public interest to accept the Offer of Settlement submitted by BT Alex. Brown.

Accordingly, IT IS ORDERED, pursuant to Section 8A of the Securities Act and Sections 15(b)(4) and 21C of the Exchange Act, that:

A. BT Alex. Brown is censured;

B. BT Alex. Brown shall cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder;

C. Within ten days of the entry of this Order. BT Alex. Brown shall pay to the United States disgorgement of $ 603,996 in connection with the Commonwealth of Pennsylvania March Refunding that closed on March 30, 1994;

D. BT Alex. Brown shall comply with its undertaking to pay $ 14,701,250 as follows: (1) $ 14,573,576 to the United States, which, together with the $ 603,996 in disgorgement ordered in paragraph C above, will total $ 15,177,572, such total amount being the Settlement Amount under an agreement simultaneously entered into among BT Alex. Brown, the Internal Revenue Service and the United States Attorney for the Southern District of New York related to the March Refunding and other refundings; and (2) $ 127,674 to certain issuers related to other refundings, as set forth in BT Alex. Brown's offer of settlement;

E. The amounts to be paid to the United States as described in paragraphs C and D above shall be electronically transferred to the United States or its designees pursuant to instructions to be provided, in writing, to counsel for BT Alex. Brown by the United States Attorney's Office for the Southern District of New York. Copies of payments made to the United States and the issuers as described in paragraphs C and D above and any cover letter accompanying them shall be sent by BT Alex. Brown to Brian A. Ochs, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0805.

By the Commission.

OTHER CASES

In the Matter of Dougherty Summit Securities LLC, successor to Dougherty Dawkins, Inc.,[1] Thomas M. Strand, Ralph L. McGinley, and Daniel G. Eitrheim, Exchange Act Release No. 41584, A.P. File No. 3-9929 (June 30, 1999).

I.

The Securities and Exchange Commission (Commission) deems it appropriate and in the public interest that administrative proceedings be instituted against Dougherty Summit Securities LLC (Dougherty Summit Securities), successor to Dougherty Dawkins, Inc., Thomas Strand /(Strand), Ralph McGinley (McGinley), and Daniel Eitrheim (Eitrheim) pursuant to Sections 15(b), 15B(c), 19(h) and 21C of the Securities Exchange Act of 1934 (Exchange Act).

In anticipation of the institution of these administrative proceedings, Dougherty Summit Securities, Strand, McGinley, and Eitrheim have submitted Offers of Settlement (Offers) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings contained in this Order Instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b), 15B(c), 19(h) and 21C of the Securities Exchange Act of 1934, Making Findings, Imposing Remedial Sanctions, and Ordering Respondents to Cease and Desist (Order), except as to the Commission's jurisdiction over respondents and the matters set forth in this Order, which is admitted, respondents consent to the entry of this Order.

II.

Accordingly, IT IS HEREBY ORDERED THAT public administrative proceedings pursuant to Sections 15(b), 15B(c), 19(h) and 21C of the Exchange Act be, and hereby are, instituted.

III.

On the basis of this Order and the Offers submitted by respondents, the Commission finds that:

Respondents

A. Dougherty Summit Securities, a broker-dealer registered with the Commission and located in Minneapolis, Minnesota, is the surviving entity of a merger between Dougherty Dawkins LLC and Dougherty Summit Securities LLC. Dougherty Dawkins LLC succeeded to the business of Dougherty Dawkins, Inc. (Dougherty Dawkins) in a prior reorganization. Dougherty Dawkins' registration with the Commission was cancelled in February 1998 after the merger. Dougherty Dawkins specialized in the underwriting, trading and marketing of municipal securities.

B. Strand, age 53, resides in North Oaks, Minnesota, and at all relevant times was associated with Dougherty Dawkins. Between 1989 and 1993, Strand was President of Dougherty Dawkins and from 1994 to 1996 was Vice-Chairman of the firm.

C. McGinley, age 53, resides in North Oaks, Minnesota, and at all relevant times was associated with Dougherty Dawkins. Between 1989 and 1995, McGinley was the Executive Vice-President in charge of the Public Finance Division of Dougherty Dawkins.

D. Eitrheim, age 43, resides in Bloomington, Minnesota, and at all relevant times was associated with Dougherty Dawkins. In 1992, Eitrheim became a Senior Vice-President of the Public Finance Division of Dougherty Dawkins.

Other Entity Involved

E. Presbyterian Retirement Village of Rapid City, Inc. is a non-profit South Dakota corporation. It was formed in 1979 to develop and operate a retirement center in Rapid City, South Dakota, known as the Westhills Village Retirement Community (Westhills). It was the recipient of the proceeds and the ultimate obligor of the bond issues that are the subjects of this Order.

Factual Background

F. In 1983, Dougherty Dawkins underwrote an $11.12 million municipal bond issue on behalf of Westhills (Series 1983 Bonds). The proceeds were used for the construction of Westhills Retirement Community. In January 1987, Westhills issued $10.5 million of refunding bonds (Series 1986 Bonds), also underwritten by Dougherty Dawkins, to refinance the Series 1983 Bonds using a technique known as a "crossover refunding."

G. Westhills invested the proceeds of the Series 1986 Bonds in an escrow account. The escrow account served as collateral for the Series 1986 Bonds, which were rated "AAA." The offering documents for the Series 1986 Bonds contemplated that the issue would be

remarketed in August 1993 and provided that the Series 1986 Bonds would become unsecured and nonrated after the funds in the escrow account were released to retire the Series 1983 Bonds on October 1, 1993.

H. Under the terms of the original issue, the Series 1986 Bonds were to be automatically tendered to the trustee at par on or before August 15, 1993, and, in a process known as remarketing, the remarketing agent was to re-sell the bonds to the public at par on August 15, 1993. Bondholders who desired to retain the Series 1986 Bonds beyond the remarketing date were required to notify the trustee in writing of their intention to retain the bonds.

I. In January 1987, the entire Series 1986 Bond issue was sold to another registered broker-dealer, which immediately resold interests in the bonds to its retail customers.

Discussions on Refinancing the Series 1986 Bonds

J. In or about September 1992, Eitrheim suggested to Westhills that Westhills consider refinancing the Series 1986 Bonds, in view of falling interest rates. In or about December 1992, Westhills asked McGinley for information on the costs of refinancing the bonds.

K. In or about February and April 1993, McGinley made presentations to the board of directors for Westhills on the costs and benefits of refinancing the Series 1986 Bonds, as well as the costs and benefits of remarketing them.

L. In or about May 1993, bond counsel for the Series 1986 Bonds advised that, for tax reasons, the Series 1986 Bonds had to be remarketed before they could be refinanced. Failure to proceed with the remarketing at par would jeopardize the tax exempt status of the Series 1986 Bonds.

M. In or about May 1993, Dougherty Dawkins submitted to Westhills, in response to a request for proposals to several firms, an investment banking proposal prepared by Eitrheim and reviewed by McGinley, which recommended that Westhills first remarket the bonds and then wait for 30 to 90 days before effecting a refinancing.

N. In or about May 1993, the board of directors of Westhills hired Dougherty Dawkins to serve as its investment banker on an ongoing basis for future bond issues and remarketings.

O. In or about July 1993, the board of directors of Westhills made a preliminary determination that it would refinance the Series 1986 Bonds after they had been remarketed by Dougherty Dawkins on August 15, 1993, should then current market conditions remain favorable.

P. On or about July 15, 1993, Dougherty Dawkins prepared a Remarketing Memorandum which established February 15, 1994 as the first callable date for the Series 1986 Bonds, at a call price of 108.

Trades in the Series 1986 Bonds

Q. In or about July 1993, Eitrheim called a representative of the broker-dealer described in Paragraph III.I above to remind him that the date for the remarketing of the Series 1986 Bonds was near. Eitrheim informed the representative that Dougherty Dawkins offered to buy the bonds in a secondary transaction at 102 to the extent that bondholders did not wish to tender their bonds to the trustee at par during the remarketing. Eitrheim did not inform the representative about the probability that the Series 1986 Bonds would be refinanced. The representative asked Eitrheim to put the offer in writing and to send him a copy of the notice to be sent to bondholders concerning the remarketing.
R. Eitrheim confirmed Dougherty Dawkins' offer to purchase the Series 1986 Bonds at 102 from the bondholders by letter dated July 14, 1993. On or about July 16, 1993, Eitrheim sent the representative a copy of the proposed notice to bondholders. The draft notice stated that the remarketed bonds would no longer be secured by escrow funds and would be unrated. However, the notice made no mention of the probability that the remarketed bonds would be refinanced should then current market conditions remain favorable.

S. In or about August 1993, holders of approximately $3.7 million of the Series 1986 Bonds sold their bonds to Dougherty Dawkins at 102, and holders of $6.3 million of the bonds tendered their bonds to the trustee at par. Dougherty Dawkins did not inform the bondholders of the probability that the Series 1986 Bonds would be refinanced. The holders of an additional $500,000 of the bonds chose to retain their bonds.

T. In August 1993, the trustee transferred the $6.3 million in tendered bonds to Dougherty Dawkins, as remarketing agent, to resell to the public at par. Dougherty Dawkins sold these bonds to eight of its officers, including Strand, McGinley and Eitrheim, for their personal accounts at par and on margin. Westhills paid Dougherty Dawkins a fee of $52,100 for performing the remarketing.

U. Dougherty Dawkins resold the bonds it purchased at 102 to its own customers in September 1993, at an average price of 109. Dougherty Dawkins did not inform its customers of the probability that the Series 1986 Bonds would be refinanced.

V. In December 1993, a new series of bonds was issued on behalf of Westhills to replace the remarketed Series 1986 Bonds, as planned. The proceeds of the new bonds were used to retire the Series 1986 Bonds on February 15, 1994 at 108.

W. Dougherty Dawkins' officers sold $1.2 million of the Series 1986 Bonds they purchased at par in the remarketing to Dougherty Dawkins at an average price of 108, which were resold by Dougherty Dawkins to its customers at 109. The officers held the remaining bonds until February 1994 when they were redeemed by the issuer at 108. Strand, McGinley, and Eitrheim redeemed approximately $1,150,000, $650,000 and $350,000 of the Series 1986 Bonds and profited by approximately $92,000, $52,000, and $28,000 respectively.

X. Dougherty Dawkins, Strand, McGinley, and Eitrheim failed to disclose their transactions in the Series 1986 Bonds and the resulting profits to Westhills.

Violations

Y. Rule G-17 promulgated by the Municipal Securities Rulemaking Board (MSRB) requires broker-dealers to deal fairly and honestly with all persons in connection with their municipal securities business. Broker-dealers and their associated persons have a responsibility under the Rule not to exploit their superior access to information to gain financially at the expense of their customers or issuers of municipal securities. Respondents, by engaging in the above transactions in the Series 1986 Bonds without disclosing the probability of a refinancing of the Series 1986 Bonds to the bondholders who sold their bonds to Dougherty Dawkins at 102, to the bondholders who tendered their bonds to the trustee at par, and to the bondholders who purchased from Dougherty Dawkins at 109, as described in Paragraphs III.F through III.X above, failed to deal fairly and honestly with the bondholders. Similarly, by failing to disclose their transactions and profits in the Series 1986 Bonds to Westhills, Respondents failed to deal fairly with Westhills. Accordingly, Dougherty Dawkins, Strand, McGinley, and Eitrheim willfully violated Rule G-17.

Z. Dougherty Dawkins willfully violated Section 15B(c)(1) of the Exchange Act by violating MSRB Rule G-17, as described in Paragraph III.Y above.

IV.

Accordingly, IT IS ORDERED that Dougherty Summit Securities cease and desist from committing or causing any violations, and any future violations, of Section 15B(c)(1) of the Exchange Act and MSRB Rule G-17.

IT IS FURTHER ORDERED that Dougherty Summit Securities shall refund, within sixty (60) days of the entry of this Order, its $52,100 remarketing fee to Westhills, and within twenty (20) days of this payment Dougherty Summit Securities shall submit to the Commission's staff an affidavit that it has complied with its undertaking to refund the $52,100 remarketing fee.

IT IS FURTHER ORDERED that Dougherty Summit Securities shall pay a civil money penalty in the amount of $400,000 to the United States Treasury. Payment of this $400,000 penalty shall be made on the following terms: $200,000 shall be paid within ninety (90) days of the entry of the Commission's Order, and the remaining $200,000 shall be paid within one hundred and eighty (180) days of the entry of the Commission's Order. Provided, however, that if any payment is not made on the date it is due, the entire unpaid balance becomes immediately due and payable. Such payments shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the United States Securities and Exchange Commission; (C) hand delivered to Comptroller, Securities and Exchange Commission,

Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter which identifies Dougherty Summit Securities as a Respondent in these proceedings and the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Godfried B. Mensah, Securities and Exchange Commission, Midwest Regional Office, 500 W. Madison Street, Suite 1400, Chicago, Illinois, 60661-2511.

IT IS FURTHER ORDERED that Strand, McGinley, and Eitrheim cease and desist from committing or causing any violations, and any future violations, of MSRB Rule G-17.

IT IS FURTHER ORDERED, that Strand, McGinley, and Eitrheim shall each pay a civil money penalty in the amount of $35,000 to the United States Treasury within sixty (60) days of the entry of this Order. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the United States Securities and Exchange Commission; (C) hand delivered to Comptroller, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter which identifies Strand, McGinley, and Eitrheim as respondents in these proceedings and the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Godfried B. Mensah, Securities and Exchange Commission, Midwest Regional Office, 500 W. Madison Street, Suite 1400, Chicago, Illinois 60661-2511.

By the Commission.

Jonathan G. Katz
Secretary

Footnotes

-[1]- Dougherty Summit Securities LLC merged with Dougherty Dawkins LLC in September 1997. Dougherty Dawkins LLC was the successor to Dougherty Dawkins, Inc., the broker-dealer whose conduct is discussed herein.

In the Matter of H. Michael Richardson, Exchange Act Release No. 41448, A.P. File No. 3-9913 (May 25, 1999).

I.

The Commission deems it appropriate and in the public interest that proceedings pursuant to Sections 15(b) and 19(h) of the Securities Exchange Act of 1934 ("Exchange Act") be, and they hereby are, instituted against H. Michael Richardson ("Richardson").

II.

In anticipation of the institution of these proceedings, Richardson has submitted an Offer of Settlement for the purpose of disposing of the issues raised by these proceedings. The Commission has determined that it is appropriate and in the public interest to accept Richardson's Offer of Settlement.

Solely for the purposes of this proceeding and any other proceeding brought by or on behalf of the Commission or in which the Commission is a party, Richardson:

A. Admits the jurisdiction of the Commission over him and over the matters set forth in this Order; and

B. Without admitting or denying the findings in this Order, except as to the entry of the injunction in Paragraph III.C. below, which is admitted, consents to entry of this Order and the imposition of the remedial sanction set forth below.

III.

The Commission finds: [The findings herein are made pursuant to Richardson's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.]

A. That from 1985 through the present, Richardson was associated with First California Capital Markets Group, Inc., a broker-dealer registered with the Commission;

B. That a Final Judgment was entered as to Richardson permanently enjoining him from further violations of Section 17(a) of the Securities Act of 1933 and Sections 10(b) and 15B(c) of the Exchange Act, Rule 10b-5 promulgated thereunder, and Municipal Securities Rulemaking Board ("MSRB") Rules G-17 and G-19, by the United States District Court for the Northern District of California in an action entitled Securities and Exchange Commission v. First California Capital Markets Group, Inc., et. al., C 97-02761 CRB (N.D.Cal., April 5, 1999). Richardson consented to the entry of the Final Judgment without admitting or denying the allegations in the Commission's complaint; and

C. That the complaint alleged that Richardson: 1) in connection with two "pool" municipal bond offerings made material misrepresentations and omissions pertaining to the size of the pools and the intended use of the bond proceeds, and advised the pools to purchase unsuitable securities; 2) in connection with three land development municipal bond offerings made material misrepresentations and omissions pertaining to the value of the land, developer, and capitalization of the project; and 3) sold securities in contravention of MSRB Rules G-17 and G-19.

IV.

Based on the foregoing, the Commission deems it appropriate and in the public interest to accept Richardson's Offer of Settlement.

Accordingly, IT IS HEREBY ORDERED that H. Michael Richardson be, and he hereby is, barred from association with any broker, dealer, investment adviser, investment company or municipal securities dealer, with the right to reapply for association three years after entry of this order to the appropriate self-regulatory organization, or if there is none, to the Commission.

By the Commission.

Jonathan G. Katz
Secretary

FINANCIAL ADVISORS

SETTLED INJUNCTIVE PROCEEDINGS

SEC v Paschal Gene Allen, Civ. Action No. 1 99-CV-2986 (N.D. Ga.), Litigation Release No. 16362 (November 18, 1999) (settled final order).

The Securities and Exchange Commission today announced the filing of a complaint against Paschal Gene Allen, a former public finance banker in the Atlanta office of Stephens Inc., for taking undisclosed payments in connection with a securities investment he recommended to his financial advisory client, Fulton County, Georgia. The complaint also charges Allen with taking undisclosed compensation from underwriter's counsel in connection with five local bond issues in Georgia.

The complaint, filed in the Northern District of Georgia, alleges the following: In the Fall of 1994, Allen recommended to Fulton County that it take certain County funds and invest them in a portfolio of long-term United States Treasury securities and an associated put option. The County adopted Allen's recommendation, and the transaction closed on November 29, 1994. Allen did not disclose, however, that he arranged to take, and subsequently took, $20,970.10 in payments in connection with the transaction. Allen's failure to disclose the arrangement, the payment, and the actual and potential conflicts of interest created thereby violated the following antifraud provisions of the

federal securities laws: Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. By 1998, Allen had paid the $20,970.10 over to Stephens, after disclosing the payments to the firm. In other conduct occurring between September 1991 and April 1993, Allen also received undisclosed compensation totaling $10,900 from underwriter's counsel in connection with five separate municipal securities offerings in Georgia. In these offerings, Stephens served as underwriter and a Georgia law firm served as underwriter's counsel. In each offering, the issuer paid the underwriter's counsel fees of the law firm. Yet, Allen, who served as Stephens' lead banker on the transactions, did not disclose his payment arrangement with the law firm to the issuers or in the bonds' offering documents. Allen's failure to disclose this compensation violated Section 15B(c)(1) of the Exchange Act and Rule G-17 of the Municipal Securities Rulemaking Board.

Simultaneously with the filing of the complaint, without admitting or denying the complaint's allegations, Allen agreed to the entry of a final judgment permanently enjoining him from future violations of Sections 10(b) and 15B(c)(1) of the Exchange Act and Rule 10b-5 thereunder, as well as MSRB Rule G-17. In addition, Allen agreed to pay (1) disgorgement to Fulton County totaling $6,216.84, consisting of prejudgment interest on the $20,970.10 in undisclosed payments he received, during the period he retained those payments, and (2) a civil penalty of $20,000. As part of his settlement with the Commission, Allen has also agreed to the entry of a Commission order barring him from associating with any securities broker or dealer or municipal securities dealer.

ADMINISTRATIVE PROCEEDINGS – COMMISSION DECISIONS

In the Matter of County of Nevada, City of Ione, Wasco Public Financing Authority, Virginia Horler, and William McKay, Exchange Act Release No. 39612, A.P. File No. 3-9542 (February 2, 1998).

On February 2, 1998, the Securities and Exchange Commission ("Commission") issued an Order Instituting Public Administrative Proceedings against three central California municipalities and two professionals for causing or committing securities fraud in connection with the sale of $ 58 million in municipal bonds. The Order names the County of Nevada ("Nevada County"), the City of Ione ("Ione"), the Wasco Public Financing Authority ("Wasco"), Virginia Horler ("Horler"), of Dain Rauscher Incorporated (formerly known as Rauscher Pierce Refsnes), and William McKay ("McKay"), a real estate appraiser. The Order alleges that the municipalities and individuals created and approved written materials, used in selling the bonds, that fraudulently misstated or omitted important information.

Last July, the Commission sued the underwriter of the offerings, First California Capital Markets Group, and two of its executives, H. Michael Richardson and Derrick Dumont, in the United States District Court for the Northern District of California. See Lit. Rel No. 15423. That litigation is pending.

Nevada County raised $ 9.07 million through the sale of "Mello-Roos" bonds, which are used to finance real estate development. The Order alleges that the Official Statement for the Nevada County offering contained misrepresentations and omissions concerning: (1) the value of the property to be developed; (2) the developer's ownership interest in the property; (3) the developer's experience and financial condition; (4) cost estimates to complete the project; and (5) how the project would be financed by the developer and Nevada County. The Order further alleges that Horler, Nevada County's financial advisor, drafted the Official Statement, which was reviewed by Nevada County staff and officials, and approved for distribution by resolution of the County Board of Supervisors.

Ione raised $ 14 million in two "Mello-Roos" bond offerings. The Order alleges that the Official Statements for the Ione offerings contained misrepresentations and omissions concerning: (1) the ability to complete all of the listed improvements with the offering proceeds; (2) the value of the property to be developed, and (3) the sufficiency of the developer's capital to complete the project.

The Order further alleges that McKay prepared the appraisals for both Nevada County and Ione, as well as summaries of each which he knew were to be included in the Official Statements for the offerings.

The misrepresentations and omissions in the Nevada County and Ione Offering Statements were important to investors because they made the projects and the bonds appear to be less risky than they actually were.

The Wasco offering, which raised $ 35 million, involved the sale of "Marks-Roos" municipal bonds, which are issued to form pools of money to finance a number of local projects. The Order alleges that the Official Statement for this offering failed to disclose that nearly all of the projects listed were highly contingent, if not speculative. These misrepresentations were important to investors because they falsely created the impression that the pools were fully allocated to particular projects. Because the projects were speculative, there was a greater risk to investors that the bonds would not be repaid with interest.

The Order alleges that Nevada County, Ione, Wasco, Horler and McKay violated the antifraud provisions of the federal securities laws, including Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 issued thereunder.

An administrative hearing will be scheduled to litigate the allegations and determine whether the Commission should order any remedial action.

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and they hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") to determine whether: (i) Respondents are violating, have violated, or are about to violate Sections 17(a)(1), (2) and (3) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; (ii) Respondents are, have been, or were causes of violations of Sections 17(a)(1), (2) and (3) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; and (iii) an order should be issued as to Respondents pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act to require them to cease and desist from committing or causing a violation and to comply, or to take steps to effect compliance with Sections 17(a)(1), (2) and (3) of the Securities Act, Section 0(b) of the Exchange Act and Rule 10b-5 thereunder.

II.

The Division of Enforcement alleges:

A. Summary of the Action

1. This matter involves violations of the antifraud provisions of the federal securities laws in connection with four municipal bond offerings by three California local governmental entities; a $ 9.07 million offering by the County of Nevada; two offerings with a combined value of $ 14.05 million by the City of Ione; and a $ 35 million offering by the Wasco Public Financing Authority. In each offering, the municipal bonds were offered and sold to investors by means of an Official Statement. An "Official Statement" is a written offering document that is prepared by the issuer and its agents for the purpose of disclosing to investors all material facts about the municipal bond offering. It is distributed to investors by the underwriter of the bond offering. Each Official Statement for the offerings at issue in this proceeding contained material misstatements and/or omissions which made the municipal bonds seem much safer and more desirable to investors than they actually were.

2. By their conduct and by using, directly or indirectly, the means or instruments of interstate commerce or the mails, Respondents committed or caused violations of Sections 17(a)(1), (2) and (3) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

B. Respondents

3. County of Nevada ("Nevada County" or the "County") is a political division and legal subdivision of the State of California invested with corporate powers.

4. City of Ione ("Ione") is a political division and legal subdivision of the State of California invested with corporate powers.

5. Wasco Public Financing Authority ("Wasco PFA") is a public agency formed by a joint powers agreement between the City of Wasco, California, and the Wasco Redevelopment Agency. The City of Wasco is a political division and legal subdivision of the State of California invested with corporate powers. The City of Wasco is governed by an elected City Council whose members also serve as the directors of the Wasco PFA and the Wasco Redevelopment Agency.

6. Virginia Horler ("Horler") resides in Moraga, California, and is a Senior Vice President of Dain Rauscher Incorporated, successor to Rauscher Pierce Refsnes, Inc. ("Rauscher") investment banking firm in its San Francisco office. She served as Rauscher's principal directing its work as financial adviser to Nevada County and prepared the Official Statement for Nevada County's municipal securities offering.

7. William McKay ("McKay") resides in Sacramento, California, and is a real estate appraiser who does business under the name McKay & Associates. McKay's appraisals of the land to be developed were incorporated into the Nevada County and Ione Official Statements.

C. Other Relevant Entities And Persons

8. First California Capital Markets Group, Inc. ("First California") is a California corporation with its principal place of business located in San Diego, California. First California has been registered with the Commission as a broker-dealer since June 12, 1985 and is a regional investment banking firm specializing in the California municipal financing market. First California is a defendant in the action, SEC v. First California Capital Markets Group. Inc., et al., Action No. Civ-97-2761 DLJ (N.D. Cal.), filed July 28, 1997 (the "First California Proceeding").

9. H. Michael Richardson ("Richardson") resides in Lafayette, California, and is the Chairman and Chief Executive Officer of First California. He has been associated with registered broker-dealers since 1967, and associated with First California since 1985, owning 70% of the firm. Richardson is a defendant in the First California Proceeding.

10. Derrick Dumont ("Dumont") resides in Calistoga, California, and was formerly employed by First California as the Manager of its Assessment District/Mello-Roos department. Dumont was the manager of the Nevada and Ione underwritings. Dumont is a defendant in the First California Proceeding.

11. G. Michael Montross ("Montross") is currently incarcerated in a California facility. In late December 1997, Montross was convicted by a California state jury of over 70 felony counts of California state securities law violations. Montross was the proposed developer of the Wildwood Estates subdivision in Nevada County.

12. Rauscher Pierce Refsnes, Inc. ("Rauscher") was a Delaware corporation with its principal place of business in Dallas, Texas, until January 998, when it merged with an affiliate and became Dain Rauscher Incorporated, which is registered with the

Commission as a broker-dealer. Rauscher had been registered as a broker-dealer with the Commission since 1982 and was registered under the name of its corporate predecessor since 1965.

D. Background

The Mello-Roos Bond Act

13. The California Mello-Roos Community Facilities Act of 1982, Cal. Gov. Code @@ 53311, et seq. (the "Mello-Roos Act"), authorizes municipalities to organize community facilities districts ("CFDs") to finance the building of infrastructure.

14. Mello-Roos bonds are paid off through special taxes levied on the property being developed. The bonds are not personal debts of the landowners or general obligations of the issuing municipality. Because they are paid off using future real property tax levies, the bonds' financial attractiveness depends upon the underlying value of the land being developed, the contemplated improvements to the land and the developer's ability to carry out the contemplated improvements.

Nature of the Value-to-Lien Ratio for a Mello-Roos Bond Financing

15. The value of the land being developed in relation to the amount of bond debt against the land constitutes the value-to-lien ratio. To determine the value of the land, a real estate appraisal is normally performed. Investors rely on the "value-to-lien" ratio to measure the creditworthiness of Mello-Roos bonds because land-secured municipal debt is often sold without a credit rating. If there is a default on a Mello-Roos bond, the issuer will foreclose on the tax lien and use the proceeds to bring the bonds current or possibly pay off the bonds to the extent funds are available to do so. Alternatively, the issuer will attempt to sell the property to another developer who will complete the project.

16. Adequate land values offer the best assurance that bondholders will receive principal and interest payments. A high value-to-lien ratio usually provides greater safety for the investor and leads to a lower interest rate for the issuer. In California during the relevant time period, a 3-to-1 value-to-lien ratio was normally required to complete a Mello-Roos bond offering.

17. The "value" securing a bond issue, and therefore the risk to investors, must be accurately disclosed in Official Statements. Otherwise, no investor can really assess the true level of risk.

18. Because a fundamental premise of the value-to-lien ratio for a land development project is that the contemplated project will actually be built and sold, one material consideration for any Mello-Roos bond purchaser is whether the property owner/developer actually possesses the experience, technical capability and financial capability to complete the project. Unless the owner/developer possesses the necessary resources to complete the project, the claimed value-to-lien ratio might be materially

overstated and/or the project might not attract sufficient buyers to ensure that the tax levies are paid in a timely manner. Another material consideration is whether the project -- or lots in a subdivision project -- can be sold within a sufficient time frame to ensure payment of all liens against the property and thereby cover principal and interest payments on the bonds.

E. The Nevada County Bond Offering

Nevada County's Mello-Roos Offering Guidelines and Infrastructure Finance Committee Procedure

19. On February 20, 1990, the Nevada County Board of Supervisors adopted a public resolution setting out a procedure for considering and approving land-based public financings (the "Procedure"). Under the Procedure, each proposal was to be forwarded to the Board of Supervisors with a report from the Infrastructure Finance Committee (comprising County officials and staff) and its recommendation to proceed. The purpose of the Procedure was to guard against unwise public financings including the bonds for the Wildwood Estates public improvements described below.

20. The Procedure specified a value-to-lien ratio of "at least" 4-to-1 "after the installation of the public improvements to be financed" in order to undertake a Mello-Roos bond offering. That 4-to-1 ratio was adopted in light of the declining property values in Nevada County. Although the Procedure permitted the County Board to consider a lesser value-to-lien ratio on a case-by-case basis, there must first be a "compelling justification" offered by the Financial Adviser or lead underwriter in order to deviate from the 4-to-1 ratio.

21. The Procedure also provided that Mello-Roos bonds "will be issued only when it can be demonstrated that a financing of solid structure and strong marketability can be implemented." With respect to "strong marketability," the Procedure provided that a "market absorption study may be required by the county to provide assurance that the development will find market acceptance. . . . Real Estate Appraiser or Market Absorption Analyst service costs will be considered for eligibility for public funding on a case-by-case basis. The County may require independent review of appraisal/absorption analysis provided by the applicant."

Formation of the Wildwood Estates District

22. Located within Nevada County is a contiguous, undeveloped, 286-acre parcel which became known as "Wildwood Estates" and which had been owned by a bankrupt entity. In early 1990, Montross purchased -- subject to final bankruptcy court approval -- Wildwood Estates for $ 1.98 million using funds raised through four limited partnerships. During 1990, Montross placed title to the 286 acres into his wholly-owned corporation, Wildwood Estates, Inc. ("Wildwood Corp."), even though he had promised the investors in the four limited partnerships ("Wildwood Partners") that those entities would receive title to the property.

23. In addition to paying the $ 1.98 million purchase price for Wildwood Estates, Montross took the land subject to liens against the property for $700,000 in unpaid real estate taxes to Nevada County. Additionally, Nevada County had deposited $ 160,000 in its funds for sewer bonds on the property.

24. On March 20, 1990, the Nevada County Board of Supervisors considered an application by Montross to form the Wildwood Estates Community Facilities District ("Nevada County CFD") in accordance with the Mello-Roos Act. As a part of that application, Montross agreed to finance privately the roads and recreational facilities (estimated at the time to cost approximately $ 5 million) in Wildwood Estates. Montross presented to the Nevada County Board a one-page memorandum prepared by Dumont, along with a three-page appraisal summary prepared by a Member of the Appraisal Institute ("MAI") valuing the property at $ 28 million after final completion. Montross had selected Dumont to structure public financing to pay for the remaining Wildwood Estates infrastructure (primarily sewers, drainage, and utilities costing over $ 8 million) using Mello-Roos bonds.

25. Montross' application to the Nevada County Board contained errors and inconsistencies that raised serious issues about his integrity and the project's viability. In his one-page memorandum, Dumont falsely characterized the $28 million appraisal figure as being a "raw land" value. But as was known to Nevada County and its officials, the assessed value of Wildwood Estates' raw land was just a small fraction of the $ 28 million figure. Additionally, Montross' application did not contain meaningful financial statements, an original signature, or a proof of completion bond.

26. The Nevada County Board was also advised during the March 20th meeting of Montross' problems in obtaining financing. According to the meeting minutes, Montross "hoped that there was not still the serious question of whether or not the County wants to use Mello-Roos, because, if so, he indicated he was in deep trouble because all of his plans were based on the use of Mello-Roos financing. He noted that, because of problems associated with the savings and loan institutions, there were practically no institutions left that would loan money for the project -- even if it were located in downtown Sacramento."

27. Notwithstanding the deficiencies in Montross' application and "red flags" regarding his financial resources, the Nevada County Board of Supervisors voted to form the Nevada County CFD and to retain Dumont and First California to underwrite its Mello-Roos bonds. After forming the Nevada County CFD, the Board conducted a ballot election to determine whether a majority of property owners within the CFD favored the use of Mello-Roos financing. Even though Montross signed a ballot -- on behalf of Wildwood Corp. -- in favor of the bonds, a majority of the Board voted to reject the results because they were not sure who the real property owner was. According to the meeting minutes, Montross then produced a title report showing that Wildwood Corp. was the owner, and the Board reversed itself by voting to ratify the election.

Horler is Retained as a Financial Adviser

28. In May 1990, the Nevada County staff contacted Horler, Senior Vice President of Rauscher, and retained her as its Financial Adviser. On July 2, 1990, Nevada County and Rauscher formally executed a financial advisory contract in which Rauscher represented that "it [was] skilled in making the studies and analyses described in the contract and represented that it is qualified by training and experience to perform the work required by the county." Horler accepted the responsibility of carrying out Rauscher's performance under the contract. Rauscher agreed to "prepare the preliminary and final official statements describing ... the economic and financial background of the property owner in accordance with the disclosure required by the Securities and Exchange Commission Rule 15c2-12." Rauscher also agreed to "review and analyze all data and information which have a bearing on the program to finance the County's Community Facilities District, including but not limited to ... the value of the appraisal, coverage ratios and debt capacity [and] projected special taxes." In addition, Rauscher agreed to confer and consult with county staff and elected officials, architects, contractors, property owners, bond counsel and the underwriter "to assist the county in developing a financing plan that meets the county's specific needs for funds and the property owners ability and willingness to pay." Nevada County agreed to pay Rauscher $ 30,000, but only if and when its bond offering closed.

McKay is Retained to Appraise Wildwood Estates

29. Nevada County permitted Dumont to retain the appraiser in order to determine the value-to-lien ratio. McKay had bid only $ 4,000 to perform the appraisal. The next highest bid was $ 20,000. McKay was not on MAI.

30. On June 6, 1990, McKay prepared a "preliminary" appraisal which was discussed at a June 8, 1990 meeting involving the Infrastructure Finance Committee and Horler. None of McKay's appraised values satisfied Nevada County's 4-to-1 value-to-lien guidelines. However, Horler stated that 3-to-1 was the industry standard and focused on the two highest values in McKay's appraisal -- the only two which satisfied the 3-to-1 ratio. There was never the requisite finding under the Procedure of a "compelling justification" to use a ratio of less than 4-to-1.

31. McKay then prepared a 60-page appraisal which was circulated to Horler and Nevada County. McKay found values ranging from $ 2.98 million to $ 38 million. McKay also prepared a 14-page summary to be included in the Official Statement to be provided to investors. McKay, the County and Horler knew the summary would be included in the Official Statement and relied upon by investors to measure the security of the bonds. The summary appraisal only contained the three highest values, ranging from approximately $ 32 million to $ 38 million.

Nevada County Violates Its Guidelines for Bond Approval

32. At the November 1990 Nevada County Board of Supervisors meeting, County Treasurer and Tax Collector Christina Dabis made a presentation, as the Chair of the

Infrastructure Finance Committee, by reading into the record a letter stating the Committee's failure to recommend favorably Nevada County's proposed Mello-Roos bond offering. The Committee's statement included Dabis' "professional concerns" that real estate values and sales were declining and that an economic recession was forecast. That statement also noted that "if this development has the great potential we've been told that it has, then it can also be a success without Mello-Roos financing, which means the developer could finance the project privately and recover the costs in the selling price. This approach would not double or possibly triple the property tax levy of the future property owners." The clear import of the Committee's statement was that the Mello-Roos offering should be terminated.

33. Concerns regarding the marketability of the proposed development were also raised within the Committee by Bruce Bielefelt, the County Auditor. On May 18, 1990, he sent an e-mail to the other Committee members stating: "It sounded like the Board was planning to go ahead with the financing before they heard from the County Infrastructure Finance Committee. I know I have some concerns. . . . Why would the county want to go ahead with public financing before exploring other financing alternatives [?] Why would we want to go forward without [having] seen a marketability study?"

34. In fact, the declining real estate market prevented the absorption of developed lots at a sufficiently rapid rate to cover the interest expense for the private construction loan and the concurrent Mello-Roos bond financing. An absorption study performed by the construction lender in 1993 determined that revenues from the anticipated sale of lots at Wildwood Estates would be less than the carrying costs and marketing expenses for the project. As a result, the absorption study concluded that the project was not viable under current conditions.

35. Despite the objections of its Infrastructure Finance Committee and the guidelines set out in the Procedure, the Nevada County Board approved the issuance of the bonds. The Nevada County Board therefore undertook the Mello-Roos bond offering without receiving the necessary favorable recommendation of its Infrastructure Finance committee and without ever finding either that the 4-1 value-to-lien ratio specified by its guidelines had been satisfied or that there was a compelling justification for accepting a lower value-to-lien ratio.

Nevada County Issues $ 9.07 Million in Mello-Roos Bonds

36. On December 20, 1990, First California underwrote $ 9.07 million in tax exempt Mello-Roos bonds for the Nevada County CFD (the "Nevada County Bonds"). At the time, the County also intended to issue an additional $ 2 million in taxable Mello-Roos bonds to finance the remaining public infrastructure which did not qualify for tax-exempt treatment. When its Mello-Roos bond offering closed, Nevada County used over $ 500,000 of the proceeds to retire a special sewer assessment against the property. That, in turn, allowed the County to recover approximately $ 160,000 that it had deposited to secure pay-off of the assessment. Additionally, $ 30,000 of the bond proceeds were used to pay Rauscher for Horler's activities.

37. Some of the Nevada County Bonds matured between September 1, 1993 and September 1, 2003 and bore an interest rate of between 6.75% and 8.00%, depending upon the maturity date. Most of the Bonds, about $ 7,370,000, matured on September 1, 2019 and bore a 8.40% interest rate. Those Nevada County Bonds maturing on or after September 1, 2001 could not be redeemed before September 1, 2000. Additionally, if such early redemption for those Bonds occurred before March 1, 2002, a prepayment penalty, along with accrued interest, would have to be paid to the bond holders.

The Official Statement Contains Material Misrepresentations and Omissions

38. Horler drafted the Official Statement. The Official Statement was also reviewed by Nevada County staff and officials, and it was approved by resolution of the County Board of Supervisors.

Misleading Valuations

39. The Nevada County Official Statement represented that the build-out value of Wildwood Estates (the estimated value for all the lots after completion of the infrastructure if sold individually to builders or homeowners) was $ 35,280,000. This representation was important to investors because it indicated that there would likely be adequate security in the event property owners failed to pay the special taxes needed for making principal and interest payments to the bondholders.

40. The $ 35,280,000 figure in the Official Statement was materially overstated by at least $ 4 million because it was based on the inclusion of 45 single family lots to be located on a 22-acre parcel in Wildwood Estates when, in fact, the developer had not sought -- and never received -- approval to develop that parcel into 45 single family lots. McKay also assigned a per lot value almost $ 10,000 higher for these 45 lots than the average value for the approved 384 lots. Without the additional $ 4 million, the Nevada County Bonds would not have met a 3-to-1 value-to-lien ratio (after the County issued the additional $ 2 million in taxable bonds necessary to complete the project). Additionally, without a clear and viable plan to develop the 22-acre parcel, the Mello-Roos tax liens against that parcel would go unpaid unless Wildwood Corp. was willing and able to pay the taxes.

41. Because it had approved the development plan for Wildwood Estates, Nevada County knew or should have known that, contrary to the stated assumption in McKay's appraisal, there was no plan for developing the 22-acre parcel as 45 single-family lots and that Montross had not submitted a proposed map for subdividing the 22-acre parcel when he submitted his application on March 20, 1990 for a Mello-Roos bond offering.

42. McKay's appraisal failed to take into account the fact that Wildwood Estates lots were subject to the special tax to repay the bonds. That special tax was estimated to be $ 2,935 per parcel per year for 29 years on single family lots, and it was in addition to property taxes and other applicable fees.

43. The appraisal also used comparables from the neighboring Lake Wildwood community without any adjustment for the far superior amenities in Lake Wildwood. In addition, the Nevada County Official Statement falsely stated that all comparables were cash sales when in fact some of the comparables were only listing prices. McKay's full 60-page appraisal, which Nevada County and Horler received, disclosed the basis for his comparables. The full appraisal was not distributed to the bond investors; instead, they received a 14-page summary, which excluded this information, and had to request copies of the full appraisal from Nevada County, Rauscher, or First California.

44. The Nevada County Official Statement failed to disclose that, in addition to the appraised build-out value of $ 35,280,000 represented in the Official Statement, the land had also been appraised using other methods of valuation which resulted in substantially lower appraised values which did not meet the 3-to-1 ratio. Horler, McKay and Nevada County knew of these other values, but they did not include them in the Nevada County Official Statement.

Misleading Owner and Developer Information

45. The Nevada County Official Statement misrepresented the ownership of Wildwood Estates and Montross' background and experience. According to the Official Statement, "all of the taxable land within the District is currently owned by G. Michael Montross of Montross Barber Investments, Inc." In fact, Nevada County knew since the March 20, 1990 Board meeting that Wildwood Corp. owned the property because Montross signed the election ballot on behalf of that entity and provided a title report disclosing Wildwood Corp's ownership. This misidentification of the property's ownership was materially misleading because it suggested that Montross' personal resources were at risk in the project when, in fact, only a shell corporation's assets were at risk. Additionally, the Official Statement led investors to believe that the owner's background and resources had been disclosed when, in fact, no information had been provided about Wildwood Corp., the true owner, or about the Wildwood Partners' claims to the property.

46. Nevada County knew that the question of the ownership of Wildwood Estates was material because it had already stopped the bond sale once in August 1990 because of a concern about title. Nevada County had documents in its possession which put the County on notice of continued title problems. Both a bankruptcy order "confirming" the sale of the property and Montross' financing application filed with the County identified partnerships with names sounding similar to Wildwood Estates as possibly being related to Montross' acquisition of the property.

47. In 1991, after the Nevada County Bonds were sold, a group of limited partners sued Montross, his real estate firm, and Wildwood Corp. for fraud in connection with the offer and sale of the limited partnership interests in Wildwood Estates. This lawsuit further clouded title to Wildwood Estates and resulted in the Nevada County CFD not going forward with the additional, taxable public financing necessary to complete the project. The question of whether Montross individually, Wildwood Corp., or Wildwood Partners owned Wildwood Estates also delayed repayment from bond proceeds for the

infrastructure already completed. That slowed further construction and eventually contributed to the project's collapse.

48. The Official Statement falsely represented the experience of Montross and Montross Barber Investments, Inc. as follows:

"[Montross Barber Investments] now holds more than $ 250 million worth of Northern California property for more than 3,000 investors.

“. . . Montross has invested in and developed commercial and residential properties for the past 18 years. He has purchased over $ 200 million worth of residential units and created over 1,200 subdivision lots in the last eight years."

In fact, Montross' real estate experience consisted of managing apartment buildings and forming limited partnerships to syndicate the purchase of apartment buildings and commercial properties. In these syndications, Montross and his firm retained a minority interest as general partner, usually no more than 6 percent. Montross was not an experienced developer. Montross did not have 18 years of experience developing vacant land into subdivisions, and he had not created 1,200 subdivision lots. Additionally, the reference to "over $ 200 million worth of residential units" suggested that Montross Barber Investments, Inc. had enormous financial resources when, in fact, the Montross Barber firm had, as of March 1989, a purported tangible net worth of only $ 300,000 and was experiencing a negative cash flow from its business operations.

49. The representations about the experience and financial strength of the developer were material to investors because, without an experienced and financially strong developer, investors had little, if any, assurance that the raw land would be developed into subdivided single family lots with special recreation facilities and that the lots would be sold to homeowners willing to pay the anticipated asking prices and special taxes. If the developer/landowner did not pay the special taxes, the land would have to be sold in foreclosure sale to make principal and interest payments to the bondholders.

Misleading Cost Estimates

50. The Official Statement falsely represented that the "Total Cost Estimate of Subdivision Improvements" on the property would be $ 13,474,298.91. In fact, by early November 1990, the cost engineer on the project had received bids totaling $ 15,370,172 for the improvements, or approximately $ 2 million more than the represented amount. The use of the lower estimate figure -- when bids had already been received -- was materially misleading because it called into question the sufficiency of the bond financing to complete the public improvements and because it increased the amount of financing that the developer would have to provide.

Misleading Financing Description

51. The Official Statement falsely represented that the "portion of the subdivision improvements that will be financed directly by the Developer includes recreational facilities, drainage facilities, roads and certain fees. The remaining subdivision improvements will be financed from proceeds of the Aggregate Bonds." The Official Statement also falsely represented that $6,900,579.41 in improvements would be financed with public Series E-1990 bonds, $ 1,392,371.71 in improvements would be finance with public Series T-1990 bonds and $ 5,089,756.76 would be privately financed. In fact, Nevada County did not intend to -- and would not -- provide any construction financing for any of the improvements using the public Series bond proceeds. Instead, Nevada County was requiring the property owner and developer to obtain all of the construction financing from private lending institutions because Nevada County would release the Mello-Roos bond proceeds only after each phase of the project was completed. Nevada County therefore used the Mello-Roos bond proceeds to provide "take out" or "permanent" financing for the public improvements, rather than using the proceeds -- as represented in the Official Statement -- for the construction financing as well. Eventually, the developer lacked the resources to perform any of the later phases, and the project was abandoned without generating sufficient market value to repay the bond investors.

52. The Official Statement's representations regarding financing were materially misleading because they understand the type and amount of financing that the owner and developer would have to provide and the amount of improvement work that would have to be performed before the Mello-Roos bond proceeds were released. Additionally, the representations were misleading because they dramatically understated the amount of debt that would be placed against the property. Given the disbursement arrangement adopted by Nevada County, the property was going to have to secure both the construction financing arranged by the developer and the Mello-Roos financing arranged by Nevada County until such later time as Nevada County could pay off some or all of the bonds. This dual financing burden essentially left the equity in the project "under water" until at least September 2000, because Nevada County could not pre-pay any of the Bonds before then and subjected the bondholders to the risk that income on the undisbursed proceeds would be insufficient to cover interest on the bonds. As a result, there was no easy way to use the undisbursed bond proceeds to reduce the tax liens against the project and no reasonable opportunity to locate additional financing or a new developer to complete the project.

53. On December 14, 1993, the Nevada County Board of Supervisors terminated the Nevada County CFD. At the time, not a single lot in Wildwood Estates had been sold.

54. Nevada County, Horler and McKay knew or recklessly disregarded that material facts were misrepresented or not disclosed to investors in the Nevada County Official Statement, and thereby committed or caused the violation of Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5.

55. Nevada County, Horler and McKay obtained money or property by means of

material misstatements and omissions and engaged in a transaction, practice, or course of business which operated as a fraud or deceit upon the purchasers of the Mello-Roos bonds so as to commit or cause the violation of Section 17(a)(2) and (3) of the Securities Act.

F. The Two City Of Ione Bond Offerings

56. Ione wanted to finance the infrastructure for a 460-acre real estate development project called Castle Oaks Country Club Estates ("Castle Oaks"), consisting of a residential subdivision, a golf course, and other recreational and commercial uses. Dumont of First California recommended that Ione issue two series of Mello-Roos bonds to finance the infrastructure. The first series, Ione CFD-1, was to be used to finance the development of the Castle Oaks golf course, which was to be owned by Ione, but leased to a private, for-profit operator. Because that lease arrangement would prevent that series of Mello-Roos bonds from being tax free, the Ione CFD-1 offering was delayed for several months. The second series, Ione CFD-2, was to be used to develop certain infrastructure at Castle Oaks. Because of the delay in issuing the Ione CFD-1 bonds, the Ione CFD-2 bonds were actually issued first.

The Ione CFD-2 Offering in February 1991

57. On February 14, 1991, First California underwrote $ 7.5 million in Ione CFD-2 bonds under the Mello-Roos Act. The Ione CFD-2 Official Statement represented that the proceeds of the Ione CFD-2 bond offering were sufficient to build certain public infrastructure for Castle Oaks. In fact, however, the estimated cost to build that infrastructure was at least $3 million more than the funds being raised through the Ione CFD-2 offering. The project engineer for the Castle Oak project advised Ione before issuance of the Ione CFD-2 bonds that the cost estimate did not accurately represent the total estimated cost and that the bond proceeds would fall short by more than $ 3 million.

58. The Ione City Council knew about the shortfall. Prior to the offering, it passed a resolution in 1989 which stated in part that "it is expressly declared that the proposed authorizations herein may not be sufficient to complete all of the proposed facilities. In that event, it is the intention of the City Council that alternative sources of funds sufficient to complete the facilities shall be secured to the satisfaction of the City by the property owner(s) as a condition to the issuance of the special tax bonds."

59. Information about the funding shortfall of the Castle Oaks Project was important to investors because it related to the risk of whether the developer would be able to complete the project and sell the lots so that the special tax could be levied and collected to repay investors.

60. The Ione CFD-2 Official Statement failed to mention the City Council's resolution. Despite the fact that the bond proceeds would not be sufficient, the Official Statement represented that all the public improvements would be acquired with the bond proceeds.

61. After the Ione CFD-2 bonds were issued, Ione noticed that the tentative map had not been drawn in conformity with the minimum lot size requirement set forth in the Development Agreement between Ione and the developer. When the lot size was recalculated, the development had only 584 single family lots rather than 667 as originally calculated. This misstatement was important to investors because it affected the ultimate value of the property as developed, which affected the ability of investors to receive full payment of principal and interest.

62. Ione knew or recklessly disregarded the fact that the Ione CFD-2 Official Statement contained material misrepresentations and omissions, and thereby committed or caused the violation of Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5.

63. Ione obtained money or property by means of material misstatements or omissions and engaged in a transaction, practice, or course of business which operated as a fraud or deceit upon the purchasers of its Ione CFD-2 bonds so as to commit or cause the violation of Sections 17(a)(2) and (3) of the Securities Act.

The Ione CFD-1 Offering in June 1991

64. On June 6, 1991, in a separate underwriting. First California underwrote $6.55 million of Ione CFD-1 bonds under the Mello-Roos Act. The Ione CFD-1 Official Statement represented that the build-out value of the Castle Oaks Project was $44,906,000, an amount that appeared to satisfy the 3-to-1 value-to-lien ratio for the $14.05 million in total bonds (CFD-2 and CFD-1) then issued. The value was based on an appraisal prepared by McKay.

65. This representation was false and misleading. The $ 44,906,000 appraisal was almost $ 3 million higher than an appraisal prepared the previous year, despite the fact that in the one year intervening period the number of single family lots in the project had been reduced from 667 to 584 and real estate values in California had declined. In addition, the $ 44,906,000 appraisal was based on the assumption that part of the land would be developed into 90 high-density single family lots. That assumption, however, was not part of the developer's immediate plans, did not meet the required minimum square foot requirements, had not been approved, and lacked any apparent market.

66. McKay improperly disregarded the developments as planned, and instead included in his appraisal the value of improvements which were not planned, approved or financed.

67. The Ione CFD-1 Official Statement failed to disclose that the Castle Oaks Project lacked sufficient capital to finance the planned development. The estimated cost of the infrastructure and golf course was between $25 and $30 million. Ione agreed to raise approximately $ 10 million by issuing bonds, and the developer was to bear the balance of the construction costs. The developer had obtained a $ 3.2 million letter of credit and made an unverified representation that it also had approximately $ 6.5 million in private

construction financing. A shortfall of $ 5 million to $ 10 million remained, even assuming the developer had $ 6.5 million in construction financing. This shortfall was not disclosed in the Ione CFD-1 Official Statement.

68. Information about the cost of the Castle Oaks project and the funding shortfall were key facts in determining whether the developer would be able to complete the project so that the special tax could be assessed to repay investors.

69. Further, back in February 1991, the Ione CFD-2 Official Statement had represented that Ione would not issue more than $ 12.725 million in bonds secured by the Castle Oaks property until it made a finding that the "fair market value of land and then existing private improvements" was at least three times the value of all of the bonds outstanding and proposed to be issued. Ione did not make the required finding prior to issuing the Ione CFD-1 bonds four months later, in June 1991, which placed in excess of $ 14 million in debt on the property. Ione failed to disclose to Ione CFD-1 bondholders that it issued additional debt without ensuring that the fair market value of the land exceeded the debt by three times. Had Ione performed the review, it would have found that it could not issue the additional bonds. To satisfy the 3-to-1 ratio, the fair market value and the then existing improvements of the property needed to be at least $ 42.165 million. When the Ione CFD-1 bonds were issued, the fair market value of the property and then existing improvements was substantially lower than that amount. The information about the debt limit was important to investors because it potentially affected the collateral for both sets of bonds.

70. On October 6, 1994, Ione announced that there were no funds to make the October 1, 1994, interest and principal payments on the Ione CFD-1 and CFD-2 bonds and that the bonds were in default. Not a single lot had been sold. The construction lender foreclosed on the property. After the construction lender was unable to sell the property at two successive foreclosure sales and failed to bring the special tax bonds current, Ione foreclosed on the property. On December 1, 1995, Ione sold the property to an investment group for $3.3 million at a sheriff's auction.

71. Ione and McKay knew or recklessly disregarded the fact that the Ione CFD-1 Official Statement contained material misrepresentations and omissions, and thereby committed or caused the violation of Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5.

72. Ione and McKay obtained money or property by means of material misstatements or omissions and engaged in a transaction, practice, or course of business which operated as a fraud or deceit upon the purchasers of its Ione CFD-1 bonds so as to commit or cause the violation of Sections 17(a)(2) and (3) of the Securities Act.

G. The Wasco Public Financing Authority Bond Offering

73. On September 20, 1989, the Wasco PFA issued $ 35 million of its 1989 Local Agency Bonds pursuant to the Marks-Roos Act. The Wasco PFA offered and sold its

bonds to investors by means of an Official Statement. The bonds were underwritten by First California.

74. The Board of Directors for the Wasco PFA approved the Official Statement. The Wasco PFA Official Statement represented that the Wasco PFA intended and reasonably expected to purchase certain specific local obligations with its bond funds. In fact, however, the Wasco PFA had no reasonable basis for making most of its representations about the local obligations.

75. The Wasco PFA Official Statement failed to disclose the highly tentative and questionable nature of a number of the projects for which there were variously no development sites, no maps, no plans, no engineering reports, no environmental impact reports, no permits and/or construction financing.

76. For example, the Wasco PFA Official Statement represented that the Wasco PFA would finance the purchase by the Delano Regional Medical Center ("the Delano RMC") of an existing facility in Wasco with $ 1.2 million in bond funds. The Official Statement failed to disclose that the Delano RMC and the city were still in negotiations and that no agreement had been reached to purchase the facility. After the bonds were issued, negotiations terminated, and the Delano RMC never purchased the facility in Wasco.

77. The Official Statement also stated that $ 1.125 million of the bond funds would be used to finance the "Johnson Housing Project Infrastructure" and that construction of the infrastructure for a mobile home park was expected to commence toward the end of 1989. At the time the Official Statement was disseminated, however, there were no maps, permits or financing for the park; it was never constructed.

78. The "Ramos & Barker Single Family Low/Moderate Housing" project was listed as a $ 3.425 million obligation designed to fund the construction of single family housing projects for low and moderate income families. While Ramos and Barker were established developers, there is no evidence that they ever intended to construct this project.

79. The $ 2.075 million "Wasco Civic/Recreation Center" was also listed as a project the PFA was to finance. While the city had discussed the idea for years, it had no concrete plans to actually proceed. No site was ever selected and no center was ever constructed.

80. A listed $ 5.5 million "Shopping Commercial Development" was a catch-all for a series of projects. In the Preliminary Official Statement, $ 3 million was originally allocated for this project. When one of the other local projects withdrew, the City Manager assured the lawyer drafting the Official Statement that there were at least $ 5.5 million in commercial projects "in the formative stages with discussions ongoing ... [which] should proceed to construction within two-three years." In the end, the only project funded was the re-financing of a parking lot for $ 1.75 million.

81. The $ 4 million "Housing Authority Multi-family Housing Project" was purportedly for the construction of 100 units of low income housing. While the Official Statement stated that the Housing Authority "is in the process of taking the necessary steps to start construction," no approvals, sites, plans or matching funds had been obtained, and never were.

82. By including these and other projects in the Official Statement, the Wasco PFA created the materially misleading impression with investors that the bond proceeds would be used within three years. In fact, within three years of the offering, the Wasco PFA applied only about fifteen percent of the funds as it had represented in the Wasco PFA Official Statement.

83. Wasco PFA knew or recklessly disregarded the fact that the Official Statement contained material misrepresentations and omissions, and thereby committed or caused the violation of Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5.

84. Wasco PFA obtained money or property by means of material misstatements or omissions and engaged in a transaction, practice, or course of business which operated as a fraud or deceit upon the purchasers of its bonds so as to commit or cause the violation of Section 17(a)(2) and (3) of the Securities Act.

III.

The Commission deems it necessary and appropriate in the public interest and for the protection of investors that a public administrative hearing be conducted, pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, to determine if the allegations contained in this order instituting proceedings are true, to accord the Respondents an opportunity to establish defenses to such allegations, and to determine whether any order should be issued as to the Respondents pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act.

IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof, shall be convened not earlier than 30 days and not later than 60 days from service of this Order at a time and place to be fixed and before an Administrative Law Judge to be designated by further order as provided by Rule 200 of the Commission's Rule of Practice, 17 C.F.R. @ 201.200.

V.

IT IS HEREBY FURTHER ORDERED that the Respondents file an answer to the allegations contained in this order instituting public administrative proceedings within twenty days after service of this order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. @ 201.220. If the respondents fail to file an answer or fail to appear at a hearing after being duly notified, they may be deemed in default and the proceedings may be determined against them upon consideration of this order instituting public administrative proceedings, the allegations of which may be deemed to be true as provided by Rules 310 and 220 of the Commission's Rules of Practice, 17 C.F.R. @ 201.310 and 201.220.

This order shall be served upon the Respondents personally or by certified mail forthwith.

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision upon this matter, except as witness or counsel in proceedings held pursuant to notice. Because this proceeding is not "rule-making" within the meaning of Section 4(c) of the Administrative Procedure Act, it is not deemed to be subject to the provisions of that section delaying the effective date of any final Commission action.

By the Commission.

In the Matter of County of Nevada, City of Ione, Wasco Public Financing Authority, Virginia Horler, and William McKay, A.P File No. 3-9542, A.P. Rulings Release No. 567 (June 18, 1998).

On June 12, 1998, Respondent Virginia Horler filed a Motion for Leave to File Her Motion for Partial Summary Disposition together with a Motion for Partial Summary Disposition. In these pleadings, Respondent asserts that she is entitled to a judgment in her favor, as a matter of law, regarding one specific allegation in the Order Instituting Proceedings: that she violated the federal securities laws in connection with the inaccurate cost estimates contained in the Official Statement for the Nevada County bond offering at issue in these proceedings. Specifically, Respondent argues that there is "uncontroverted evidence" that disproves the "allegation that she was responsible for the [Official Statement's] purportedly inaccurate cost estimates" and "demonstrates that Respondent took reasonable and prudent steps necessary to uncover the alleged inaccuracy . . . ." Motion for Leave at 4.

In its response, the Division of Enforcement ("Division") argues that there is a factual dispute as to whether Respondent "should have known about the increase in estimated construction costs," which were not represented in the Official Statement. Division's Opposition to Virginia Horler's Motion for Leave to File Motion for Summary Disposition at 2. The Division cites as support for its proposition the same evidence cited

by Respondent in her pleadings: the testimony of James B. Cranmer, the cost engineer for the related project. The Division argues also that Respondent untimely filed her pleadings pursuant to Judge Bober's April 15, 1998, Supplemental Pretrial Order, which set an April 27 deadline for requests for dismissal (i.e. summary disposition).

The Comment to Rule 250 of the Securities and Exchange Commission's Rules of Practice states: "Where a genuine issue as to material facts clearly exists as to an issue, it would be inappropriate for a party to seek leave to file a motion for summary disposition or for a hearing officer to grant the motion." As there are material factual issues presently in dispute, it would be inappropriate to now consider a motion for summary disposition. In addition, I will not consider any further motions for summary disposition, pursuant to Judge Bober's established deadline. See Comment to Rule 250 ("The hearing officer is authorized to set schedules for the submission of summary disposition motions in order to prevent the use of such motions as a tactic for delay or as a means for needlessly increasing the costs of prehearing preparation. The hearing officer may deny or defer ruling on such a motion if it is not filed timely in light of the prehearing schedule.").

Accordingly, I ORDER that Respondent Virginia Horler's Motion for Leave to File Her Motion for Partial Summary Judgment is DENIED.

Brenda P. Murray
Chief Administrative Law Judge

In the Matter of County of Nevada, City of Ione, Wasco Public Financing Authority, Virginia Horler, and William McKay, A.P File No. 3-9542, Initial Decisions Release No. 153 (October 29, 1999).

COUNSEL: John S. Yun, Nancy E. Allin, and David Bayless for the Division of Enforcement, Securities and Exchange Commission

Richard J. Morvillo, Joseph I. Goldstein, Reed Brodsky, and Jeffrey F. Robertson for the Respondent Virginia Horler

INITIAL DECISION

BEFORE: Brenda P. Murray, Chief Administrative Law Judge

The Securities and Exchange Commission ("Commission") has accepted offers of settlement from four of the five Respondents named in the Order Instituting Proceedings ("OIP") that the Commission issued on February 2, 1998, pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"). n1

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n1 At a prehearing conference on July 17, 1998, I granted the Division of Enforcement's ("Division") Motion to Amend the OIP by withdrawing Paragraphs 39 through 44 and Paragraph 50 as to Respondent Horler. Orders at Prehearing Conference, July 20, 1998. The amendment eliminated two of the five allegations against Ms. Horler.

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On July 21 through July 24, 1998, I held a hearing as to Respondent Horler at three locations in California: in Sacramento, in Represa at Folsom State Prison, and in San Francisco. The Division of Enforcement ("Division") presented seven witnesses, including one expert, and offered sixty-two exhibits. Respondent Horler presented four witnesses, including one expert, and offered ninety-seven exhibits. n2

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n2 "(Tr.)" refers to the transcript of the hearing. I will refer to Division and Respondent exhibits as "(Div. Ex.)," and "(Resp. Ex.)," respectively.

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The voluminous posthearing filings included the Division's Proposed Findings of Fact and Conclusions of Law (fifty-eight pages), and Posthearing Brief (seventy-four pages) filed about September 23, 1998. Respondent Horler filed three documents: Proposed Findings of Fact and Conclusions of Law (ninety-one pages), Posthearing Brief (eighty-one pages), and Responses to the Division's Proposed Findings of Fact and Conclusions of Law (fifty-eight pages) about November 17, 1998. The Division filed its Posthearing Reply Brief (thirty-one pages) about December 1, 1998.

ISSUES

The first issue is whether Respondent violated or aided and abetted violations of Sections 17(a)(1), 17(a)(2), or 17(a)(3) of the Securities Act or Section 10(b) of the Exchange Act and Rule 10b-5 thereunder ("antifraud provisions") while acting as financial advisor responsible for preparing the official statement for a municipal bond offering by the County of Nevada, California. To decide this issue it is necessary to decide several subsidiary issues, including: (i) whether Ms. Horler was required by law to conduct a "due diligence" investigation prior to drafting the official statement; (ii) whether Ms. Horler did adequately investigate the representations contained in the official statement; (iii) whether the official statement contained material misrepresentations or omitted to state material facts; and (iv) whether Ms. Horler knew or should have known that the official statement contained the alleged material misrepresentations and omissions.

If I find that Ms. Horler committed the alleged violations of the antifraud provisions, the next issue is whether it is in the public interest to order her to cease and desist from violating or aiding and abetting violations of those provision.

THREE PRELIMINARY MATTERS

1. At the conclusion of the Division's case and again on brief, Respondent moved for involuntary dismissal of the allegations or for a directed verdict. Respondent argued first that the ruling in Johnson v. SEC, 87 F.3d 484 (D .C. Cir. 1996), bars the Commission from imposing a cease and desist order here because to do so would penalize Respondent for actions that occurred more than five years before the Commission initiated the proceeding. Respondent further argued that a financial advisor who drafts an official statement in connection with a municipal bond offering does not have the same disclosure obligations as the issuer or the underwriter. (Tr. 475-95; Respondent's Posthearing Brief at 33-37.)

I deny the motion. First, the holding in Johnson does not, as a matter of law, prohibit the Commission from seeking a cease and desist order against the Respondent. See Warren G. Trepp, 1999 WL 753922 (Sept. 24, 1999). Second, the extent of Ms. Horler's responsibilities depends on the facts surrounding this particular bond offering. It would therefore be premature to reach the legal conclusion that Respondent advocates without first making factual findings.

2. On December 11, 1998, Respondent Horler, pursuant to Rule 340 of the Commission's Rules of Practice, 17 C.F.R. @ 201.340, filed both a Motion for Leave to File Supplemental Response to the Division's Posthearing Reply Brief ("Motion"), and a Supplemental Response. Respondent maintains that this additional submission is necessary to provide "a comprehensive understanding of the facts upon which to render a decision in this proceeding" on the issue of "whether Ms. Horler intended to mislead the Nevada County Board of Supervisors when she told it that [the real estate developer] had secured enough financing to construct Phase 1 of the project." Motion at 2. On December 23, 1998, the Division responded with a Brief in Opposition. The Division argues that, among other things, (i) the Motion is an attempt by Respondent to recant critical testimony; (ii) neither good cause nor concerns of essential fairness support the Motion; and (iii) under the briefing schedule the Division had the right to rely on matters already in the record when it made its last filing. On January 5, 1999, Respondent filed a Reply to the Brief in Opposition.

I deny the Motion because the parties have already submitted briefs totaling almost 400 pages, and Respondent has failed to show good cause for allowing more.

3. On August 20, 1999, Respondent wrote to bring to my attention an order issued in SEC v. Dain Rauscher, Inc., No. 98-639 (C.D. Cal. Aug. 18, 1999). In that case, the defendant prepared official statements for six municipal bond offerings in 1993 and 1994. The Commission charged the defendant with failing to provide investors with material Information in the official statements, in violation of the antifraud provisions of the securities statutes, Municipal Securities Rulemaking Board Rule G-17, and Section 15B(c)(1) of the Exchange Act. On August 18, 1999, U.S. District Court Judge Gary L. Taylor granted defendant's motion for summary judgment based on his finding that:

The SEC has not shown the existing standard of care and competence in the industry was different from that suggested by [the defendant], and has not, therefore, shown [defendant's] conduct constituted a reckless or negligent departure from the norm.

Id. at 11. Respondent argues that the Dain Rauscher order buttresses her contentions that, in light of the evidence adduced at the hearing: (i) the official statement did not contain material misstatements because the information disclosed conformed to industry standards prevailing in December 1990; and (ii) Ms. Horler's conduct satisfied industry standards prevailing at the time she drafted the official statement.

Pursuant to Rule 340(b), 17 C.F.R. @ 201.340(b), I will consider the arguments made by Respondent in her cover letter of August 19, 1999; the Division's responsive letter of September 7, 1999; and Respondent's reply letter of September 9, 1999. Unlike the previous ruling where I refused to allow the filing of supplemental briefs, the arguments contained in the letters address something that occurred after the hearing concluded which the parties could not have addressed in their prior filings.

FINDINGS OF FACT

My findings and conclusions are based on the record and hearing the witnesses' testimony and observing their demeanor. I applied preponderance of the evidence as the applicable standard of proof. See Steadman v. SEC, 450 U.S. 91, 102 (1981). I have considered all proposed findings, conclusions, and contentions. I accept those that are consistent with this decision and I reject those that are not.

County of Nevada Special Tax Bonds, Series E-1990, Community Facilities District No. 1990-1 (Wildwood Estates)

Nevada County, California, extends from the Sacramento valley across the Sierra Nevada Range to the California-Nevada border. (Div. Ex. 1 at 12.) By the mid-1980s, two companies had tried and failed to develop a 286-acre parcel of land located in the county which became "Wildwood Estates." n3 The land had "reverted back to acreage," meaning that although there was a development map on record, a new plan had to be approved before development could occur. (Tr. 9, 92.) Due to unpaid taxes and special assessment fees on the land, the issue of title to the land was in the hands of the bankruptcy court. (Tr. 9.) G. Michael Montross, a real estate developer, became interested in developing Wildwood Estates in the late 1980s. (Tr. 9-10, 28.)

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n3 One unsuccessful developer was Boise Cascade which had successfully developed a gated residential community, Lake Wildwood, on adjacent land. Lake Wildwood was also the name of a man-made lake in the immediate area. (Div. Ex. 1 at 12; Tr. 9-11.)

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A California statute, the Mello-Roos Community Facilities Act of 1982 ("Mello-Roos"), provides a method of financing certain public capital facilities and services in the state. The statue authorizes the legislative bodies of local agencies to issue bonds for community facilities districts, and authorizes it to levy and collect a special tax within the district to repay the indebtedness. (Div. Ex. 1; Resp. Ex. 88.)

On February 13, 1990, the County's Board of Supervisors (the "County" or "Board") appointed the San Francisco investment banking firm Wulff, Hansen & Co. managing underwriter of a proposed Mello-Roos bond offering. (Resp. Ex. 9.) The offering was designed to finance the acquisition or construction of certain public improvements to Wildwood Estates. (Div. Ex. 1.) Mr. Montross's firm, Montross Barber Investments, Inc. ("Montross Barber") was to be the project developer. (Div. Ex. 1 at 12-13.) Also on February 13, 1990, the County retained Edwin Ness as bond counsel and Cranmer Engineering as "engineer of work." (Tr. 62; Div. Ex. 1 at ii.) Cranmer Engineering, the largest engineering firm in the county, would also serve as project engineer for Montross Barber. n4

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n4 In Nevada County, it was not unusual for an engineering firm to work for both the County and the project developer on the same project. (Tr. 62.)

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On March 20, 1990, pursuant to Mello-Roos, the County formed "Community Facilities District No. 1990-1 (Wildwood Estates)." (Div. Ex. 26.) On the same date, the County entered into an agreement with First California Capital Markets Group ("First California") to perform the same underwriting duties that Wulff, Hansen & Co, had agreed to perform. The switch occurred because Derrick Dumont, who had been with Wulff, Hansen & Co., transferred to First California and took the business with him. (Tr. 530-31, 634-36; Resp. Ex. 9E.) Selection of the underwriter was on a negotiated, as opposed to a competitive, basis. (Tr. 111-12.) In a competitive underwriting, the issuer selects the underwriter at the end of the process based on sealed bids that result from a public solicitation, whereas in a negotiated underwriting, the underwriter is selected at the beginning of the process for a variety of reasons and the underwriter works with the issuer throughout the process. (Robert Zipf, How Municipal Bonds Work, 198-200 (1995); Tr. 111-12.) In this offering, the underwriter's responsibilities included preparing a "report of due-diligence" and providing "the municipality with [a] securities offering statement." (Resp. Exs. 3, 9A; Tr. 636, 641.) The underwriter assumed liability for the accuracy and completeness of the offering statement. (Resp. Ex. 1 at SN 01259.)

Wildwood Estates was to be a gated private residential community in which the majority of lots offered panoramic views of Lake Wildwood and the Sierras. (Div. Ex. 1, 13.) The County accepted the developer's proposal to complete the improvements in three phases. The developer chose to phase the development because Mr. Montross was unable to raise the money to do the entire subdivision at one time. (Tr. 17.) For tax purposes, it was

important to the County that all three phases be completed within two years. (Tr. 167-69.) After hiring Ms. Horler and the company she worked for, Dain Rauscher, Inc. ("Rauscher") to act as the County's financial advisor (see below), the County entered into an Acquisition Agreement with Mr. Montross on July 24, 1990. The Acquisition Agreement specified that the County would pay for the improvements for each of the three phases, provided that each phase was fully completed and certified by the County engineer as being properly completed. (Resp. Ex. 9F.) Because the development involved both[*12] public and private facilities, it was necessary to raise funds from sources other than a Mello-Roos offering. (Tr. 177-79.) The proceeds of the Mello-Roos tax-exempt Series E bond offering would cover the construction cost of the public improvements such as underground electric lines, storm drainage facilities, sanitary sewer collection systems, and water distribution systems. (Resp. Ex. 19 at SN 00180; Tr. 30.) The proceeds of a related Series T-1990 bond offering, where interest on the bonds was subject to federal income tax, would be used to finance a portion of the private improvements such as roads. (Tr. 16, 29-30, 177-78.) The developer was to finance a portion of the improvements such as recreational facilities, drainage facilities, roads, and certain fees. (Div. Exs. 1, 13; Resp. Ex. 9F.)

The County had originally intended to make the offering in mid-July 1990. The first attempted offering failed to close, and further delay occurred because of a controversy as to the validity of a final bankruptcy court order awarding legal title to the land. n5 (Respondent's Pretrial Brief at 6 n.5.) The controversy concerned whether the judge who signed the order should have done so, it did not question the substance of the order. (Tr. 376.) Mr. Ness and Montross Barber wanted to proceed with the offering, but County Counsel James Curtis and Ms. Horler convinced the Board to wait until legal title was resolved. (Tr. 377-82; Resp. Exs. 51, 53, 55, 57.) On November 5, 1990, the bankruptcy court confirmed that Wildwood Estates, Inc., a California corporation, was and had been owner of the land since January 1990. (Div. Ex. 76.) Mr. Montross acquired the land on December 14, 1989, and he transferred title to Wildwood Estates, Inc. in January 1990. (Tr. 86; Div. Ex. 25 at FCB 00703.)

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n5 Ms. Horler testified that August 21, 1990, was the anticipated preliminary closing date, but there were not enough buyers at the interest rates offered and, in addition, an issue arose as to title to the property. (Tr. 135.)

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On December 21, 1990, the County closed the $ 9.07 million Series E bond offering. n6 (Div. Ex. 83 at RPR 00930.) The offering was "not rated" which indicates both a much higher risk to the investor than a rated offering, and a corresponding higher rate of interest. (Tr. 547.)

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n6 A proposed schedule on Rauscher letterhead shows December 21, 1990 as the closing date. (Div. Ex. 83 at RPR 00930.) The official statement cover page bears two dates: December 17, 1990 and December 20, 1990. (Div. Ex. 1.)

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Respondent Horler

Virginia L. Horler worked for the City of Richmond, California, for twelve years. During this time, she attended St. Mary's College of California in the evening. She earned a bachelors degree from St. Mary's in 1982 and an MBA, with honors, in 1984. (Tr. 98, 505; Div. Ex. 39.)

In 1983, Ms. Horler left her position as a budget analyst with the City of Richmond and joined Rauscher, a registered broker-dealer and one of the largest regional investment banking firms based outside of New York. n7 (Tr. 99; Div. Ex. 39.) In 1989, Ms. Horler was appointed a senior vice president and managing director in Rauscher's Public Finance Department, a division of the Fixed Income Department. (Tr. 100-02.) In this capacity, Ms. Horler was the project manager or the person with full responsibility for Rauscher's involvement with various public financing projects. (Tr. 100-02.) Ms. Horler served on Rauscher's Fixed Income Commitment Committee which recommended whether or not the firm should undertake project underwritings. (Tr. 604.)

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n7 When Ms. Horler joined the firm it was registered as Rauscher Pierce Refsnes, Inc. (Div. Ex. 39; Resp. Ex. 17.)

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Ms. Horler is an expert in the field of public finance and in Mello-Roos bond offerings. (Tr. 606-07.) She authored Guide to Public Debt Financing in California in 1982 (revised 1987), which is used extensively by lay persons working in the area, and she has participated in many educational programs related to financing public debt. (Div. Ex. 12; Resp. Ex. 87; Tr. 299-30, 504-09, 640.) Ms. Horler earned Series 7 (General Securities Representative) and Series 63 (Uniform Securities State Law Examination) licenses granted by the National Association of Securities Dealers ("NASD") early in her career. She earned a Series 53 license (Municipal Securities Principal) after 1990. (Tr. 102-03.) In her fifteen-year career with Rauscher, Ms. Horler was involved as an underwriter or financial advisor in about 135 municipal finance transactions which raised over $ 4 billion. (Tr. 498.) In most instances, she acted as underwriter, and about one-third of her time was spent as financial advisor. Her clients were cities, counties, and special districts, and the types of public financings ranged from general obligation bonds to leased securities -- the entire gamut of transactions that local agencies in California could issue. (Tr. 499.) Ms. Horler was one of the public finance professionals whom the California Debt Advisory Commission, the state's clearinghouse for public debt issuance

information, thanked for their contributions to the guidelines which the Commission published in 1996. See Disclosure Guidelines for Land-Based Securities, California Debt Advisory Commission, (Sept. 12, 1996) ("Disclosure Guidelines"). Ms. Horler is a Certified California Municipal Treasurer, a certification conferred by the California Municipal Treasurers Association.

In early May 1990, Linda Wheeler, an administrative assistant in the County Counsel's office, alerted Ms. Horler to the upcoming Wildwood Estates bond offering. (Tr. 108, 517-18.) Ms. Horler submitted a proposal to the County on behalf of Rauscher on May 14, 1990, describing the many services Rauscher offered. Later, Ms. Horler learned from Ms. Wheeler that the County only wanted Rauscher to give it financial advice or serve as a "pricing consultant" because the Board had already adopted the special tax formula and the notice of intention to proceed, and it intended to sell the bonds in the middle of July. (Tr. 116.) Mr. Ness confirmed that when Ms. Horler became involved in May-June of 1990 the project had been under consideration for almost two years, and that Mr. Curtis, Mr. Montross, and Mr. Cranmer of Cranmer Engineering, had already done most of the work. (Tr. 634-35, 642-48.) The project was quite far along: the Board had held a public meeting and had already determined a special tax formula; Mr. Ness had filed a "validation proceeding," and he expected the County to sell the bonds in a relatively short time. (Tr. 525-26.) Based on this information, Ms. Horler noted on the Rauscher proposal, "Proposed [not to exceed] $ 10,000 including expenses, 5/15/90." (Tr. 116; Div. Exs. 5 at 135, 39 at date stamp 657.)

Where the issuer selected the underwriter on a negotiated basis, it was customary for the underwriter to prepare the official statement for the issuer, and Ms. Wheeler informed Ms. Horler that First California would prepare the official statement for this offering. (Div. Ex. 5, 135; Tr. 113, 117; see also Final Rule on Municipal Securities Disclosure 43 SEC Docket 2245, 2249 (July 10, 1989) ("Final Rule").) Ms. Horler knew the County wanted to hire a financial advisor who would prepare the official statement to give it "a comfort level with the project and the bond issue." (Resp. Ex. 5D, page stamp FCB 02696; Tr. 342.) There is conflicting testimony as to why the County delegated responsibility for preparing the official statement to a financial advisor rather than using the underwriter. According to Mr. Curtis, due to the fact that Mr. Montross had recommended the underwriter, the County was aware of a possible conflict of interest and wanted an independent entity to prepare the official statement. (Resp. Ex. 5D, page stamp FCB 02696; Tr. 342.) Ms. Horler testified, however, that the County hired Rauscher to prepare the official statement because the underwriter lacked the staffing capabilities to produce the official statement in a fairly short time. (Tr. 121-22.)

Ms. Horler testified further that she offered to prepare the official statement for the County when she learned the underwriter had done no work towards preparing it, and she knew the County was preparing to go forward with pricing the bonds. (Tr. 117.) Ms. Horler represented that Rauscher had the expertise and staff required to prepare the official statement because the firm customarily drafted official statements when it acted as a financial advisor in competitive bid underwritings. (Tr. 113, 117-18.) Within a week of submitting the proposal to act as financial advisor for $ 10,000, Ms. Horler noted on

the Rauscher proposal, "5/21/90 Proposed $ 30,000 [plus] out-of-pocket expenses includes preparation of [the official statement]." (Div. Ex. 39; Tr. 122.)

On July 2, 1990, Ms. Horler, acting for Rauscher, signed a "Contract Employing Financial Advisor" ("Contract") with the County for $ 30,000, plus reimbursable expenses, payable by the County on receipt of bond proceeds. (Div. Ex. 56; Resp. Ex. 36.) The Contract provided that Rauscher would, among other things:

1. Review and analyze all data and information which have a bearing on program to finance the County's community facilities district, including but not limited to . . . cash flow requirements during the design and construction periods . . . coverage ratios and debt capacity . . . .

2. Confer and consult with County staff and elected officials, architects and contractors, property owners, bond counsel and the underwriter, as needed, to assist the County in developing a financing plan that meets the County's specific needs for funds and the property owner's ability and willingness to pay.

8. Prepare the preliminary and final official statements describing the County's financing program, the bonds, security for payment of the bonds, and the economic and financial background of the property owners in accordance with the disclosure required by Securities and Exchange Commission Rule 15c2-12.

10. Coordinate printing and mailing of the preliminary and final official statement to investors.

(Div. Ex. 56, Resp. Ex. 36.)

Ms. Horler was Rauscher's representative on the project. In this capacity, she supervised Robin J. Rappaport who had been with the firm for two or three years and had earned an MBA from the University of California at Berkeley. (Tr. 524-25.)

Ms. Horler considered Rauscher's position as financial advisor and drafter of the official statement a unique, "hybrid" transaction for the firm. (Tr. 153, 501, 509-10, 526.) Customarily, Rauscher's financial advisory services in a negotiated offering included the selection of underwriters, definition of financial structure, credit review process, document review sessions, pricing and sale of bonds, preparation of pre and post pricing books, and closing of financing. (Div. Ex. 36; Resp. Ex. 17 at RPR 00631.) In this negotiated transaction, however, the County had selected the underwriter prior to Rauscher's involvement with the project. (Tr. 526.) Rauscher submitted an invoice to the County on December 31, 1990 for $ 31,749.55 which the County paid. (Div. Ex. 92; Tr. 176.)

Ms. Horler believes that she worked very hard on the offering. n8 According to Respondent's expert, Ms. Horler: advised the County regarding the offering's financial structure; she evaluated the size, timing, and pricing of the offering; she prepared a pre-

pricing book containing interest rates on comparable offerings and descriptions of the municipal bond market at time of the sale; she verified the developer's loan commitment; she encouraged the use of specific language in the Acquisition Agreement; and she assisted in preparation of the official statement in accordance with Commission Rule 15c2-12. (Resp. Ex. 88 at 4-5.) With respect to her role in preparing the official statement, Ms. Horler's position is contradictory. On the one hand, she viewed her role as a passive reviewer of information gathered by others; on the other hand, she claims she checked the accuracy of some, but not all, of the information in the official statement. (Tr. 152.)

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n8 In referring to Ms. Horler's efforts, I included work that Ms. Rappaport performed at Ms. Horler's direction, unless otherwise indicated.

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On direct examination, Ms. Horler described her role in drafting the official statement:

Q: Can you describe the nature of your responsibilities as you saw them?

A: Yes. It was to carefully review all of the information that I received, compare it with documents that I had read, and look for any inconsistencies in the documents, to continually inquire of others that had more expertise in areas I did not have, and to be sure that there was nothing that had come to my attention that was not adequately and correctly and completely disclosed in the document.

Q: [You had agreed to] "prepare an official statement, describing among other things the economic and financial background of the property owner." What, if anything, did you do to discharge that obligation?

A: Yes. When we were first hired, and began to prepare the official statement, we asked all parties to submit information to be included in the document. With our request for that information, we made sure that the various parties understood that whatever they gave to us was going to be included in the offering document that was part of a securities offering to investors. . . . We stressed that it must be accurate and complete.

Q: Did you understand that you were required . . . to investigate and look behind the assets and experience of the developer?

A: Only if something came to my attention that showed me that what he provided me was untrue, or was inconsistent with what I was learning about the project.

I think it's important to reflect here for a minute that I was coming on this financing team as the last party. So when I talked to people like Ed Ness, and Jim Cranmer, and the County itself, they all had had a much longer knowledge and background with this

developer. I was looking to hear if there was anything that anybody could tell me, or any factual basis that would tell me that what [Mr. Montross] provided us for the official statement was not correct. I never did receive anything that showed me it was not.

(Tr. 530, 542-43.) Ms. Horler circulated several drafts of the preliminary and final official statement and she made phone calls gathering or checking information. (Tr. 511-12, 561-67; Resp. Exs. 29, 30, 37, 40.)

On cross-examination, Ms. Horler explained that:

A: I did check the accuracy on many of the statements in the official statements.

Q: [With respect to] the property ownership, and the developer, I thought you acknowledged that you didn't go behind what the developer told you. So you didn't independently check that information, right?

A: [That] is correct, I did not investigate. Other matters I did.

(Tr. 140, 152.)

Although Ms. Horler testified that she believed she had a duty to investigate any "red flags" that indicated the information she had was not accurate, it is evidence that she did not adequately investigate any of the matters underlying the alleged material misrepresentations and omissions, and she was aware that other professionals involved in the offering had not done so. (Tr. 152, 509-10.)

Mr. Ness submitted a 10b-5 opinion letter to Ms. Horler which stated that:

Based upon our participation in the preparation of the Official Statement and without having undertaken to determine independently the accuracy or completeness of the statements in the Official Statement, we have no reason to believe that, as of the date of Closing, the Official Statement . . . contains any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements made therein, in the light of the circumstances under which they were made, not misleading.

(Resp. Ex. 77.)

Prior to her involvement in the offering, Ms. Horler had not heard of Mr. Montross or Montross Barber. (Tr. 142-43.) At the request of the County's Director of Finance, Ms. Wheeler asked Ms. Horler to look into the developer's financial background, and Ms. Horler agreed to see that an investigation was completed. (Tr. 257-58, 520.) Yet, Ms. Horler did not investigate the finances of either Mr. Montross or the firm, and she did not verify any of the financial information Mr. Montross provided. (Tr. 147-48, 155.)

Ms. Horler retired from Rauscher on February 28, 1998. (Tr. 97.) She does not intend to return to the business of investment banking-public finance. (Tr. 602.)

G. Michael Montross and Montross Barber Investments, Inc.

In 1990, Mr. Montross was president and 60% owner of Montross Barber. (Tr. 213, 413.) Mr. Montross and George A. Barber, a 30% owner, formed the firm in 1981. (Tr. 213, 215; Resp. Ex. 5B.) Mr. Barber met Mr. Montross when they both worked at the National Science Foundation in 1971. (Tr. 215.) Mr. Montross represented to First Commercial Bank that he had held high level positions with several government agencies. (Resp. Ex. 5.) In 1966, Mr. Barber earned a degree in economics from Northeastern University and went on to become a budget analyst with agencies of the federal government for twelve years. Mr. Barber moved to California in 1978 to go into business with Mr. Montross. (Tr. 215.)

Montross Barber's business consisted of syndicating and managing private placement partnership interests in residential real estate, mainly in the area of Sacramento, California. (Tr. 216, 232-33.) The firm did very well in the early 1980s when it earned a 20% return for investors. (Tr. 232.) The Tax Reform Act of 1986, however, eliminated many of the tax benefits that had made real estate an attractive investment and drastically changed the kind of real estate that investors found attractive. (Tr. 232-33.) The firm began forming limited partnerships for land subdivisions in the late 1980s but only managed to completely sell one of several projects. (Tr. 222-24.) By 1989-90 most of the firm's limited partnership residential properties, which had been organized with slight negative cash flows, had used up their contingency reserves. (Tr. 229-30.) At the beginning of 1990, the firm employed about twenty-five people at its main office in San Mateo, California, which handled accounting and investments, and 100 to 200 people at a second office that managed the properties. (Tr. 233-34.)

Mr. Montross originally purchased the land for Wildwood Estates in his own name on December 14, 1989, for approximately $ 2.2 million. (Div. Ex. 25.) The price included a $ 793,000 delinquent tax assessment for 1980-81 and all subsequent years up to 1989-90. (Resp. Ex. 5D.) In January 1990, Mr. Montross transferred title to Wildwood Estates, Inc., a corporation he had formed. (Tr. 28-29; Resp. Exs. 19, 89A.) Wildwood Estates, Inc. was a shell corporation whose only asset was the land known as Wildwood Estates. (Tr. 475.) Mr. Montross was the sole shareholder and the only officer of the corporation. Mr. Montross raised close to $ 3 million from four limited partnerships to invest in Wildwood Estates. (Tr. 226.)

In 1995, Mr. Barber pled guilty to seventeen counts of state securities fraud for not disclosing Montross Barber's financial difficulties to investors in 1990. (Tr. 236; Resp. Ex. 85.) He was sentenced to six years in prison. In July 1998, he was within a month of completing his sentence at Folsom State Prison. (Tr. 236-37.) Mr. Barber testified under use immunity which prohibited him from exerting any Fifth Amendment privilege. (Tr. 212.) Respondent objects to Mr. Barber's testimony on the grounds that it is both irrelevant and lacking in credibility because Mr. Barber is a convicted felon.

(Respondent's Responses to the Division's Proposed Findings of Fact and Conclusions of Law at 3.) I disagree. The financial condition of Montross Barber in 1990 is relevant and I observed the witness's demeanor and found him to be credible. See Universal Camera v. N.L.R.B., 340 U.S. 474, 496 (1951); Howard v. Heckler, 782 F.2d 1484, 1487 (9th Cir. 1986); Anthony Tricarico, 51 S.E.C. 457, 460 (1993).

The testimony of Mr. Barber calls into question the favorable financial information that Mr. Montross supplied to First Commercial Bank which the bank relied on to support loans of $ 200,000 to Montross Barber on December 5, 1989; $ 1.14 million to Wildwood Estates, Inc. on March 8, 1990; $ 5.35 million to Wildwood Estates, Inc. on July 25, 1990; and $ 125,000 to Wildwood Estates, Inc. on November 30, 1990. (Resp. Exs. 5B, 5C, 5D, 5E.) The 1989 bank credit report represented that by 1989 Montross Barber had formed over 100 real estate partnerships with a portfolio value of over $ 200 million, and that Montross Barber's growth rate over the three previous fiscal years had been 13% with slightly higher annual profit increases of 14.5%. (Resp. Ex. 5B at 2-3.) In the normal course of business, the bank verified information supplied by the borrower by reference to independent sources. However, there is no evidence that the bank did so before making these Wildwood Estate loans. (Tr. 412, 415-17.) The bank credit report noted that Montross Barber's status as the general partner on some projects carried with it indirect liabilities. n9 (Resp. Ex. 5B at stamp FCB 01012; Tr. 410-11.) Although Mr. Montross personally guaranteed these loans, his personal guaranty is suspect because the 1989 bank credit report indicated that his "substantial personal real estate holdings . . . are of the same kind and nature as those of the firm." (Resp. Ex. 5B at FCB 01015.)

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n9 The indirect liability reference was to the fact that Montross Barber, Mr. Montross, and Mr. Barber were general partners in certain of the projects they developed and these projects had certain financial obligations for which all three had a potential financial responsibility because of their general partner status. (Resp. Ex. 5B.)

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Mr. Barber's testimony that in 1990 Montross Barber's financial situation was "extremely strapped" is unrefuted. (Tr. 229-30.) In 1990, the firm did not pay taxes on some properties and it avoided foreclosure by filing for bankruptcy protection. (Tr. 231.) In the last half of 1990, it became "very, very difficult" for the firm to acquire additional investment funds. (Tr. 232.) The firm was in "very bad straits" which were complicated by an agent who started a snowball effect by making disparaging remarks about the firm to investors. (Tr. 232.) Things got "very bad" for the firm. In some instances it defaulted on rent payments, and Mr. Montross and Mr. Barber did not get paid on occasion. (Tr. 232-33.) The firm was sold in July 1991.

In November 1997, Mr. Montross was indicted on federal charges of bankruptcy fraud and money laundering. n10 (Division's Prehearing Brief at 15.) In December 1997, Mr. Montross was convicted following a jury trial on over seventy counts of violating California state securities laws. (Division's Prehearing Brief at 15; Respondent's Pretrial

Brief at 5.) At the time of the hearing, Mr. Montross was incarcerated in a correctional facility in California. (Respondent's Pretrial Brief at 5.)

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n10 I did not see the status of this proceeding in my perusal of the record.

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LEGAL ARGUMENTS ON THE MERITS

The Division of Enforcement

The Division alleges that Ms. Horler failed to satisfy her obligation to prepare a complete and accurate offering statement. The Division further alleges that Ms. Horler violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder because the offering's official statement dated December 17, 1990, which was circulated to investors, contained material misstatements and omissions.

Specifically, the Division charges that:

1. Ms. Horler knew but failed to disclose in the official statement that the developer could not receive any of the Mello-Roos bond proceeds until all of the public and private improvements for each phase of the project had been completed, and she knew but did not disclose that the developer's loan commitment was inadequate to complete Phase I.

2. Ms. Horler knew or was reckless in not knowing that Wildwood Estates, Inc. held title to the land, and she erroneously represented in the official statement that Mr. Montross owned the land to be developed.

3. Ms. Horler was reckless in not investigating the developer's background and finances, and in the official statement she created a misleading impression that Mr. Montross and Montross Barber were experienced in creating successful real estate subdivisions and possessed sufficient skills and financial resources to complete the Wildwood Estates project. (Tr. 481; Division's Posthearing Brief at 50-66, 68; Division's Reply Brief at 3-20.)

The Division also charges that Ms. Horler was reckless in that she: (i) ignored red flags about Mr. Montross's representations concerning himself and Montross Barber; and (ii) assumed that the lending bank had done a thorough due diligence inquiry into Montross Barber's and Mr. Montross's finances which she could reasonably rely on. According to the Division, an investigation could have revealed adverse information about Mr. Montross and Montross Barber. (Division's Posthearing Brief at 62-67.)

The Division rejects Respondent's claim that she had no legal duty to ensure that the official statement was accurate and complete because: (i) she did not offer or sell the

bonds, and (ii) her obligation as a financial advisor was only to the County. (Division's Reply Brief at 20-27.) The Division argues that the securities statutes impose an "overlapping," rather than a "divisible," duty to ensure the accuracy. (Division's Posthearing Brief at 3.) The Division notes that Sections 17(a) and 10(b), and Rule 10b-5 impose liability on persons who "directly or indirectly" engage in certain deceptive conduct. (Division's Reply Brief at 22.) Thus, "every offering participant who directly or indirectly makes an expressed or implied representation to investors is jointly and severally liable for his or her misstatements or omissions." (Division's Posthearing Brief at 3; Division's Reply Brief at 22 (citing Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994)) (Division's emphasis).)

The Division maintains that the case law supports the proposition that, in addition to the issuer, professionals may be held primarily liable for violations of the antifraud provisions, even where they did not actually sell or offer shares. (Division's Posthearing Brief at 49. See Kline v. First W. Gov't Sec., Inc., 24 F.3d 480, 486-87 (3d Cir. 1994) (attorney drafters of opinion letter held liable); Eisenberg v. Gagnon, 766 F.2d 770, 776-77 (3d Cir. 1985) (auditor drafters of financial statements); Employers Ins. of Wausau v. Musick, Peeler & Garrett, 871 F. Supp. 381, 389-90 (S.D. Cal. 1994) (attorney and auditor drafters of registration statement and prospectus), amended in part, 948 F. Supp. 942 (S.D. Cal. 1995). See also In re Software Toolworks Inc. Sec. Litig., 50 F.3d 615, 626-29 (9th Cir. 1994) (underwriter and auditor liability for participating in group that drafted misleading response letter to Commission); In the Matter of Peacock, Hilsop, Staley & Given, Inc., 1996 SEC LEXIS 2812 (Settlement Order, Oct. 2, 1996) (financial advisor in municipal bond offering liable for misstatements in official statement).)

In the alternative, the Division charges that Ms. Horler aided and abetted the County's violations of these antifraud provisions by taking on a duty of the issuer and not performing that duty. (Division's Posthearing Brief at 3, 69-71.) The Division alleges that Ms. Horler failed to keep her commitment to the County to determine the developer's ability to pay, and "worse yet, misled Nevada County about the sufficiency of a construction loan commitment to finance Phase 1 of the Wildwood Estates Project." (Division's Posthearing Brief at 3, 69-71.)

In my third ruling under Preliminary Matters, I noted Judge Taylor's recent ruling in Dain Rauscher that a securities professional who prepared official statements for municipal bond offerings had not violated the antifraud provisions where he satisfied industry standards for disclosure. The Division, as could be expected, disagrees with that ruling and argues that, even if the order is correct, it does not support Respondent's position because Ms. Horler's conduct was reckless and "was not consistent with industry practice." (Division's Letter of Sept. 7, 1999.)

Respondent Horler

Respondent maintains that she did not violate or cause a violation of the antifraud provisions because: (i) she did not have a legal duty that could give rise to liability as a primary violator; (ii) the Division has not shown any omission or misrepresentation for

which she might be liable; and (iii) she did not act with scienter, and her actions were entirely reasonable under the circumstances. (Respondent's Posthearing Brief at 37-71.) Respondent urges rejection of the allegations on the grounds that the Division's theory of liability has no basis in law. The underwriter, not the financial advisor, was responsible for "due diligence" both as a matter of law and by contract. n11 (Respondent's Posthearing Brief at 2.) Respondent argues that the "overlapping" disclosure duty presumed by the Division does not arise simply from drafting the official statement. According to Respondent, "As various courts have recognized, participation in the preparation of an offering document, without more, does not subject one to liability for disclosure inaccuracies in that document," (Respondent's Posthearing Brief at 38.)

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n11 Respondent's expert, Timothy J. Schaefer, opined that Ms. Horler acted appropriately in drafting the official statement based on data she compiled from various sources without making a thorough, direct check for accuracy because the underwriter had contracted to perform the due diligence investigation. (Tr. 689-90.) According to Mr. Schaefer:

Financial advisors who prepare disclosure documents in negotiated municipal bond offerings have no professional obligation to investigate, or perform due diligence regarding, information provided to them in land-secured offerings, absent any "red flags" concerning the information they received.

(Resp. Ex. 88 at 10; Tr. 632.)

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Respondent maintains that to be liable for misstatements or omissions in an offering statement, a person must have a disclosure duty that arises from being a seller or from "some other relationship of trust and confidence with the investors upon which they relied." (Respondent's Posthearing Brief at 38.) Respondent contends Ms. Horler had no such duty because: (i) she did not offer or sell securities; and (ii) under the Contract her duties and responsibilities ran only to her client, the County. (Respondent's Posthearing Brief at 39-51.) Respondent cites Pinter v. Dahl, 486 U.S. 622, 650 (1988), as support for the first proposition, and contends that the language from Central Bank that the Division relies on is inapplicable because it assumes the existence of all the requirements for primary liability. (Respondent's Posthearing Brief at 39, 40 n.35.)

On the second proposition, Respondent insists that the record is devoid of evidence that her duties as a financial advisor ran to anyone other than her client. (Respondent's Posthearing Brief at 50.) Respondent contends that courts are reticent to hold accountants, attorneys, and other professionals liable as primary violators of the antifraud provisions when they simply draft securities documents, but do not provide certifications or opinions upon which investors could rely. (Respondent's Posthearing Brief at 50.) Ms. Horler argues that she did not make representations to investors or otherwise create a

relationship with investors by preparing the official statement for the issuer.
(Respondent's Posthearing Brief at 50-51.)

Respondent further contends that, even assuming that the official statement contained material misrepresentations or omissions, she did not violate the antifraud provisions because there is no showing that she acted negligently or with scienter. She argues, rather, that the substantial evidence is that her actions were all taken in good faith without any hint of intent to deceive. (Respondent's Posthearing Brief at 61-76.)

Finally, Respondent contends that the Dain Rauscher order supports her position that there were no material misstatements in the official statement because, in part, the disclosure was in accord with industry standards at the time. (Respondent's Letter of Aug. 19, 1999.) Ms. Horler also relies on the Dain Rauscher order to support her position that her conduct was neither reckless nor negligent, and that she was entitled to rely on bond counsel's 10b-5 opinion letter. (Respondent's Letter of Aug. 19, 1999.)

CONCLUSIONS OF LAW

The bonds at issue are municipal securities under Section 3(a)(29) of the Exchange Act. Except for the antifraud provisions, the provisions of the Securities Act and the Exchange Act, such as registration and reporting requirements, do not apply to municipal securities. This peculiarity in the federal regulation of the securities markets is attributed to the following factors that existed in 1933-34: (i) the market in municipal securities was considered to be relatively free of abusive practices that required legislative attention; (ii) the municipal markets were dominated by institutional investors who were not perceived as needing the same protections as individual investors; and (iii) the market for most municipal securities largely was confined to limited geographic regions so that, arguably, investors were aware of factors affecting the issuer and its securities. (Proposed Rule on Municipal Securities Disclosure, 41 SEC Docket 1402, 1403 (Sept. 28,1988) ("Proposed Rule");
Disclosure Guidelines, at 6.

In response to changing conditions, in 1975 Congress enacted legislation that created the Municipal Securities Rulemaking Board and a self-regulatory scheme to prevent abuses in the municipal securities markets. See Proposed Rule. The Commission adopted Rule 15c2-12 in 1989, in part pursuant to authority given by Section 15(c) of the Exchange Act to adopt rules and regulations "reasonably designed to prevent [] such acts and practices as are fraudulent, deceptive, or manipulative." See Final Rule, 43 SEC Docket at 2246. In comments adopting the Final Rule the Commission noted that:

The Rule is intended to assist the underwriter in satisfying its responsibilities under the antifraud provisions of the federal securities laws. As emphasized in the Interpretation, by participating in an offering, an underwriter makes an implied recommendation about the securities. This recommendation implies that the underwriter has a reasonable basis for belief in truthfulness and completeness of the key representations contained in the official statement.

Final Rule, 43 SEC Docket at 2249.

Elements of Antifraud Violations

Section 17(a) of the Securities Act is a comprehensive prohibition against using the mails or the instruments of interstate commerce to perpetrate fraud in the offer or sale of securities. Section 17(a)(1) makes it unlawful "to employ any device, scheme, or artifice to defraud." Section 17(a)(2) prohibits the use of false statements or omissions of material fact to obtain money or property. Section 17(a)(3) forbids any person from engaging "in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon" a purchaser of securities. Section 10(b) of the Exchange Act and Rule 10b-5 thereunder make it unlawful for any person, directly or indirectly, in connection with the purchase or sale of a security, to make an untrue statement of material fact; omit to state a material fact; use any device, scheme or artifice to defraud; or engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person. The antifraud provisions are catchalls expressly designed to thwart misrepresentations in securities trading. See Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 859 (2d Cir. 1968) (en banc); SEC v. Softpoint, Inc., 958 F. Supp. 846, 861 (S.D.N.Y. 1997), aff'd, 159 F.3d 1348 (2d Cir. 1998) (unpublished table decision). They are thus liberally construed to embrace a wide range of misconduct. Softpoint, 958 F. Supp. at 862.

Scienter, which has been defined as "a mental state embracing intent to deceive, manipulate, or defraud," is required to establish a violation of Section 17(a)(1), Section 10(b) and Rule 10b-5, but scienter is not required to establish a violation of Section 17(a)(2) or 17(a)(3). Aaron v. SEC, 44 6 U.S. 680, 697, 701-02 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976). Scienter is established by showing that the respondent acted intentionally or with severe recklessness. Hackbart v. Holmes, 675 F.2d 1114, 1117 (10th Cir. 1982). Recklessness is defined as "an extreme departure from the standards of ordinary care . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." Meyer Blinder, 50 S.E.C. 1215, 1229-30 (1992) (quoting Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977)). For purposes of Sections 17(a)(1) and 10(b) and Rule 10b-5, proof of scienter need not be direct but may be "a matter of inference from circumstantial evidence." Herman & MacLean v. Huddleston, 459 U.S. 375, 390 n.30 (1983); Pagel, Inc. v. SEC, 803 F.2d 942, 946 (8th Cir. 1986); Meyer Blinder, 50 S.E.C. at 1230.

Courts have interpreted broadly the requirement of Section 10(b) and Rule 10b-5 that violative conduct must occur "in connection with" the purchase or sale of a security." Superintendent of Ins. of N.Y. v. Bankers Life and Cas. Co., 404 U.S. 6, 12 (1971); In re Ames Dep't Stores Inc. Stock Litig., 991 F.2d 953, 964-66 (2d Cir. 1993). In general, "fraud can be committed by any means of disseminating false information into the market on which a reasonable investor would rely." Ames Dep't Stores, 991 F.2d at 967; SEC v. Hasho, 784 F. Supp. 1059, 1106 (S.D.N.Y. 1992).

Finally, the jurisdictional requirements of the antifraud provisions are interpreted broadly, and are satisfied by intrastate telephone calls and even the most ancillary mailings. Softpoint, 958 F. Supp. at 865.

Applicability of the Antifraud Provisions to Ms. Horler

1. The "Offer or Sale" Requirement.

Ms. Horler contends that she cannot have violated the antifraud provisions because she neither offered nor sold the Mello-Roos bonds. In support of that position she cites the U.S. Supreme Court's decision in Pinter. The issues in that case were unrelated to the issues to be decided here. The issues in Pinter were:

“Whether the common-law in pari delicto defense is available in a private action under @ 12(1) of the Securities Act . . . for the rescission of the sale of unregistered securities, and (b) whether one must intend to confer a benefit on himself or on a third party in order to qualify as a 'seller' within the meaning of @ 12(1)."

Pinter, 486 U.S. at 624-25. With regard to the second issue, the Pinter Court held that civil liability under Section 12(1) of the Securities Act was limited to sellers of a security or to nonowners who solicit the purchase of a security with the intention of serving either their own financial interests or those of the owner. Pinter, at 642-55. By contrast, the broader "offer or sale" requirement of Securities Act Section 17(a) extends to "any person in the offer or sale of any securities . . . [who] directly or indirectly" commits one of the proscribed acts. (Emphasis added.) The "directly or indirectly" language, which is not included in Section 12(1), is also found in Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Furthermore, the Supreme Court has recognized that "any person or entity . . . who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met." Central Bank, 511 U.S. at 191. I therefore conclude that one does not have to be either an issuer or an underwriter to be held liable for committing fraudulent activities in the offer or sale of securities.

Ms. Horler played a key role in accomplishing the offer and sale of these securities. Her testimony is replete with references to being part of the "key financing team," along with County officials, bond counsel, the underwriter, the developer and the engineer, that achieved the successful offering. (Tr. 656.) Moreover, Rauscher's Contract with the County, which Ms. Horler negotiated, specified that Rauscher would provide services that were essential to the offering. In addition to preparing the official statement, the Contract obligated Rauscher to "coordinate printing and mailing of the preliminary and final official statement to investors" (Div. Ex. 56; Resp. Ex. 36; Tr. 122.) Ms. Horler claims that Rauscher did not offer or sell the bonds because, among other things, it was not obligated to actually do the mailing. (Tr. 122-23.) I disagree. It is not necessary that Rauscher processed the mailing. The determining fact is that Rauscher not only prepared

the official statement, it also fulfilled its contractual obligation to accomplish the mailing by coordinating the efforts of the various service providers needed to do so.

2. The "In Connection With" Requirement.

As noted above, long-standing case law endorses a flexible, not technical and restrictive, interpretation of conduct that comes within the meaning of "in connection with the purchase or sale of any security" as that phrase is used in Section 10(b) and Rule 10b-5. Superintendent of Ins. of N.Y., 404 U.S. at 12. I find that Ms. Horler's conduct, as described herein, satisfies the nexus requirement of Section 10(b) and Rule 10b-5.

3. Legal Duty to Disclose.

I reject Respondent's position that the antifraud provisions of the securities statutes do not apply directly to Ms. Horler because: (i) she was not the underwriter; (ii) her duty of disclosure ran only to the County, her client; and (iii) she did not otherwise assume a disclosure duty to any one else, least of all the investing public. (Respondent's Posthearing Brief at 41-51.) I find that Ms. Horler did have a duty of disclosure to the investing public for the following reasons.

Rule 15c2-12 was in effect when the County of Nevada official statement was issued in December 1990. Rule 15c2-12 requires underwriters participating in primary offerings of municipal securities of $ 1 million or more to obtain, review, and distribute to investors copies of the issuer's disclosure documents. n12 Respondent acknowledges that to prepare an official statement "in accordance with the disclosure" required by Rule 15c2-12, Ms. Horler had to prepare a document that included information "concerning the terms of the proposed issue of securities; information, including financial information or operating data, concerning such issuers of municipal securities and those other entities, enterprises, funds, accounts and other persons material to an evaluation of the offering." (Respondent's Pretrial Brief at 9 n.11.) An official statement is the municipal bond equivalent of a corporate prospectus, which is "a formal written offer to sell securities that sets forth . . . the facts concerning an [existing business enterprise] that an investor needs to make an informed decision." (Tr. 112, 631-32. See also, Rule 15c2-12(e)(3), 17 C.F.R. @ 240.15c2-12(e)(3) (1990); Zipf, supra, at 138, 245; Barron's Dictionary of Finance and Investment Terms, 294, 382, 445 (4th ed. 1995).)

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n12 The County of Nevada bond offering was for $ 9.07 million. The comments accompanying publication of Rule 15c2-12 note that, generally, the larger the bond issue the more thorough the disclosure, and that many offerings for less than $ 10 million are in types of securities that present higher risks to investors that should be highlighted in a complete disclosure document. Final Rule, 43 SEC Docket at 2247.

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Conducting a due diligence investigation and disclosing material information in the official statement are separate endeavors, yet they are inextricably connected in that the material information disclosed in the official statement should be true and complete, attributes that can only be accomplished by a process of verification. See Final Rule, 43 SEC Docket at 2249. The underwriter, First California, agreed to prepare the official statement and to perform the due diligence for the offering. In June 1990, however, the County co ntracted with Rauscher to:

8. Prepare the preliminary and final official statements describing the County's financing program, the bonds, security for payment of the bonds, and the economic and financial background of the property owners in accordance with the disclosure required by Securities and Exchange Commission Rule 15c2-12.

(Div. Ex. 56; Tr. 636, 640-41.) First California retained its obligation to perform due diligence, but Rauscher assume the underwriter's duties to disclose all material facts when it prepared the official statement. (Div. Ex. 56; Tr. 636, 640-41.)

Ms. Horler testified at the hearing, "I think that where our roles differed was where the underwriter had additional obligations, because he was making representations to investors. A financial advisor does not do so." (Tr. 530.) I reject Respondent's position that the antifraud provisions do not apply to Ms. Horler because she was not the underwriter on the offering. In a negotiated offering such as this, the underwriter customarily prepared the official statement. Horler, supra, at 11, 64. Moreover, First California had specifically agreed to do so. Ms. Horler contracted to perform this underwriter's responsibility when she agreed to prepare an official statement for the offering that met the requirements of Rule 15c2-12. In doing so, Ms. Horler undertook not only the procedural obligations set forth in the Rule, but also the substantive responsibility to see that the representations contained in the offering statement were accurate and complete.

Finally, Respondent's arguments that she had no duty of disclosure because she "did not issue any opinion . . on which the investing public could rely," and the "record is devoid of any showing that her duties . . . ran to anyone other than her client" are unpersuasive. (Respondent's Posthearing Brief at 50-51.) Ms. Horler recommended that the County hire Rauscher to prepare the official statement because the underwriter had not done so. In promoting Rauscher for the job she stressed its expertise at performing the task. (Tr. 113-14, 117, 613-14; Div. Ex. 39.) Rauscher increased its original $ 10,000 proposal to act as financial advisor to $ 30,000 when it agreed to draft the official statement. (Tr. 117.) As a securities professional and an expert in municipal offerings, Ms. Horler knew the significance of the official statement as a disclosure document in such offerings. n13 In her widely disseminated guidebook, Ms. Horler acknowledges the importance of disclosure: "It is the responsibility of issuers, financing consultants, underwriters, and bond counsel to make full disclosure of all material information pertinent to securities offered in the municipal bond market." Horler, supra, at 10 (emphasis added). I am at a loss to understand why Ms. Horler did not understand that by taking on the underwriter's

responsibility for preparing the official statement she also took on the underwriter's duty to make full and accurate disclosure of material information to the investing public.

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n13 Ms. Horler held two securities licenses and an MBA. She was a senior vice president of a firm that was both a registered broker dealer and a large investment banking firm specializing in public finance.

Members of the securities industry agree to be subject to the statutes, rules and regulations administered by the Commission and self-regulatory organizations, and, before entering the business, generally must apply for registration and pass examinations demonstrating their knowledge of the securities laws. Thereafter, these professionals are subject to ongoing obligations to secure compliance with the law in order to protect public investors from illegality.

Jacob Wonsover, 69 SEC Docket 694, 1712 (Mar. 1, 1999).

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4. Material Errors and Omissions In the Official Statement.

Information is material if, under all circumstances, there is a substantial likelihood that a reasonable investor would consider the omitted or misstated information significant in making an investment decision. Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988) (citing TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)).

a. Financial Considerations Relevant to the Wildwood Estates Project

The Division alleges that Ms. Horler knew but failed to disclose in the official statement that the Acquisition Agreement provided that the developer could not receive any of the Mello-Roos bond proceeds until the public and private improvements planned for each successive phase of the project had been completed and accepted by the County, and that she knew but did not disclose that the developer's loan commitment was inadequate to complete Phase I.

The official statement disclosed the following information about the developer's intention to build the project in three phases:

	FINANCED WITH SPECIAL TAX BONDS		PRIVATELY FINANCED
	Series E-1990 Bonds	Series T-1990 Bonds	
Phase I	$ 2,937,504.85	$ 389,463.63	$ 2,390,589.36
Phase II	1,473,894.15	320,711.29	1,261,456.83
Phase III	2,489,180.41	682,196.79	1,437,710.57
	$ 6,900,579.41	$ 1,392,371.71	$ 5,089,756.76

(Div. Ex. 1 at 14.)

Ms. Horler knew but did not tell the Board at a November 13, 1990 meeting, and she did not disclose in the official statement, that the developer did not have a financing commitment for Phases II and III because it "didn't come up for discussion" at the Board meeting. (Tr. 164-66, 169, 459.) At the same meeting, Ms. Horler informed the Board that First Commercial Bank had loaned Mr. Montross $ 1.14 million for the project and that the bank had provided him with a commitment letter for an additional $ 4.2 million. (Div. Exs. 74, 78.) Ms. Horler admits that she knew at the time, however, that this level of funding would be insufficient to finance Phase I of the project. (Tr. 164-66.)

Mrs. Horler acknowledged that her representation to the Board that, "In our estimate, this is sufficient money to adequately complete all the improvements necessary" was "not completely accurate. It was something given kind of spur of the moment at the meeting." (Tr. 163-65.) Ms. Horler did not disclose in the official statement that the developer lacked sufficient funding to complete Phase I of the project and lacked any financing for Phases II and III. (Tr. 192-93; Div. Ex. 1.) These omissions were material because: (i) the developer's financial stability was significant to the project's success; (ii) the developer phased the project because "he didn't have enough money to do the whole subdivision at one time"; and (iii) it was important to the County for federal income tax purposes that all three Phases be completed within two years.(Div. Ex. 78 at 21-22; Tr. 12, 167-69.)

The County Counsel was the impetus for the Acquisition Agreement's payment schedule whereby the developer was paid from the proceeds of the bond offering only after he completed all the improvements in a phase, and only after the appropriate County agency accepted the improvements. This acquisition type agreement was thought to offer the issuer more protection. (Tr. 158, 557.) An acquisition or reimbursement agreement is more financially burdensome for a developer than a progressive agreement under which the developer receives periodic payments as it completes the work because it forces the developer to finance expenses up-front and to wait longer for reimbursement. The Division's expert, Patrick A. Gibbons, opined that it was not normal practice in December 1990 to use acquisition type agreements which denied the developer any reimbursement from the Mello-Roos bond proceeds until all facilities in a given phase of construction were accepted by the appropriate public agency. n14 (Div. Ex. 171 at 6.) Mr. Gibbons testified that this provision required the developer to raise additional capital during construction, and estimated that it caused the developer to have a shortfall in construction funds of $ 487,274. n15 (Div. Ex. 173.)

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n14 Mr. Gibbons is president of GCI Group, located in Irvine, California, a real estate consultant in the areas of special district formation, due diligence, and restructuring. A 1985 graduate of New York University, Mr. Gibbons worked for a year with Chemical Bank Capital Markets Group before becoming a consultant. (Div. Ex. 171.)

n15 The parties strenuously disagree as to the meaning of First Commercial Bank's loan report dated July 25, 1990 for Wildwood Estates, Inc.'s $5.3 million loan showing total costs of this amount and $ 1,378,152 in "credits paid by Mello-Roos directly." (Resp. Ex. 5D, date stamp FCB 02695.) I find the Division's position persuasive that inasmuch as Mello-Roos funds could not be disbursed until after the County accepted the improvements, this notation indicates that the developer would need this amount in addition to the loan amount to complete Phase I. (Division Posthearing Brief at 43-44.)

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Timothy J. Schaefer, Respondent's expert, disagreed with Mr. Gibbons and testified that a variety of both progressive and acquisition type agreements were in use in municipal bond offerings in California in 1990. n16 (Tr. 679-80.) In addition, bond counsel Ness, a practicing bond attorney for about sixty years, opined that while an acquisition agreement was not unusual, it was not the most common type of agreement in use at the time. (Tr. 654.) Ms. Horler knew that under the terms of the Acquisition Agreement the developer could not receive the bond proceeds to pay for the Phase I construction costs until Phase I was completed and the County accepted the improvements. (Tr. 166.) Mr. Ness and Respondent's expert support Ms. Horler's decision not to disclose this information in the official statement based on their view of the practice in the industry in 1990. (Tr. 646, 654, 669, 681.)

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n16 Mr. Schaefer has had more than thirty years experience in municipal securities and is executive vice-president of Fieldman, Rolapp & Associates, located in Irvine, California, a regional consulting firm specializing in advising local governments on public finance, financial consulting, and fiscal planning. (Resp. Ex. 88 at 2.) In Mr. Schaefer's expert opinion, Ms. Horler acted appropriately in drafting the official statement based on data she compiled from various sources without a thorough, direct check for accuracy because the underwriter had contracted to perform the due diligence investigation. (Tr. 689-90.)

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The terms of the Acquisition Agreement are material because they directly affected the project's possibility of financial success, a significant consideration to a reasonable investor. I find therefore that a reasonable investor would consider it significant in making an investment decision that, unlike the more common situation, in this offering the developer had to advance funds to finance construction until the Phase I improvements were completed and accepted by the County. For developers with limited resources, the additional financial burden of advancing capital could be especially difficult. This developer was not well known and the record indicates that its resources in 1990 were quite limited. Ms. Horler had not heard of Montross Barber before the offering. Ms. Horler characterized the risk that the developer could not raise the additional funds needed because of the terms of the Acquisition Agreement as "significant" in her discussion with the Board. (Tr. 166-67.) A witness with many years

of banking experience, who had been a loan official with First Commercial Bank, considered the terms of the Acquisition Agreement important because "it's always important for the bank to know what -- what has to happen for it to be repaid." (Tr. 452.) This witness noted in the bank's loan file an August 1990 conversation with a municipal bond counsel who characterized the Acquisition Agreement as the key document between the County and the developer. (Resp. Ex. 5D at FCB 02697.)

Ms. Horler's position that there was no need to disclose that the Acquisition Agreement required up front financing by the developer because investors who bought these kinds of bonds - an unrated offering of a land-based security - understood this fact because the official statement said the County would "acquire" the improvements. (Tr. 191.) The evidence does not support Respondent's assessment of what that term meant or would mean to investors. I have considered and found unpersuasive the opinions of Mr. Ness and Mr. Schaefer that Ms. Horler acted appropriately because the prevailing practice in California in 1990 was not to disclose an acquisition type agreement in the official statement. n17

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n17 The argument that behavior is acceptable because "everybody is doing it" is not a valid defense to fraudulent conduct. "Proof of adherence to an industry practice is not dispositive on the issue of" liability because "what ought to be done is fixed by a standard of reasonable prudence, whether it usually is complied with or not." Doe v. Cutter Biological, Inc., 971 F.2d 375, 382-83 (9th Cir. 1992) (citations omitted).

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Because of the omissions noted above, Ms. Horler's disclosure in the official statement did not satisfy the terms of Rauscher's Contract with the County that required Rauscher to describe in the official statement the "security for payment of the bonds, and the economic and financial background of the property owners in accordance with the disclosure required by Securities and Exchange Commission Rule 15c2-12." (Div. Ex. 56 at page stamped RPR 00611.)

Ms. Horler further contends that she is not responsible for material misstatements and omissions in the official statement because drafting the official statement was a collaborative effort. She circulated drafts and held meetings with people who had skills she did not have, and she urged those people to assist her in making the statement accurate. (Tr. 512-13, 543, 565-66.) I find this argument unpersuasive. The County paid Rauscher approximately $ 20,000 to draft the official statement because Ms. Horler and her firm represented themselves as municipal finance experts experienced in drafting official statements. (Tr. 113, 117, 613-15.) County officials believed Ms. Horler wanted the official statement to be accurate, but they did not think it was their shared responsibility to verify the accuracy of the information in the statement. For example, Mr. Curtis recognized that the County Counsel's office was not expert in municipal bond offerings and it "would entrust the development of those documents to the bond

professionals" it hired to prepare them. (Tr. 369.) Ms. Wheeler looked to Ms. Horler and Ms. Rappaport as the source of all information she had about the representations in the official statement. (Tr. 271.) Ms. Dabis thought she received copies of the official statement only as a courtesy. (Tr. 322.) Moreover, it was not that Ms. Horler was uninformed -- she knew the terms of the Acquisition Agreement, she knew the developer had insufficient financing for Phase I and had no financing for Phases II and III, yet she chose not to disclose that information to investors in the official statement.

Finally, the official statement's general disclaimer that "Information was obtained from the County and other sources which are believed to be reliable but it is not guaranteed as to accuracy or completeness and is not to be considered as a representation of the financial advisor or the underwriter" does not absolve Ms. Horler from responsibility. (Div. Ex. 1 at i; see Kline, 24 F.3d at 487.)

For all these reasons, I conclude that a reasonable investor would consider the reimbursement arrangement and the insufficient or nonexistent up-front financing to be material information. Ms. Horler was required to disclose this information in the official statement because without it the official statement was misleading.

b. Ownership of Wildwood Estates

The Division alleges that Ms. Horler knew or was reckless in not knowing that Wildwood Estates, Inc. held title to the land which was the site of the Wildwood Estates development, and that she caused the official statement to state that Mr. Montross owned the land, a material misrepresentation.

Ms. Rappaport told Ms. Wheeler that "Montross's land title is clear." (Tr. 261-62; Div. Ex. 71.) The official statement erroneously represented that, "All of the taxable land within the District is currently owned by G. Michael Montross of Montross Barber Investments, Inc. (the 'Developer')." (Div. Ex. 1 at 13.)

Respondent's position is that the error was not material because Wildwood Estates, Inc. and Mr. Montross were essentially the same, especially since Mr. Montross personally guaranteed the bank loans to the corporation. I reject this argument. The legal differences between personal liability as opposed to corporate liability are significant. This holding is supported by: (i) Ms. Horler's advice to the County that the issue of clean title was important because "the bond holders look first to the reserve and then to the County's foreclosure obligation with title being a must at the outset"; (ii) the Contract required Rauscher to assist the County in developing a financing plan that would, among other things, take into account the property owner's ability to pay; (iii) the Contract further required Rauscher to prepare an official statement describing the "economic and financial background of the property owner"; and (iv) the testimony of the bank official that "from a practical standpoint, when you have a real estate deed of trust, as a lender you basically have only one recourse. You can look to the real estate, or you can do a judicial foreclosure, and then look to the guarantor." (Tr. 136-37, 382-83, 431-32; Div. Ex. 56.)

Ms. Horler's positions on her responsibility for the error are contradictory and confusing. She testified that she read the materials that were sent to her and she admits to receiving a copy of the bankruptcy court order affirming that Wildwood Estates, Inc. held title to the land. Yet she also testified that she only learned this fact long after the bond offering had closed. (Div. Ex. 70; Tr. 132-34, 582.)

Ms. Horler claims she was not responsible for this error in the official statement because Mr. Curtis, Mr. Cranmer, and Melanie K. Wellner, an attorney in the County Counsel's office, failed to tell her that the draft official statement incorrectly identified Mr. Montross as the land owner. n18 (Tr. 90, 370-72, 569-71.) Ms. Horler also testified that in her experience bond counsel was responsible for "resolving or deciding questions of title and ownership." (Tr. 536-37.) Ms. Horler's attempt to shift responsibility to bond counsel is unpersuasive. Bond counsel was adamant that he reviewed the official statement "only as to . . . the legal issues that are in it. We specifically do not include in our opinion anything that indicates we've delved into the due diligence or disclosure, whatever." (Tr. 632.) Finally, Ms. Horler claims she was justified in relying on the erroneous minutes of the Board meeting on March 20, 1990. Matters of title to land, however, are resolved by checking primary public documents that reveal legal ownership. n19 (Tr. 536-37.) Ms. Horler had an obligation to either personally check the official public records, or to otherwise make certain that the official statement disclosed the true owner of the property.

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n18 Persons in the County Counsel's office wrote letters and memoranda that identified Mr. Montross as the owner even though the County Counsel and several others in the office knew that the bankruptcy court order dated November 5, 1990, confirmed that Wildwood Estates, Inc., a California corporation, had owned the property since January 1990. (Div. Ex. 76.)

n19 The minutes mistakenly state that Mr. Montross was the land owner even though a transcription of an oral recording of the meeting describes a title document showing title in Wildwood Estates, Inc., a California corporation. (Resp. Ex. 12, minutes at page 987, and transcription at 30.)

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Rauscher had no due diligence obligation. However, Ms. Horler knew the County hired Rauscher to draft the official statement because the underwriter had failed to do so. (Tr. 181.) Mr. Ness expected that the person preparing the official statement would consider the results of the due diligence probe, however, there is no evidence that Ms. Horler did so. (Tr. 660.) Rather, the persuasive evidence is that Ms. Horler caused to be distributed to investors an official statement that misidentified the land owner without confirming, or even asking, whether the underwriter had conducted the most basic due diligence inquiry on this point - a title search to determine who held legal title to the land. n20 As an expert in municipal securities, and in land-based financing in particular, Ms. Horler knew that

legal title was important to the value of the bonds. (Tr. 553.) The official statement did not satisfy the terms of Rauscher's contract with the County which required Rauscher to describe in the official statement the "security for payment of the bonds, and the economic and financial background of the property owners in accordance with the disclosure required by Securities and Exchange Commission Rule 15c2-12." (Div. Ex. 56, Resp. Ex. 36.) Ms. Horler erred in omitting information material to an evaluation of the offering.

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n20 The only evidence of the underwriter's due diligence activities is bond counsel's testimony that Mr. Dumont with First California "started out pretty well" because he called two or three meetings and he went over a checklist he had prepared that indicated "he was doing pretty well." (Tr. 638.)

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As drafter of the official statement, Ms. Horler was responsible for the false information in the official statement on the material issue of title to the land. For the reasons previously stated, she cannot shift this responsibility to others.

c. The Background and Resources of Mr. Montross and Montross Barber

The Division further alleges that Ms. Horler was reckless in preparing an official statement that misrepresented the real estate experience and financial resources of Mr. Montross and Montross Barber. According to the Division, the official statement conveyed the misleading impression that in December 1990, Mr. Montross and Montross Barber were experienced, successful real estate developers who possessed sufficient skills and financial resources to complete the Wildwood Estates project. n21

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n21 I have given no weight to the suspicions of Ms. Dabis, the County Treasurer/Tax Collector, who publicly questioned Mr. Montross's trustworthiness, because she could not substantiate her suspicions with credible evidence.

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Testimony that Montross Barber's properties had declined substantially in value after 1986, that by 1990 the firm was extremely strapped for funds, that it did not pay taxes on some properties, and that it was in "very bad" financial condition is unrefuted. (Tr. 218-20, 223-24, 229-34, 236.) This evidence and the criminal convictions of Mr. Barber and Mr. Montross for securities fraud in connection with their real estate activities in this time period are persuasive that the official statement was false and/or misleading in representing that, in late December 1990:

The firm now holds more that $ 250 million worth of Northern California property for more than 3,000 investors.

[Mr. Montross] has purchased over $ 200 million worth of residential units and created over 1,200 subdivision lots in the last eight years. Some of Mr. Montross's substantial real estate interests include the following: El Dorado Estates, Wolf Creek and Bear Lake Estates, El Dorado County; Lake Kensington Park, Folsom; College Oaks, Carmichael; Lakeshire, Sacramento County; Sunnyside Terrace, Martinez and Cameron Park Estates, Cameron Park. Mr. Montross also has significant ownership interests in real estate partnerships for residential and commercial property located in Millbrae, Sacramento and San Francisco.

(Div. Ex. 1 at 13.)

County officials expected that Ms. Horler would do the work called for by the Contract, including developing a financial plan that, among other things, would address "the property owner's ability and willingness to pay." The County Counsel interprets that provision to mean that the financial advisor would conduct an independent examination and reach a determination as to the owner's capacity to meet its payment obligations. (Tr. 344-48; Div. Ex. 56.) Ms. Horler, however, claims that she was not required to do any independent research or analysis, but was entitled to rely on the investigation the bank presumably undertook prior to loaning $ 7 million to the developer. When asked what caused her to believe that the bank was utilizing due care in evaluating Mr. Montross's credit worthiness, Ms. Horler did not recall any specifics but referred to her general belief that:

Well, I know that when banks give loans . . . and you know, I thought all through this project the loan to Mr. Montross was as a sole individual – they would have to look at his financial statements, his tax returns, his projects. They would have to satisfy themselves that he was a credible developer, that he had the wherewithal and experience to carry through with the project.

(Tr. 534.)

As noted above, First Commercial Bank loaned $ 200,000 to Montross Barber on December 5, 1989; $ 1.14 million to Wildwood Estates, Inc. on March 8, 1990; $ 5.35 million to Wildwood Estates, Inc. on July 25, 1990; and $ 125,000 to Wildwood Estates, Inc. on November 30, 1990. n22 (Resp. Exs. 5B, 5C, 5D, 5E.) Ms. Horler did not know that the bank loans in March 1990 and July 1990, totaling about $ 6.5 million were[*72] to Wildwood Estates, Inc., a California corporation. (Resp. Exs. 5C, 5D.) Mr. Montross gave a "continuing guaranty" on the loans. (Tr. 413-14, 425-27; Resp. Exs. 5B, 5C, 5D, 5E.)

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n22 On the loans to Wildwood Estates, Inc., the bank earned a 2% loan fee and interest at prime plus 2 - 2 1/2%. (Tr. 444-45.)

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Ms. Horler reiterated her position several times that she could rely on the bank's loans to represent that the bank had conducted a thorough investigation of Mr. Montross and that he was financially successful. "Yes, that's what banks do. And I was familiar with bank loans in other situations, and I felt that it would be obvious to me that that was typical bank procedure." (Tr. 594-95.) Ms. Horler assumed that "as part of the bank's review in processing the loan to Mr. Montross, that they would undoubtedly look at the [real estate development] projects in [the] development history" that Mr. Montross listed on his loan application. (Tr. 538.) Ms. Horler did not consider that the bank's review differed depending on the borrower. The evidence is, however, that that bank's loans to Wildwood Estates, Inc. did not involve a detailed review of the finances of Montross Barber. (Tr. 430-31.)

Ms. Horler offers no support for her position that she knew the bank loans "entailed a detailed background and personal asset check of Mr. Montross." (Tr. 541-42.) When asked whether Mr. Montross was financially sound on November 13, 1990, about a month before the offering, Ms. Horler responded, "that would be obvious, if the bank was willing to lend him money. Because I knew that that would certainly be something that the bank would be checking." (Tr. 594.)

The evidence does not support Ms. Horler's assumption that the bank did a thorough analysis of Mr. Montross's or Montross Barber's finances. The source of the bank's information was the borrowing entity. (Tr. 415-16.) The basis of the bank's approval was the credit report complied by a loan officer. The senior credit administrator for First Commercial Bank at the time the Wildwood Estates loans were made, Charles E. Gram, testified that he did not know whether the loan officer verified the financial information that Mr. Montross supplied, as he should have, by checking with independent sources. (Tr. 415-16.)

When the official statement was issued in December 1990, Ms. Horler did not know whether Mr. Montross or Montross Barber were financially sound. (Tr. 155.) Moreover, there is no evidence that Ms. Horler asked the bank whether it had conducted a thorough investigation of Mr. Montross's personal finances or the finances of Montross Barber before she finalized the official statement. If it had been asked whether it had done a due diligence examination, First Commercial Bank would have confirmed that it made the loan commitment, but it would not have disclosed any of the documentation it had gathered. (Tr. 460.)

Based on these facts, I reject Ms. Horler's position that her role in preparing the official statement was largely that of a compiler of data. I conclude that she made material errors and omissions in the official statement that conveyed the erroneous impression that Mr. Montross and Montross Barber were experienced in creating successful real estate subdivisions and possessed sufficient skills and financial resources to complete the Wildwood Estates project.

5. Scienter.

As noted above, to violate Section 17(a)(1) of the Securities Act or Section 10(b) of the Exchange Act, a person must be shown to have acted with scienter, i.e., a mental state embracing intent to deceive, manipulate, or defraud; scienter can be established by a showing that a person acted intentionally or with severe recklessness. Aaron, 446 U.S. at 697; Ernst & Ernst, 425 U.S. at 193 n.12; Hackbart, 675 F.2d at 1117.

The County did not have either the experience or the personnel to do what was required to prepare the official statement. The County's one prior bond issue financed the cost of its administrative building. (Tr. 263.) The County's analyst on the offering, Ms. Wheeler, who attended meetings, gathered information, and acted as the "communications interface" among the parties and the Director of Finance and the County Administrator, had been in her position for about two months when the County retained Ms. Horler. n23 (Tr. 242-44.) Ms. Wheeler had no prior experience in municipal finance. Before joining the County in 1988, her work experience had been as a business manager of a food processing plant and a school district, (Tr. 239-40.) She spent several years with a welfare agency, and had directed the County's community action agency. (Tr. 239-40.)

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n23 Ms. Wheeler received a BA degree from Chico State in the early 1980s, and was hired by the County on July 13, 1988. She earned a Masters in Public Administration from the University of Southern California in 1996. (Tr. 238-40.)

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The County hired Ms. Horler because she was one of the state's leading experts on the subject of municipal finance. In the well-known book Ms. Horler wrote in 1982 as a guide for municipal officials, she stated that it was the responsibility of issuers, financial consultants, underwriters, and bond counsel to make full disclosure of all material information pertinent to securities offered in the municipal bond market. (Div. Exs. 10, 12 at 64; Tr. 184.)

The evidence is persuasive that, due to Ms. Horler's knowing and reckless misconduct, the official statements contained material misstatements and omitted to state material information required to make the information in the statement not misleading. Jay Houston Meadows, 61 SEC Docket 2444, 2453 n.16 (May 1, 1996), aff'd, 119 F.3d 1219 (5th Cir. 1997); SEC v. Steadman, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992) (citing Aaron, 446 U.S. at 701-02); Newcome v. Esrey, 862 F.2d 1099, 1102 n.7 (4th Cir. 1988). Based on the findings and conclusions set forth above I therefore conclude that Ms. Horler, acting with scienter, willfully violated Sections 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

Because I conclude that Ms. Horler is primarily liable for these violations, there is no need for an analysis of the aiding and abetting allegations.

CEASE-AND-DESIST

Section 8A(a) of the Securities Act and Section 21C(a) of the Exchange Act, authorize the entry of an order requiring a person found to have violated or to have caused violations of the securities statutes and rules thereunder to cease and desist from committing or causing such violations and any future violations. I do not find the entry of such an order necessary or appropriate. I credit Ms. Horler's assurances that, based on her experience with the Wildwood Estates bond offering, she would do things differently today and would not repeat the conduct that is at issue here. (Tr. 600-01.) In 1996, the State of California published the Disclosure Guidelines, which set out the standards for land-based securities and suggest a greater level of disclosure than Ms. Horler observed in 1990. For example, the Guidelines suggest that: In applying [the] materiality standard, the issuer may assume that a reasonable investor would consider it important to be informed of any foreseeable factor that might jeopardize the timely payment of debt service. . . . The information needs of investors . . . extend to indicators of the feasibility of the development project itself. In particular, a reasonable investor would consider it important to be informed of facts concerning the developer's experience, its plans for financing development, and the sources of capital committed to that financial plan.

(Disclosure Guidelines, at ii.) Ms. Horler willingly followed the Guidelines after their publication in 1996. Over the course of her long and distinguished career as a securities professional, Ms. Horler has never been disciplined for professional misconduct. The wrongdoing at issue here occurred during a very brief period of time some nine years ago, and involved a single bond offering.

Although it is not necessary to find a likelihood of future violations to impose a cease-and-desist order, where, as here, it is highly unlikely that a respondent will commit future violations and no remedial purpose will be served by issuing a cease-and-desist order, such an order need not automatically follow upon finding that a respondent has violated the securities laws. See, e.g., Trepp, 1999 WL 753922, at *1. I therefore deny the Division's request for a cease-and-desist order against Ms. Horler.

RECORD CERTIFICATION

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. @ 201.351(b), I certify that the record includes the items described in the record index issued by the Commission's Secretary on September 10, 1999.

ORDER

Based on the findings and conclusions set forth above, I ORDER that this administrative proceeding IS DISMISSED.

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.

Brenda P. Murray
Chief Administrative Law Judge

In the Matter of Virginia Horler, Exchange Act Release No. 42197, A.P. File No. 3-9542 (December 2, 1999).

The time for filing a petition for review of the initial decision in this proceeding has expired. No such petition has been filed, and the Commission has not chosen to review the decision on its own initiative.

Accordingly, notice is hereby given, pursuant to Rule 360(e) of the Commission's Rules of Practice, that the initial decision of the administrative law judge* has become the final decision of the Commission. The order contained in that decision dismissing the proceeding as to Virginia Horler is hereby declared effective.

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* County of Nevada, Initial Decision Rel. No. 153 (Oct. 29, 1999), SEC Docket.

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For the Commission by the Office of the General Counsel, pursuant to delegated authority.

In the Matter of Wheat, First Securities Inc. f/k/a First Union Capital Markets Corporation, Exchange Act Release No. 40376, A.P. File No. 3-9688 (August 27, 1998).

On August 27, 1998, the Commission instituted public administrative and cease-and-desist proceedings against Wheat, First Securities Inc. f/k/a First Union Capital Markets Corporation ("First Union"), a Charlotte, N.C.-based broker-dealer. The Order Instituting Administrative and Cease-And-Desist Proceedings Pursuant to Sections 15(b), 15B(c), 19(h) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") alleges that First Union committed or caused violations of Section 15B(c)(1) of the Exchange Act, and Rule G-17 of the Municipal Securities Rulemaking Board in connection with the offer, sale and/or purchase of municipal bonds. Specifically, the Order alleges that in June 1993, First Union, by and through the assistant vice-president

and manager of First Union's public finance operations in Miami, Florida ("public finance manager") entered into a two-year contract with Broward County to act as financial advisor to Broward County in connection with the offer and sale of certain municipal refunding bonds ("financial advisor contract"). The Order alleges that under the terms of the financial advisor contract, First Union warranted "that it had not employed or retained any company or person, other than a bona fide employee working solely for [First Union], to solicit or secure this Agreement, and that they have not paid or agreed to pay any person, company, corporation, individual or firm, other than a bona fide employee working solely for [First Union], any fee, commission, percentage, gift, or other consideration contingent upon or resulting from the award or making of this Agreement." The Order also alleges that pursuant to Florida statute, First Union was required to disclose to Broward county "[a]ny fee, bonus, or gratuity paid . . . in connection with the bond issue, to any person not regularly employed or engaged . . ." by First Union within 90 days after the delivery of the bonds.

According to the Order, First Union, through its public finance manager, retained an outside consultant and lobbyist ("the lobbyist") to, among other things, secure the financial advisor contract. First Union is also alleged to have agreed to pay the lobbyist a contingency fee based upon the business the lobbyist generated for First Union in connection with the financial advisor contract and remitted a percentage of its earnings under the contract to the lobbyist between December 1993 and October 1994. The Order states the First Union's warranty to Broward County in the financial advisor contract was therefore false and that First Union failed to disclose to the county its agreement with the lobbyist and the payments made to him. The Order further alleges that as a result of these misrepresentations and omissions, First Union was able to act as financial advisor to Broward County on three bond refundings for which it was compensated approximately $175,653.

A hearing will be scheduled to determine whether the allegations against First Union are true, and if so, what sanctions, if any, are appropriate in the public interest against it.

<u>In the Matter of Wheat, First Securities Inc. f/k/a First Union Capital Markets Corporation,</u> A.P. File Nos. 3-9688 and 3-9794 (December 17, 1999).

Appearances: Christian R. Bartholomew, John C. Mattimore and Nicholas A. Monaco for the Division of Enforcement, Securities and Exchange Commission
Thomas Tew and Daniel S. Newman for Respondent Teressa L. Cawley
Michael K. Wolensky, Steven H. Lang and Calvin H. Cobb for Respondent Wheat, First Securities f/k/a First Union Capital Markets Corp.

Before: Herbert Grossman, Administrative Law Judge

I. Introduction

The Securities and Exchange Commission (SEC) initiated this proceeding on August 27, 1998, under Sections 15(b), 15B(c), 19(h) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Wheat, First Securities, f/k/a First Union Capital Markets Corp. ("First Union"). On December 23, 1998, the SEC filed an action against Teressa L. Cawley ("Cawley") under the same sections of the Exchange Act. The actions were consolidated on January 25, 1999.

The SEC's Division of Enforcement ("Division") charges First Union and Cawley with violating Rule G-17 of the Municipal Securities Rulemaking Board ("MSRB") and Section 15B(c)(1) of the Exchange Act. The Division alleges that Respondents entered into a financial advisory agreement with Broward County containing a false warranty that First Union had not retained any person, other than a bona fide employee working solely for First Union, or agreed to pay any such person compensation based upon the award of the agreement when, in fact, it had retained an outside lobbyist to secure the agreement and had agreed to pay him compensation based on business generated by the agreement. The Division further alleges that Respondents later omitted to disclose the payments to the lobbyist when required to disclose them in connection with bond issuances under the financial advisory agreement.

Respondents deny these allegations, stating that they were under no duty to disclose their relationship with the individual in question and that even if they had committed violations, the action is time-barred under the applicable statute of limitations.
A hearing was held in Miami from March 2-5, 1999 and March 22-24, 1999. The Division filed its post-hearing brief on May 25, 1999. Respondents Cawley and First Union each filed their post-hearing briefs on July 29, 1999. The Division filed its Reply to the post-hearing briefs on September 10, 1999.

The Division requests four types of relief: (1) that cease-and-desist orders be entered against both Respondents; (2) that First Union disgorge its profits of $175,653 received under the FA Agreement plus $97,654 in prejudicial interest thereon; (3) that both Respondents be required to pay civil monetary penalties in the amount of $175,000 by First Union and $35,000 by Cawley; and (4) that Cawley be suspended from associating with any broker, dealer, or municipal securities dealer for a period of six months.
I find that Respondents have violated MSRB Rule G-17 and Section 15B(c)(1) of the Exchange Act, although not in all particulars alleged by the Division, and issue orders to

cease and desist, for suspension, and to pay disgorgement and civil penalties on the violations not barred by the statute of limitations.

II. Statement of Facts

A. Primary Facts

Respondent First Union is based in Charlotte, North Carolina and is a principal subsidiary of First Union Corporation, a bank holding company. During the period relevant to this proceeding, First Union was a registered municipal securities dealer and member of the Municipal Securities Rulemaking Board engaged in municipal securities business in the southeastern United States. *See,* First Union Answer ¶ I; Cawley Answer ¶ ¶ 1-2.
Respondent was employed as an assistant vice-president and manager of First Union's public finance operations in Miami until April 20, 1994. She was the registered municipal securities principal for the South Florida office. Tr. 895. Cawley is presently the sole owner, president and secretary of Southern Municipal Advisors, Inc., a financial advisory services firm providing services in the field of public finance. Tr. 490-91.
As of February of 1992, First Union Corporation and its broker-dealer subsidiary had a public finance operation in North Carolina and Georgia, but it had no presence in South Florida. Steven Martin Johns ran the public finance operation. In February 1992, Johns hired Cawley away from NCNB, the predecessor of Bank of America, to build a public finance business for First Union in Miami. Tr. 495-96 (Cawley); 451-96 (Johns). Cawley was 30 years old when Johns hired her and had been running NCNB's public finance operation; Johns had worked on deals with her in that capacity. First Union had just acquired a Miami bank (Southeast), which had a small bond trading desk, and because Cawley wished to move to South Florida, First Union decided to try to establish a business there. Tr. 1052 (Evans). Accordingly, Cawley was hired to "[s]tart a new operation in Florida in Public Finance" and to "[g]et [First Union] into Florida underwritings." Ex. DX 99C (Cawley 1992-93 Performance Plan)."

Because Cawley spent most of 1992 closing deals in the Carolinas, the Miami office was not fully staffed and operational until March of 1993. Tr. 510-11 (Cawley); Ex. DX 99A (Cawley memo data Jan. 11, 1993). Even then, it was very small, both physically and in terms of employees, of which there were five: Cawley; the secretary Ann-Jeannette Jean Baptiste, a/k/a "AJ"; Orlando Rafael Cruz, Jr.; Eugene Grey; and Sue Levere. Tr. 98-99 (Cruz). Although the employees had different responsibilities, they worked closely together. Tr. 99-100.

Orlando Cruz, who supplied the critical evidence in the proceeding, joined the Miami office during the summer of 1992 as a temporary employee. Tr. 61-62. In November of 1992, Cawley hired Cruz as a full-time municipal analyst. Tr. 59-62.
Cruz had a very good professional relationship with Cawley and greatly admired her as leader. Tr. 67. Cruz described Cawley as a very hands-on-manager who had the "final say" on and was aware of everything the office did. Tr. 135-37. His opinion was later confirmed by the secretary AJ, who stated: "She [Cawley] knew everything that was going on." Tr. 1588.

Upon moving to Miami to run the office, Cawley set about investigating the political lay of the land. As part of her "plan to get out First Union's name among the movers and shakers" of the community, Cawley met with numerous people in the municipal finance area, seeking their views as to who the major players were in the market. Tr. 563-64, 700; Ex. DX 154 (1993 calendar). She also went to dozens if not hundreds of political functions, such as fund raisers and receptions. Tr. 552-55, 564-65.

As of the Winter of 1992 and early Spring of 1993, Ronald L. Book was South Florida's preeminent lobbyist. Book, a North Miami native, spent most of his childhood and all of his professional life in politics. Book served as Florida's then-Governor Bob Graham's chief legislative and cabinet affairs liaison and chief fund raiser during 1978-1982, and then parlayed that position into a lucrative lobbying practice. Tr. 1296-1303. Book has not missed a single session of the Florida legislature since 1978 (Tr. at 1300-01), and his clients have included dozens of municipalities and high-profile business clients. Over the years, Book has made hundreds, if not thousands, of political contributions. By his own admission, contributions secure Book access; they get his phone calls returned and they get him face-to-face meetings. Tr. 1318-20.

In 1992-1993, Book lobbied for the City of Miami, the City of North Miami, the City of North Miami Beach, and "probably" Miami-Dade Country. In February 1993, Broward County hired Book to lobby the State legislature in connection with a half-million dollar damage claim against the County. Book's retention was widely reported in the local newspapers as being due to Book's admittedly long-standing personal and political friendship with Broward County Commissioner Scott Cowan. Tr. 1302-05; Exs. DX 1A-G (Herald and Sun-Sentinel articles); DX 2 (Broward County letter dated March 12, 1993 ratifying Book's retention).

Book also represented a broad variety of private clients, including Wayne Huizenga, then owner of Blockbuster Entertainment, in his efforts to build Blockbuster Park - a massive theme park - on the Date-Broward country line. In fact, Book spent a great deal of 1992 successfully persuading Dade County and Broward County to permit the creation of the necessary special taxing district. Then, when Huizenga sold Blockbuster to Viacom, Book, on behalf of Viacom, lobbied to have those same approvals repealed. Tr. 1309-11. As a result of these experiences, by 1992-1993, Book had close connections with Broward public officials. In addition to his admitted "long-time friendship with Commissioner Cowan" (Tr. 1305), Book developed relationships with key Broward County Commissioners, including Commissioners Gunzberger and Poitier. Book also worked closely with the County Administrator, Jack Osterholt, whom he knew from the Graham Administration in the 1970s. Book also developed a relationship with Phil Allen, the Director of the Department of Administrative and Finance Services. Tr. 1315-17. All of these people sat on the Broward committee that ultimately selected First Union to be the Financial Advisor under the agreement at issue; Cowan was the chair. Ex. DX 103.

Book also acted as a "finder" for at least two broker-dealers who were seeking municipal finance business in South Florida. In February 1992, Book agreed to represent Dillon Read, Inc. for a monthly retainer of $3,500 in connection with, *inter alia*, "advis[ing]

[Dillon Read] on how best to implement a public finance business expansion program within the State of Florida. " Ex. DX 119 at 2; Tr. 1320-23. In addition to the retainer, Dillon Read agreed to pay Book a "success fee for business obtained by [Dillon Read]" in an amount to be determined based upon Dillon Read's fee and Book's "contribution . . . in obtaining the business." Ex. DX 119 at 3. Book had a similar agreement with Kidder Peabody. *See*, Ex. DX 120 at Schedule III, page 2 (January 25, 1994 bond purchase agreement disclosing $20,000 fee paid to Book as a finder).

Cawley knew much if not all of this information when she decided to retain Book. Cawley had seen Book in action at Miami-Dade County Commission meetings in late 1992 and early 1993, and it was clear to her that he was extremely well-known and that he had the ear of the commissioners. Tr. 619, 621 (Cawley: "it was very clear when [Book] walked in people took an interest, commissioners motioned for him to speak to them. I mean, he knew everybody in the room"). Accordingly, Cawley sought out information and opinions from many people concerning Book. Tr. 621-22. For example, Cruz told her that Book was a very well-known lobbyist who had access to elected officials through his contributions and friendships. Tr. 85-87. Ultimately, Cawley came to the conclusion that in Miami-Dade and Broward counties and in the State legislature, Book was the number one lobbyist. Tr. 622-23. Cawley also knew, at least at some point in time, that Book was a close political friend and supporter of Scott Cowan, whom she knew as of April 1993 to be the Chairman of the Broward County committee that would select the FA. Tr. 623-26, 737.

Armed with this knowledge, beginning no later than on April 1, 1993, Cawley set out to contact Book and to retain him to assist First Union. Tr. 618-19; *see* Ex. DX 154 (1993 calendar). Although First Union and Book did not formerly enter into a contract until June 22, 1993, by Cawley's own admission, she and Book discussed his compensation much earlier than that. Indeed, although Cawley sought to place this conversation after First Union had made its proposal to Broward, *i.e.*, after May 6, it is clear that it occurred no later than during her first luncheon meeting with Book on April 20, 1993.
Thus, in her investigative testimony, Cawley testified that she had only one lunch with Book and that it was then that Book had told her he wanted a $25,000 retainer in advance. At the hearing, Cawley changed her story and asserted that she had had two lunches with Book and that the discussion about money was at the second, later lunch. Cawley admitted that this was flatly contrary to her prior testimony, but claimed that her memory had improved over time. Tr. 637-39.

I find that the earlier testimony is correct and that the discussion of the terms of Book's employment by First Union, including his compensation, occurred on April 20, 1993, a lunch meeting confirmed by a Cawley calendar entry. *See*, Ex. Dx 154. I also find the alleged discussion of a $25,000 retainer to be a fiction. In his investigative testimony, Book had repeatedly denied any knowledge of a discussion of a flat fee retainer in any amount, despite the coaching of his attorney that the "numbers come to $25,000." Tr. 1371-72. The $25,000 figure, and later suggested figures of $50,000, and $25,000 plus one-half of $25,000, appear to be after-the-fact, contrived attempts at connecting the total amounts paid to Book with an alleged flat fee retainer in order to deny that they were

based, at least in part, on a percentage of fees received by First Union on the business Book brought in.

The actual terms of the agreement, as they became clear from the evidence adduced in the proceeding, and as further discussed below, were that Book was to receive 20% of the fees received by First Union from any business generated by him, plus a $2,000 monthly retainer during the period in which he was successfully developing business opportunities.

On April 5, 1993, Broward County issued and First Union received a "Request for Letters of Interest" ("RLI") seeking proposals from firms interested in serving as "financial advisor [to Broward] for the issuance of refunding bonds." Ex. DX 101; Tr. 736. Cawley knew that being an FA was not as lucrative as being the senior managing underwriter on a deal. But Cawley also understood that, in Broward County, "you first needed to be an FA, then you could move up to the underwriting pool and then finally you could become a senior [underwriter]." Tr. 720.

On May 6, 1993, First Union submitted a "Proposal to Provide Financial Advisory" services in response to the RLI. Ex. DX 6. Consistent with the RLI, First Union set forth its "Recommended approach for Broward County" and stated that First Union "currently recommend[ed]" refunding five separate bond issues, all of which could, in First Union's view, be advance refunded under applicable federal tax laws. *Id*. at 6357. First Union's proposal then discussed each of the five issues in detail and the savings to be achieved by Broward in refunding the bonds. *Id.* at 6357-6362.The Broward County Commission Selection/Negotiation Committee for the FA position was comprised of the following persons all of whom had a relationship with Book, as described above:

Commissioner Scott I. Cowan, Chairman
Commission Suzanne Gunzberger
Commissioner Sylvia Poitier
B. Jack Osterholt, County Administrator
Philip C. Allen, Director, Finance and Administrative Services Department

Ex. Dx 103 (Minutes of May 12, 1993 Meeting). At the Committee's May 12, 1993 meeting, Allen reported that 15 firms had submitted proposals in response to the RLI. Each member of the Committee then listed his or her five top firms. First Union was included on the resulting "shortlist." The five shortlisted firms were then asked to make oral presentations. *Id.*

On May 21, 1993, the Committee notified First Union that it had been ranked first among the five presenters and invited Cawley to attend a negotiating meeting on May 28, 1993. Ex. RX 4. At that meeting, Cawley and the committee discussed a draft agreement. *See*, Ex. DX 104 (minutes of meeting and draft agreement). Cawley executed the Agreement on behalf of First Union on June 3, 1993, and the Broward County Commission formally approved and executed it on June 8, 1993. Ex. DX 9.

The agreement provided, among other things, that the County was to pay First Union as compensation $.6875 per $1,000 bond on the first $200,000,000 amount of bonds issued

and thereafter at a rate of $.60 per $1,000 bond over $200,000,000 for County refunding bonds issued during the two-year term of the agreement. *Id.* Thereafter, for three refunding transactions under the agreement, First Union was paid after the closing of the sale of the bonds, as follows:

Closing Date-Refunding Amounts	First Union Fees	Payment Date
Water and Sewer Refunding Bonds September 2, 1993-$134,895,000	$92,740.31	October 18, 1993
General Obligation Refunding Bonds October 5, 1993-$92,440,000	61,160.69	November 9, 1993
Tourist Development Refunding Bonds June 30, 1994-$36,255.00	21,753.00	July 29, 1994
Total	$175,654.00	

Exs. DX 29A, 108, 110, 113. Each of these refunding transactions had been recommended by First Union in its proposal to provide the financial advisory services. Tr. 792-3; *compare* Ex. DX 6 at FUMC 6357, 6361 *with* Ex. DX 114.
In addition to having recommended refunding transactions and analyzed them in detail in its proposal to provide its financial services (Ex. DX 6 at FUMC 6357-62), First Union performed all of the duties required of it under the FA Agreement, including preparing requests for proposals to underwriters, assisting in selecting underwriters, assisting in preparation of preliminary and final official statements, obtaining ratings for the refunding bonds and reserve fund accounts, participating in the pricing of the new bonds, and attending the closings. Tr. 783-88.

The agreement included an affirmative warranty by First Union that it had not used a lobbyist to obtain the award of the Agreement, and provided that Broward could terminate the Agreement for breach thereof. Ex. DX 9, Art. 9.3; *see, also,* Ex. DX107 (Agreement as produced by Broward with note characterizing Article 9.3 as "no lobbyist provision"). Specifically, the warranty made by First Union provided in full, as follows:

9.3 ADVISOR warrants that it has not employed or retained any company or person, other than a bona fide employee working solely for ADVISOR, to solicit or secure this Agreement and that they have not paid or agreed to pay any person, company, corporation, individual or firm, other than a bona fide employee working solely for ADVISOR, any fee, commission, percentage, gift, or other consideration contingent upon or resulting from the award or making of this Agreement. For the breach or violation of this provision, the COUNTY shall have the right to terminate the Agreement without liability at its discretion, to deduct from the contract price, or otherwise recover, the full amount of such fee, commission, percentage, gift or consideration.

Ex. DX 9. It is this warranty that the Division contends that Respondents breached. Cawley read this warranty at the time and "understood it to mean exactly what it says. Tr. 776. There "was no question in [Crawley's] mind" but that what Broward wanted to know was whether First Union had retained anyone to help them get the deal. Tr. 776-77. Cawley specifically understood the warranty to require disclosure of anyone who had assisted First Union in securing the deal, and believed that that included a "finder" under

Florida law. Tr. 778-79. Accordingly, Cawley explained that the warranty was not a concern to her because Book had not assisted First Union in securing the Agreement. *Id.* On June 3, 1993, simultaneously with Respondents' executing the FA Agreement and forwarding it to Broward County, Book filed a *Lobbyist Registration Statement* with Broward County. Dx 13A. Although the form he filed does not disclose the name of his employer as it requested, Book admitted that he had registered to lobby on behalf of First Union in Broward County. Tr.1373.

On June 22, 1993, approximately one month after First Union was awarded the FA Agreement, Book executed a formal agreement with First Union. Tr. 1363; Ex. DX 3. The agreement was dated May 1, 1993, the putative starting date of employment; listed services that Book was to provide, including providing certain specified information about government entities, assisting First Union in strategic planning, and discussing potential projects on a weekly basis; provided compensation to Book of $1,000 for the month of May and $2,000 for each month thereafter; provided for an increase in Book's compensation in the event that his time spent on First Union matters increases; and provided for termination of the agreement six months after the May 1, 1993 starting date, unless extended by First Union. *Id.*

At hearing, Cawley contended that she had acted in good faith in hiring Book (and two other consulting firms at around the same time), because she had discussed his prospective hiring with her superiors in a conference call in late April 1993, and solicited a written opinion from outside counsel Dennis Haas about the hiring of consultants immediately after the conference call. According to her version of facts, Haas supplied the opinion, of which Exhibit DX 4 is allegedly a copy, on May 1, 1993, as the copy is dated, together with a form of contract that she used as a template for the Book agreement (Ex. DX 3). The Book agreement was dated May 1, 1993, and alleged by Cawley to have been signed by her superior Stephen Johns and by Book one or two weeks after that date, prior to Book's performing any services for First Union. *See*, Tr. 570-74, 578-82, 599-602.

It became clear, however, that this sequence of events was untrue. To begin with, Cawley admitted that there was nothing in her calendar about the conference call (Tr. 715), and none of the other alleged participants in the conference call could recall any such call taking place (Tr. 480 (Johns); Tr.1050 (Evans); Tr. 1079-80 (Ilario)). More important, it became readily apparent that the Haas opinion letter and template agreement were drafted in June 1993, after Cawley and Book had established the terms of the consulting arrangement, Book had begun performing his services for First Union, and the FA Agreement had been executed (on June 3, 1993), for the following reasons: Haas did not ordinarily work on Saturdays and there was no urgency in drafting the opinion letter, but the letter was ostensibly dated May 1, 1993, a Saturday. Tr. 1125, 1137. He kept time sheets on which he put down the time he did the work and it was the requirement of the law firm that the time sheets be submitted within the calendar month the work was performed. Tr. 1126-27. The time sheets indicate that Haas billed two hours to First Union on June 7, 1993 for researching, evaluating and preparing an opinion on "Finder" issues, and another hour on June 14, 1993 for preparing the letter and form agreement.

Ex. DX 4A. Cawley's calendar indicates that she placed a call to Haas on June 7, 1993, the date of the first billing entry, and another call on June 15, 1993, the day after the second billing entry. Ex. DX 154. Moreover, the agreement signed by Book that was based on Haas's template agreement was sent to Book by First Union's Johns under cover of letter dated June 22, 1993. Ex. DX 15. Book admitted that he received it on or about that date, executed it, and returned it to First Union. Tr. 1363-64. Finally, counsel for First Union indicated that the original of the letter opinion could not be located (Tr. 1150) and, on the copy entered into evidence as Ex. DX 4, the date of "May 1, 1993" is slightly, but perceptibly, darker than the lettering in the body of the document.

It is clear that the opinion letter and the Book employment agreement were drafted after-the-fact to protect First Union from any claim that it was violating the "Finders" statute in hiring consultants and had not been considered when the terms of Book's employment were determined, at least one month earlier. More important, as discussed below, the terms of the agreement were never followed with regard to the services that Book performed or compensation that he received in addition to the specified monthly retainer. First Union began paying Book his monthly retainers beginning on June 7, 1993, the date that Haas actually began work on the opinion letter and template agreement and four days after First Union executed the FA Agreement, the first payment being in the amount of $3,000, to cover May and June. Ex. DX 94.

On September 2, 1993, Broward County closed on the first the refunding bond sales under the FA Agreement, Water and Sewer Refunding Bonds in the amount of $134,895, and paid First Union $92,740.31 as its fee on October 18, 1993. Exs. DX 29, 29A, 108. Book, who had been receiving his monthly retainers of $2,000, submitted a "REVISED INVOICE," dated October 19, 1993 (the day after First Union received its fee from Broward), in the amount of $7,700 for the month of October. Ex. DX 93. He also submitted an invoice in the amount of $7,750, dated October 31, 1993, for the month of November, and an invoice in the amount of $7,700, dated November 22, 1993, for the month of December. *Id.*

In a document signed on behalf of First Union, with a handwritten date of "10-15-93," Cawley increased Book's compensation to $7,700 per month for the months of October, November, and December 1993. The document recited the provision in the formal agreement with Book that provided for an increase in compensation "in the event the amount of the Firm's [Book's] time dedicated to First Union matters increases." Ex. DX 34.

In her investigative deposition, Cawley admitted that the increase in compensation was not due to Book's putting in extra time on First Union activities. Tr. 833-36. Book claimed not to remember why the compensation was increased or whether Cawley had told him that First Union had been paid by Broward. Tr. 1392-94. Thereafter, for the months of January, February, and March 1994, Book submitted invoices that reverted back to the $2,000 per month retainer. *Id.*

The additional $17,150 paid Book for October, November, and December over Book's standard $2,000 per month retainer amounted to 18.5% of the $92,740.31 fee paid by Broward to First Union for the first refunding transaction under the FA Agreement.
In addition to claiming a loss of memory with regard to why his compensation was increased, Book was unable to remember anything that he had done for First Union under the agreement. Tr. 1356. And when asked specifically about each of the services specified in the agreement, he was unable to recall performing them. *See, e.g.* Tr. 1330-44. Nor could Cawley support Book's having performed the services specified in either the agreement or invoices submitted by Book under the agreement. Although she claimed that Book had performed legal services for First Union, they amounted to little more than helping her fill out pro forma anti-apartheid and anti-Cuba affidavits. *See*, Tr. 651-55, 763-69, 849. Book eventually received a total of $48,050 in fees from First Union. DX 94; First Union Br. 14; Cawley Br. 60, n.82.

The evidence was clear, however, that Book and two other lobbyist-consulting firms had been hired during 1993 by First Union and Cawley to secure access to public officials and thereby assist First Union in getting municipal business. This was admitted by Cruz, who was Cawley's subordinate and, later, her successor as head of the office (Tr. 95-98), by Stephen Johns, who was Cawley's supervisor (Tr. 471-72), and by John P. Evans, who was Johns' superior (Tr. 1046-48). In fact, Johns' understanding was that Book was to receive more compensation than his standard monthly retainers (of $1,000 for the first month and $2,000 per month thereafter) if Book were successful in getting business in Broward County. Tr. 471-72. And, although Evans didn't recall exactly how the consultants were paid, he never thought it a problem for them to be paid on the basis of the business they generated, in the form of finders' fees. Tr. 1049.

That the formal agreements with the consultants merely disguised the actual arrangements was confirmed by the testimony of another of the lobbyist-consultants retained by Cawley and First Union at the time, James L. Watt, who was influential in the Palm Beach area of Florida. His firm's employment agreement with First Union (Ex. DX 32), was in the identical form and had almost identical provisions for *Services* and *Compensation* as the Book agreement that had been drafted by Haas (Ex. DX 3). Watt testified that he had been hired to introduce Cawley and First Union around to the political leadership for the purpose of getting First Union's participation in municipal bond issuances and that he didn't perform any of the services specified by the agreement. Tr. 1276-78.

On October 5, 1993, Broward County closed on the second refunding bond sales under the FA Agreement, General Obligation Refunding Bonds in the amount of $92,440,000, for which it paid First Union a fee of $61,160.69 on November 9, 1993. Exs. DX 29A, 110. There is no evidence that Book received any commission on this transaction. Although, as I find, First Union and Cawley had informally agreed to pay Book 20 percent of its fees for transactions under the FA Agreement, the evidence suggests that Book was not informed of the second refunding transaction and knew nothing of it even at the time of the evidentiary hearing in this proceeding so as to have demanded his commission, as he later did on the third refunding transaction, discussed below. On two

separate occasions, Book testified that he knew of only two "deals" that First Union transacted with Broward, apparently referring only to the first and third refunding transactions. Tr. 1357-58, 1392.

On April 20, 1994, Cawley left First Union and accepted a position with the Smith Mitchell Investment Group as Senior Vice-President and Manager of the Florida office. Tr. 919-24. As the lead underwriter, Smith Mitchell later purchased the bonds issued pursuant to the third refunding transaction covered by the FA Agreement between First Union and Broward. Tr. 157, 994-98. Cawley signed the Bond Purchase Agreement and other operative documents on behalf of Smith Mitchell. *Id.* At the time Cawley left First Union, Cruz had also planned on resigning to go with another firm, but was asked to accept a promotion to assistant vice president, which he did, and became the only remaining public finance officer for First Union in Miami. Tr.158-63.

On June 30, 1994, Broward County closed on the third bond refunding transaction under the FA Agreement, Tourist Development Refunding Bonds in the amount of $36,255,000, on which it paid First Union $21,753.00. Ex. DX 113. According to Cruz, prior to the closing, on June 20, 1994, he received a call from Book, who said that "he wanted to get paid for Broward," and Cruz asked him, "which deal?" Tr.180-81, 185. Book replied that it was the last deal, the upcoming June 30, 1994 deal. Tr. 186. Cruz then asked what the arrangement was, and Book replied that it was $2,000 per month, plus 20 percent. Tr.186-87. Cruz then called Cawley, who confirmed Book's statement, agreeing with the $2,000, plus 20 percent, and that Book had helped in Broward County. Tr.191, 201-2. Thereupon, Cruz called his superior in Charlotte, Gene Calahan, who was in charge of First Union's entire public operation in the southeast region, and told him what Book had said about the $2,000 and 20 percent, and that Cawley had confirmed it. Tr. 192-93. Calahan then asked Cruz to send him the file and write him a memo. Tr. 192. As a result, Cruz wrote the following memorandum, dated June 22, 1994:

On June 20, 1994, I received a call from Mr. Ronald L. Book inquiring as to how we would settle our accounts with him. Mr. Book served as our consultant for about one year and was instrumental in securing our position as financial advisor for Broward County.

He informed me that the arrangement he had with First Union was a monthly retainer of $2000 plus 20% of the profits. In looking through the files, I did not find this agreement in the contract, however, I did find invoices that were for substantially more than $2000 (his monthly retainer). I believe that this was a good faith agreement and not a written agreement.

Gene, I informed Ronnie, that I would look into it and get back to him. Please call me if you have any questions.

Ex. DX 70.

In writing this memorandum, Cruz tried to be as accurate as possible. Tr. 194. There was no doubt in his mind that it was true. Tr. 202. A handwritten memorandum written to by Cruz to himself and dated the same day ("6/22") reads: "Ask Ronnie [Book] if the arrangement was inclusive of the retainer or in addition to retainer." Ex. DX 69. Apparently, although Cruz was certain that Book was to receive 20 percent of the

Broward fees paid to First Union on the refunding transactions, he was uncertain as to whether Book was to receive the standard $2,000 per month retainer in addition. Shortly after drafting the June 22 memorandum, Cruz received an invoice from Book for $4,350 for services "related to Broward financing and other matters." Ex. DX 72A. The invoiced sum amounted to 20 percent of First Union's earnings of $21,753 on the Tourist bond refunding sale. In light of his prior communications with Book, as confirmed by Cawley, this invoice was what Cruz expected and did not surprise him. Tr. 219-22. Cruz forwarded the bill to Calahan. Tr. 222-23.

At some point, Calahan asked Cruz for more information and, on August 9, 1994, Cruz sent him another memorandum about First Union's relationship with Ronnie Book. Tr. 227; Ex. DX 80. This time, Cruz conducted an even more detailed investigation, and asked AJ, the office secretary, to assist him in writing the memorandum both because he knew that she knew how Book had been paid, and because he valued her input. Tr. 227-29. Cruz wanted to set forth the most "accurate summary possible of First Union's relationship with Book," so he asked AJ to "research it." Tr. at 229.

In the August 9 memorandum, Cruz told Calahan that, based on his review of the file, certain matters had become "manifest." Ex. DX 80. First, Cruz explained that Book "was never retained as a legal counsel. Our contractual relationship establishes him as a consultant and lobbyist, an expertise for which he is well known in South Florida." *Id*. Second, Cruz told Calahan that the increase in Book's compensation to $7,700 for each of the months of October, November and December 1993 was "directly related to work with Broward County." Finally, Cruz told Calahan, as he had in the June 22 memorandum, that Book's efforts "were a force behind [First Union's] award" of the Financial Advisory Agreement in Broward County. *Id*. First Union paid Book's $4,350 invoice for services "related to Broward financing," amounting to 20% of First Union's fee on the transaction, on October 3, 1994. Ex. DX 94.1/

On September 2, 1993, October 5, 1993, and June 30, 1994, respectively, the closing dates for the three refunding transactions, the County's Bond Counsel on the transactions, filed documents with the Division of Bond Finance of the Florida state government as required by law, including Bond Disclosure Forms, referred to as BF Forms. Exs. DX 109, 111, 114. The BF Forms included an item 11, which requested a listing of "Any fee, bonus, or gratuity paid in connection with the bond issue, by any underwriter or financial consultant to any person not regularly employed or engaged by such underwriter or consultant." *Id.* The BF Forms stated that they were to be filed as required by Section 218.38(1)(c)1 of the Florida Statutes. *Id.* Subsection e of Section 218(1)(c)1 contained language identical to Item 11 of the BF Form. On the first two refunding transactions, Item 11 was left blank. Exs. DX 109, 111. On the third refunding transaction, two firms engaged by the underwriter were listed, but Book was not. Ex. DX 114.
The standard procedure, which was followed in these refunding transactions, is to send out the closing documents, including the completed BF Forms, to all involved parties ten days to two weeks before the closing for their corrections. Tr.1165. The documents are also available for review and comment on a big closing table at a pre-closing held in the office of underwriter's counsel the day before the closing. Any party could request a

change at any time. Tr. 1165-66. At the closing, the next day, the documents remained in the same place, and anyone noticing a mistake or inaccuracy could request that the documents be changed. Tr. 1166.

Cawley testified that she was familiar with the BF Forms and had seen at least the one filed with the first refunding transaction (Ex. DX 109), and believed that she had seen the one filed with the second refunding transaction (Ex. DX 111). Tr. 799. Her calendars for 1993 and 1994 confirm that the closings for the three refunding transactions under the FA Agreement were held on the September 2, 1993, October 5, 1993, and June 30, 1994, respectively, and that the pre-closings for each had been held on the day before the closings. Exs. DX 154, 158. In her calendar for 1993 (Ex. DX 154), Cawley inserted her "ok" next to "Preclose Broward County" on September 1, and next to "CLOSE Broward County" on September 2, indicating that she was aware of, and had attended, both the preclosing and closing of the first refunding transaction under the FA Agreement, involving the Water and Sewer Refunding Bonds, on those respective dates.

Cawley took item 11 of the BF forms at face value and understood it to ask whether the Financial Advisor for the refunding transactions had paid anyone in connection with the transaction who didn't work for it. Tr. 801-02. She testified that the sole reason she did not have Book listed as receiving payment, or even mention Book to First Union's attorney for the closing, was that Book had done nothing on the deal. Tr. 802-03. Kenneth M. Myers, Bond Counsel for Broward County on the first and second refunding transactions under the FA Agreement, testified that he was not aware of any relationship between First Union and Book on those transactions and that if he had known of one that fit the literal terms of item 11, he would have reported it to the state on the form as requested in Item 11 and in compliance with the language of Section 218.38 of the Florida Statutes on which Item 11 was based. Tr. 1170-73. He was not aware of any rules or regulations issued by the Division of Bond Finance on how to construe the BF Form or fill it out, particularly with regard to item 11. Tr. 1172.

Orlando Cruz, who had succeeded to Cawley's position when she left First Union, and his supervisor in Orlando, Phil Roberts, represented First Union at the closing of the third refunding transaction. Neither of them notified the Broward County officials that Book was involved in the transaction or that he had recently requested to be paid out of First Union's fees from the transaction. Tr. 219. Cawley, who had left First Union two months earlier, represented Smith Mitchell, the underwriter on that transaction. She signed the Bond Purchase Agreement on behalf of Smith Mitchell and all other documents for that transaction unless she happened to be unavailable when they needed to be signed. Tr. 994-97. On her calendar for 1994, she put her "ok" next to her listing of the pre-closing on June 29, 1994, and next to her listing of the closing on June 30, 1994, signifying that she was aware of and had attended each. Ex. DX 158.

B. Ultimate Facts

On the basis of the primary facts discussed above, I find the evidence overwhelming that, prior to First Union's receiving the award of the FA Agreement, Cawley and First Union informally retained Book, who was not otherwise employed by First Union, as a lobbyist to secure agreements with Broward County and other municipalities. Under the informal

agreement, he was to be paid a fee, contingent on his securing this business, which would include a monthly retainer and 20 percent of the fees paid to First Union on the business he secured. I find that as fact.

I further find as fact that Cawley and First Union attributed their securing the FA Agreement to Book's efforts, that First Union began paying him his monthly retainer when and because they had entered into the FA Agreement, and that First Union paid him approximately 20% of First Union's fees from the first and third refunding transactions, pursuant to this informal arrangement. I conclude that, having entered into this arrangement with Book, when Cawley and First Union accepted the warranty contained in the FA Agreement they knew it to be false because they knew that Book was not a regular employee of First Union, that they had retained him primarily to solicit Broward County business (including the FA Agreement), and that they had agreed to pay him fees based upon First Union's being awarded the FA Agreement and receiving fees under it. The reason that Book's written agreement provided for only $1,000 for the month of May 1993 was that First Union was informally notified that it had been awarded the FA Agreement in the middle of May, signifying the success of Book's efforts and initiating his $2,000 per month retainer rate.

I find, however, that the execution of the FA Agreement by Cawley and First Union that included the false warranty occurred on June 8, 1993, more than five years before the Division brought this action against First Union on August 27, 1998, and more than five years before it entered into an agreement with Cawley tolling the statute of limitations as of September 2, 1998.

I further find that Cawley and First Union purposely deceived Bond Counsel for Broward County at the pre-closing and closing on the first refunding transaction by deliberately omitting to mention that fees were to be paid Book on that transaction. This resulted in Bond Counsel's omitting Book's name as a person to whom a fee was to be paid when he completed Item 11 of the BF forms, contrary to his usual procedure of reporting all recipients of fees, including those receiving fees from financial advisors. In that this action was brought against First Union on August 27, 1998, within five years after the closing on that transaction on September 2, 1993, and the statute of limitations was tolled against Cawley as of September 2, 1998, the last day of the five-year period following the closing, I find that the actions against both respondents are timely as to that act of deception.

Because Cawley and First Union did not intend to pay, and did not pay, Book a fee on the second refunding transaction, I find that they did not deceive Bond Counsel in omitting mention of Book in Item 11 of the BF Form.
On the third refunding transaction, I find that First Union, through its representatives Orlando Cruz and Phil Roberts, again purposely deceived Broward County by failing to inform its officials of Book's role in the transaction and of his request to receive 20 percent of First Union's fee. Cruz's conversation with Book and his confirming conversation with Cawley had taken place only 10 days before the closing, and Cruz's

first memorandum about Book's role in the transaction and his request for a percentage of First Union's fee was written shortly thereafter.

However, although Cawley participated in the third refunding transaction as a principal of the underwriter, she no longer represented First Union, nor sat on the same side of the table with Broward County in any capacity. Consequently, I find that she had no fiduciary obligation to report fees intended to be paid by her ex-employer First Union to a lobbyist on the transaction, notwithstanding any actual knowledge she might have had of them and, consequently, cannot be considered as having deceived Broward County at that closing.

C. Lack of Credible Contrary Evidence

That is not to say that there was no evidence adduced to the contrary of what has been found above. There was testimony to the effect that there was no informal arrangement with Book to pay him fees based on business he secured in Broward County and that Cruz was an incompetent, unknowledgeable, low-level employee, who had merely speculated, erroneously, on there being such an arrangement. There was ample evidence, however, that Cruz was and remains a valued employee of First Union or affiliate and that he was knowledgeable about the three similar lobbyist-consultant arrangements entered into by First Union at the time, including Book's, even though Cawley was Book's exclusive contact at First Union before her resignation. Moreover, Cruz's August 9, 1994 memorandum (Ex. DX 80) describing Book as a "great force" behind First Union's award of a contract in Broward County takes on added weight because of the role ascribed to the office secretary, AJ, in drafting the document. According to Cruz, AJ possessed a legal background, was fully knowledgeable about the manner in which Book was paid, and, in the interest of accuracy, actually wrote the document after consultation with Cruz, who signed and sent it up. Tr. 227-229. AJ appeared as the last witness at hearing. Of all the witnesses with first-hand knowledge of the basic facts of the case, she was by far the most credible. It would be difficult to imagine her drafting a document that was not truthful and accurate.

Cruz and Cawley also gave testimony that was at odds with the facts found above, much of which is cited in Respondents' briefs. None of that testimony was credible. On almost each such item of testimony that Cruz gave, he was forced to admit that it was a newly-offered version of events that conflicted with his prior testimony given at an investigative deposition two years before and that his prior testimony was correct. *See, e.g.*, Tr. 75-77, 81-87, 90, 94, 101-03, 108-09, 114, 122-24, 138-40, 149-51, 190-91, 197-201, 221-24, 275-76. At one point, having already contradicted his prior testimony on many matters, Cruz asked to see his prior testimony before answering the question. Tr. 141.
Cawley's testimony was even less credible. She contradicted herself and was contradicted by unimpeachable documentary and testimonial evidence on numerous occasions and, on a number of matters on which she testified, she could not supply any expected details that would substantiate the testimony. *See, e.g.*, Tr. 503-07, 534, 570-78, 597-98, 600, 623, 635-641, 645-48, 683, 713, 715, 718-19, 730-33, 743, 757-62, 833-37, 844, 850, 853-54, 860-62, 865-72, 883-91, 896-98, 901-06, 926-27, 930, 953, 989-90, 999.

Similarly, Book, who admits to being a close personal and professional friend of Cawley, to representing her now under an informal arrangement, and to meeting privately with her attorney prior to hearing (while refusing to meet with the Division's attorney) (*see*, Tr. 1295-96, 1381-82), attempted to testify in Cawley's favor, including making unsolicited speeches (*see, e.g.*, 1375-76). Although he prided himself on being the best prepared lobbyist at the State legislature (Tr. 1314-15), he claimed to have an almost total lack of recall when asked of the specifics of his arrangement with First Union. But on certain matters, his professed lack of memory was telling. He could not remember whether he had discussed a fee based on a percentage of First Union's profits with Cawley (Tr. 1376-77), and he could not remember having the critical conversation with Cruz about being paid a 20 percent fee in connection with the June 30, 1994 refunding transaction, but does not deny that it happened (Tr. 1418). If, however, he had not had an arrangement to be paid a percentage of First Union's fees from Broward business, how could he not have been certain that he had not had both the conversation with Cawley providing for such fees and the conversation with Cruz demanding such a fee on the last refunding transaction? All of Cruz's, Cawley's, and Book's testimony contrary to the facts found above was carefully examined, considered, and rejected as not credible.

My findings are based on the preponderance of testimonial and documentary evidence admitted into the record and my observation of the witnesses testifying at the evidentiary hearing.

III. Discussion

A. Overview

As found above, First Union and Cawley retained Ronald Book, a lobbyist-consultant, to lobby Broward County and other municipalities on their behalf for municipal bond investment business under an informal agreement to pay Book a monthly retainer and percentage of fees derived from that business. When they subsequently entered into an agreement with Broward to act as the County's financial advisor on prospective bond refundings, they falsely warranted, as part of the agreement, that they had not retained any person other than an employee working solely for First Union to solicit the agreement, nor agreed to pay any such non-sole-employee a consideration based on the agreement. Upon being awarded the FA Agreement, however, they began paying Book a monthly retainer and, when First Union received fees on the first and third refunding transactions under the FA Agreement, First Union paid him a percentage of those fees pursuant to the informal agreement.

At the outset, First Union raises a philosophical objection to finding a violation of Exchange Act in this proceeding where the Division did not call Broward County officials to testify that they "had been lobbied or deceived when they selected First Union as financial advisor in May 1993." First Union Br. 3. According to First Union, "not a single person said he or she was lobbied or deceived, before or after the execution of the financial advisory contract." *Id.* Consequently, First Union offers, this "might be the only case in which the Division has decided that a sophisticated municipality was a 'victim,' and then elected not to call the 'victim' to testify at the trial of the alleged perpetrators, apparently aware that the 'victim' would not support the Division's theory." *Id.* at 3-4.

First Union, apparently, is confused about whom the alleged victims might be. Clearly, they are not the lobbied or corrupted officials, but the people these officials represent. It is the taxpayers and residents of Broward County who are the victims of a system in which municipal contracts are surreptitiously awarded on the basis of influence, rather than merit, and fees paid by the County are inflated by lobbyists' commissions. Public officials who collude with lobbyists in such a scheme are perpetrators, not victims, and it can hardly be expected that they would be eager to testify about their transgressions. Having to rely upon the cooperation of the lobbied officials to protect the system would be akin to having the foxes guard the chicken coop.

Neither their testimony nor their agreement is needed, however, to successfully prosecute an action to protect their constituents. The required warranty and the "finders" statute do not require proving that lobbyists actually influenced the awarding of a contract, which would be almost impossible to prove, but only that there had been a failure to disclose that they had been hired to do so or that they had been paid on the basis of the award. Presumably, if the prospective fees were disclosed to the public, the contract offer would be withdrawn.

The SEC has the authority to bring its own independent action to safeguard the process, rather than leave enforcement of the disclosure requirements to the same county officials that may have been corrupted, provided that the Exchange Act and the MSRB rules promulgated thereunder encompass the specific violation. That there is a need for SEC intervention in the municipal bond business being conducted in South Florida is apparent. From the evidence adduced at hearing, the use of outside lobbyists to influence municipal business is extensive, contrary to the intent of the statutes, and deserves corrective action. Whether this is the proper proceeding, within the statutory and regulatory framework, to begin to correct the situation, is what is discussed below.

In this case, I find that Respondents executed an agreement that contained a warranty that they knew to be false, and that Section 15B(c)(1) of the Exchange Act and MSRB Rule G-17 cover this act of deception. I find, however, that the 5-year statute of limitations has run on this initial deception. But I also find that Respondents had a fiduciary obligation, when acting as Broward County's financial advisor, to notify the County's Bond Counsel at the pre-closings and closings of the bond refunding transactions under the agreement of any fees they intended to pay to lobbyists on the transactions. Because First Union intended to pay Ronald Book on the first and third refunding transactions, it was required to disclose these fees to Bond Counsel for inclusion in Item 11 of the BF Forms when the transactions closed. The evidence shows that First Union and Cawley purposely failed to disclose to Broward County's Bond Counsel on the first refunding transaction their fee arrangement with Book, in continuing to hide Book's involvement in the transaction. Consequently, I find their non-disclosure on the first refunding transaction to be a deceptive act that violated Section 15B(c)(1) of the Exchange Act and MSRB Rule G-17. In that it occurred within five years before this action was commenced against First Union and within five years before the statute of limitations was tolled against Cawley, I find that this act of non-disclosure is actionable against both respondents.

On the second refunding transaction, First Union and Cawley did not intend to, and did not, pay Book any percentage of First Union's fee. Consequently, there was nothing to disclose, and no violation of the Exchange Act or MSRB rules occurred.

On the third refunding transaction, First Union's representatives again purposely deceived the County by not disclosing the 20 percent fee that Book had only recently demanded and which they subsequently paid. I find that this again was a deceptive act that violated Section 15B(c)(1) of the Exchange Act and MSRB Rule G-17. This action also fell within the five-year period before the commencement of this action against First Union and is not barred by the statute of limitations. However, I do not find Cawley's coincidental participation in the third refunding transaction as a principal of the underwriter which, unlike a financial advisor, places her on the other side of the table from Broward County, to have required her to disclose Book's expected fees from First Union, notwithstanding her personal knowledge of them. Consequently, I do not find any violation of the Exchange Act or MSRB rules by her on that transaction.

B. Respondents Violated MSRB Rule G-17

Section 15B(b) of the Exchange Act, 15 U.S.C. § 78o-4(b), enacted on June 4, 1975, required the Commission to establish the Municipal Securities Rulemaking Board to propose and adopt rules "with respect to transactions in municipal securities effected by brokers, dealers, and municipal securities dealers" that are designed, in part, "to prevent fraudulent and manipulative acts and practices . . . and, in general, to protect investors and the public interest."

Pursuant to this mandate, the MSRB was established and proposed rules which the Commission adopted, including Rule G-17 which provides, in full, as follows:

In the conduct of its municipal securities business, each broker, dealer, and municipal securities dealer shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice.

MSRB Manual § 3581 at 4871. The terms "broker," "dealer," and "municipal securities dealer" are defined, in turn, to include "their respective associated persons." Rule D-11, MSRB Manual § 3246. As a registered broker-dealer and municipal securities dealer, as well as an associated person of First Union, Cawley was bound by Rule G-17, as was First Union.

On the facts found above, First Union and Cawley were in violation of Rule G-17. Their actions in falsely warranting that they had not retained any person other than a bona fide employee working solely for First Union to solicit the FA Agreement and had not agreed to pay any such non-bona fide employee a fee resulting from the Agreement were deceptive, dishonest, and unfair in light of their having retained Book to solicit the agreement and agreed to pay him a percentage of First Union's fees. Similarly, especially in the context of the false warranty, their intentional failure later to inform Broward County representatives at the closing of the first refunding transaction, and First Union's failure to disclose at the third refunding transaction, that First Union intended to pay Book a percentage of its fees from the transactions, so as to have him listed in Item 11 of the BF Forms that requested such information, were acts of omission that were deceptive,

dishonest, and unfair. These acts of concealment were premised on their continuing pretense that they did not intend to pay Book a percentage of First Union's fees from the refunding transactions.

The MSRB has consistently stated that a failure to disclose material information violates Rule G-17. *See, e.g.,* MSRB Manual ¶ 3581 at 4878. For instance, the MSRB has interpreted G-17 "to require municipal securities dealers that assist in the preparation of refunding documents as underwriters or financial advisers to alert issuers of the materiality of information relating to the callability of escrowed-to-maturity securities." MSRB Manual, § 3581 at 4860-61.

Respondents, however, contend that First Union was acting in the capacity of a financial advisor, rather than a municipal securities dealer, and that, consequently, Rule G-17, which applies only to those in "the conduct of [a] municipal securities business," does not cover this situation. First Union Br. 26-30; Cawley Br. 45-49. They read into the rule the requirement that the alleged violator be "acting as" a municipal securities dealer to be covered. First Union cites Section 3(a)(30) of the Exchange Act, 15 U.S.C. § 78c(a)(30), for the definition of a "municipal securities dealer" as being one "engaged in the business of buying and selling municipal securities for his own account, through a broker or otherwise." Br. 29. Only the underwriters in each transaction, not the financial advisor to the County, were acting in the capacity of a municipal securities dealer.

Furthermore, according to Respondents, it would be unfair to apply Rule G-17 to them here in that it had never been applied before to financial advisors in their relationship with issuers, except in the context of directing financial advisors to advise issuers to deal fairly with *investors*. First Union Br. 27; Cawley Br. 46-47. They cite *Upton v. SEC*, 75 F.3d 92, 98 (2d Cir. 1996), for the proposition that the Commission may not sanction alleged violators pursuant to a change in its enforcement policy that was not reasonably communicated to the public, and *Checkosky v. SEC*, 139 F.3d 221, 225-226 (D.C. Cir. 1998), for the similar proposition that the government cannot deprive citizens of the opportunity to practice their profession without revealing the standard they have been found to be violating. First Union Br. 26; Cawley 48.

Along this vein, they continue that the Division has failed to prove that Respondents acted with scienter, which they claim is a necessary prerequisite to being found in violation of Rule G-17. First Union Br. 44; Cawley 43, 67. Citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) for the proposition that scienter refers to a mental state involving an "intent to deceive, manipulate, or defraud," they contend that the Division has failed to prove intentional misconduct on the part of Respondents. Cawley Br. 43; First Union Br. 44.

Respondents' contentions miss the mark. There is no language in Rule G-17 that restricts its coverage to those "acting as" municipal securities dealers. It is sufficient that the entity be a broker, dealer or municipal securities dealer, and that its actions be "[i]n the conduct of its municipal securities business." Rule G-17. The MSRB rules recognize that acting as a financial advisor is one of the functions typically performed by a municipal securities

dealer. Rule G-1 includes, as municipal securities activities of a bank (such as First Union), "financial advisory and consultant services for issuers in connection with the issuance of municipal securities." Rule G-1(b)(2). The same language is used in Rule G-3(b)(B) to describe the activities of a municipal securities principal, Cawley's position at First Union's South Florida office (Tr. 985). Rule G-23 is devoted to brokers, dealers, and municipal securities dealers who act as financial advisors to issuers, in further recognition that financial advisory services to issuers are part of the conduct of a municipal securities business. Similarly, First Union's own Compliance Manual classifies its activity of rendering financial advisory services as "acting as a municipal securities broker-dealer," and requires its employees to register as Municipal Securities Representatives if they supervise financial advisory services, putting itself and its employees on notice that financial advisory services are considered part of conducting a municipal securities business. Ex. DX 27 at P-7, P-9. That same Compliance Manual references MSRB Rule G-17 and points out that First Union "is required to deal fairly with all its customers and may not engage in any deceptive, dishonest or unfair practice." *Id.*

Moreover, even if there were some merit to Respondents' position that municipal securities dealers rendering financial advisory services should not ordinarily be considered as conducting a municipal securities business, which there is not, that proposition would not apply to First Union on the particular facts of this case. As Cawley agreed in her testimony, acting as financial advisor to Broward County was not as lucrative as being senior managing underwriter and, in building a municipal securities business in Broward County, you had to work your way up by, first, becoming a financial advisor, then, moving to the underwriting pool and, finally, becoming a senior managing underwriter. Tr. 720. Even if we were to consider only the latter stages, that of being an underwriter, as acting as a municipal securities dealer, in accepting the role here of financial advisor to Broward, First Union and Cawley were furthering, and hence conducting, their municipal securities business because they were using that position as a first step in becoming an underwriter to the County.

Nor was it unfair to charge Respondents with violating Rule G-17, even if that were the first time the rule was used to regulate the relationship between a financial advisor and the issuer. The situation here is unlike those in *Upton, supra* and *Checkosky, supra*, relied upon by Respondents for their every-dog-gets-its-first-bite defense, which involved complex accounting conventions in which the methodologies utilized by the respondents were not in themselves fraudulent, but were only made so by the rules (or a changed interpretation of the rules), in the context in which they were utilized. In *Upton*, it was a changed interpretation of a rule.

Upton involved a complex formula for the calculation of broker-dealers' customer reserves to be held in separate bank accounts, concerning which companies had been permitted to evade the requirements by paying down loans secured by customer securities that they replaced with unsecured loans at higher interest just before the required weekly Rule 15c3-3(e) computation, a procedure they reversed shortly after the computation. Upton was a supervisory employee of a firm in which another employee had been notified by a New York Stock Exchange examiner that the practice was questionable, but

did not stop that practice until the SEC staff had notified Upton personally that the practice violated the spirit of Rule 15c3-3(e). Thereupon, Upton immediately ceased the practice. Several months later, the N.Y.S.E. circulated an Interpretation Memo in which it advised its members, for the first time, that the paydown practice might violate Rule 15c3-3(e). After finding that the paydown practice did violate the rule, the Commission censured Upton for failing reasonably to supervise his subordinate with a view toward's preventing the violation.

The Court of Appeals, however, after finding that Upton's firm had "complied with the literal terms of the Rule at all times (75 F.3d at 94), reversed, on the ground that, "[b]ecause there was substantial uncertainty in the Commission's interpretation of Rule 15c3-3(e), Upton was not on reasonable notice that [his firm's] conduct might violate the Rule" (*id.* at 98).

In contrast to *Upton*, the instant case does not involve a long-established practice that is not inherently wrongful, except as interpreted by the Commission within the context of a particular situation, nor a literal compliance with the rule as written. Here, there was no uncertainty as to whether First Union and Cawley's actions in executing a false warranty and concealing information required to be disclosed in the documentation were wrongful. Those actions were inherently and knowingly wrong without being made so by a rule or regulatory interpretation, and are wrong in every context. Respondents cannot seriously contend that, if they had retained Book to secure the FA Agreement on a commission basis, they would not have known that their acts of concealment were wrongful. It is not the wrongfulness of their actions on which they are claiming to have been misled, as in *Upton,* but on the reach of Rule G-17 to embrace these wrongful actions, in that they were performed while acting as a financial advisor and not as a municipal securities dealer.

And also here, unlike *Upton*, the literal language the rule does not aid them. Rule G-17 only required that the acts take place within the conduct of a municipal securities business, and other MSRB rules (G-1, G-3, and G-23) specifically included financial advisory services within the scope of a municipal securities business, as did First Union's own Compliance Manual. Once that condition, of conducting a municipal securities business, was satisfied, Rule G-17 required that a "municipal securities dealer . . . deal fairly with all persons," necessarily including the issuer, Broward County, for whom First Union acted as financial advisor. Consequently, Respondents cannot claim they were not on reasonable notice that their wrongful acts would be covered or that they should not be covered because of the literal words of the rules. It is they who would vary the literal words by adding an "acting as a municipal securities dealer" condition to Rule G-17 and ignoring the other pertinent MSRB rules.

Nor is it even necessary, in the context of an act of deliberate deceit by a fiduciary that is inherently and transparently wrongful, to demonstrate that the wrongdoer knew the specifics of the rule or statute that was violated. In this regard, *see, the Matter of Wonsover*, 69 SEC Docket 169, 1999 WL 100935 (Mar. 1, 1999), and the cases cited therein at n. 36, where the Commission interpreted the word "willful" in Section 15(b)(4)

of the Exchange Act as not requiring knowledge that the wrongful act was unlawful. Here, it is apparent that Respondents knew or should have known that the act was wrongful, whether or not they knew that it violated a specific rule or statute, which is clear from the nature of the act itself. Moreover, First Union's entering into the bogus, pre-dated, written agreement with Book is confirmation that they viewed their actual, informal agreement with him as being in violation of their warranty in the FA Agreement, making their execution of the warranty wrongful, as was their subsequent concealment from Broward representatives of the intended payments to Book when they closed the refunding transactions. Having been shown to have intentionally deceived the County in deliberately falsely warranting, and then intentionally concealing, their intended payments to Book, even the strictest construction of scienter has been satisfied. Certainly, the test of *Ernst & Ernst v. Hochfelder, supra*, requiring a showing of an intent to deceive, manipulate, or defraud, has been fully satisfied.

Checkosky, supra, is also inapposite. Like *Upton, supra*, it involved an accounting practice that was not inherently wrongful except as proscribed by rule, in this case rules of the Financial Accounting Standards Board determining whether start-up costs should be capitalized or expensed under generally accepted accounting principals (GAAP). The company had improperly deferred $37 in start-up costs and the two respondents, independent auditors, improperly reported that the company's statements conformed to GAAP. The Commission suspended them from practicing before it for two years for violating its rules. The Court of Appeals reversed on the ground that the Commission had failed to provide a clear mental standard that it applied to the respondents for disciplining their alleged improper professional behavior, after having gravitated in its discussion from a reliance on "recklessness," to "negligence," to "negligent actions . . . under certain [undefined] circumstances." 139 F.3d at 224-27.

Unlike *Checkosky,* there is no ambiguity in this proceeding on Respondents' culpability or state of mind, based on the findings made, above. They were aware that falsely warranting and concealing required information from the County were acts of deception and, hence, wrongful, whether or not covered by a specific statute or rule, and they intentionally committed those wrongful acts.

First Union also contends that Rule G-17 does not apply to municipal securities dealers acting in the capacity of financial advisors because Rule G-23 sets the exclusive ethical standards and disclosure requirements for dealers acting in that capacity. First Union Br. 30-32. In support of that proposition, First Union cites Rule G-23(a), as follows:
(a) *Purpose*. The purpose and intent of this rule is to establish ethical standards and disclosure requirements for brokers, dealers, and municipal securities dealers who act as financial advisors to issuers of municipal securities.
Id. at 31.

Its argument follows that, because Rule G-23 does not require disclosure of the engagement of a lobbyist to secure a financial advisory agreement in exchange for a contingent fee, or of disclosure of a "breach of contract, there is no established disclosure standard under MSRB Rules" that applies here. *Id.* at 31-32.

It is not irrational to read the language of Rule G-23(a) in isolation and conclude, as does First Union, that the rule contains the exclusive standards and disclosure requirements for municipal securities dealers acting as financial advisors. We cannot ignore, however, the structure of the MSRB rules, their administrative history and their purposes in determining the reach, respectively, of Rules G-17 and G-23.

Although Rule G-23 was adopted in final form after the adoption of Rule G-17, both were proposed by the MSRB at the same time as part of a group of proposed rules. *See*, *Notice of Filing of Fair Practice Rules*, 1977-78 CCH Transfer Binder ¶ 10,030 (Sept. 20, 1977). In explaining proposed Rule G-17, the Board made it clear that it covered financial advisory services. The Board stated, as follows:

The Board has adopted the suggestion of one commentator to expand the scope of the proposed rule to cover conduct in the municipal securities business, rather than conduct solely involving transactions in municipal securities. The Board believes this to be an appropriate expansion, given the fact that the activities of a municipal securities professional relate not only to transactions actually effected, but to a variety of other matters, including financial and investment advice.

Id. at 10,373.
In contrast, when the Board explained proposed rule G-23, it stated as follows:

Proposed Rule G-23 addresses *certain activities* of the conduct of a municipal securities professional acting as a financial advisor or consultant to a state or local governmental unit.

Id. at 10,377; emphasis added.

In adopting the MSRB rules, in which it did not at first include proposed Rule G-23, the Commission endorsed this concept of Rule G-17's establishing the general standard of conduct for municipal securities professionals, applicable to all, and the other rules' addressing only specific aspects of the municipal securities business. The Commission stated that Rule G-17 was an "omnibus fair practice rule" meant to "establish the general standard for conduct of a municipal securities professional," while "[t]he other proposed rules would provide, in essence, an elaboration upon this general standard, by establishing guidelines for particular subject matters." *In the matter of Municipal Securities Rulemaking Board*, Order Approving Proposed Rule Change, Exchange Act Rel. No. 15247 (Oct. 19, 1978).

Nor is it even reasonable to suppose that, having established general rules of ethical behavior to govern the conduct of the municipal securities business, which the MSRB recognized as including financial advisory services, either the Board or the Commission would have intended to exempt municipal securities professionals acting as FAs from those general ethical standards. What purpose could have been served by carving out an exemption from the general ethical standards for some municipal securities professionals because of the particular function they are currently performing within their municipal securities business?

First Union attempts to further its position with a misleading paraphrase of the MSRB's explanation of proposed Rule G-23 in its proposed rule submission. First Union offers that the MSRB told the SEC that it was "neither necessary nor appropriate to have a rule requiring financial advisors to disclose to issuers *all* material information in the selection process." First Union Br. 27. In fact, the MSRB referred only to limiting disclosures relating to the experience and qualifications of financial advisors, not disclosures relating to their dealings with the issuers. 1977-1978 CCH Transfer Binder ¶ 10,030 at 10,380. Rule G-23 does not address the acts of deception that Respondents committed against Broward County because its focus was primarily upon a narrow aspect of the municipal securities business, that of a financial advisor who intends to assume the role of underwriter, in whole or in part, on the securities being issued. That it does not also cover the disclosure and fair dealing requirements of a municipal securities professional acting as a financial advisor with regard to the circumstances of its entering into the relationship with the issuer is not surprising considering its narrow focus. But that relationship, in all of its aspects, remains, nonetheless, still subject to the general and universally applicable (to municipal securities professionals) requirements of disclosure and fair dealing imposed by Rule G-17. In this case, it required disclosure of First Union's actual relationship with Book when Respondents were confronted with the warranty and closing documents. Having entered into the false warranty and concealed First Union's relationship with Book at the closings, respondents violated MSRB Rule G-17.

C. Respondents Violated Section 15B(c)(1) of the Exchange Act

Section 15B(c)(1) of the Exchange Act provides:

(1) No broker, dealer, or municipal securities dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or induce or attempt to induce the purchase or sale of, any municipal security in contravention of any rule of the [Municipal Securities Rulemaking] Board.

15 U.S.C. § 78o-4(c)(1). Having determined that Respondents violated MSRB Rule G-17, the Division further contends that it has violated this section of the Exchange Act. Respondents respond, however, that Section 15B(c)(1) is not applicable. To begin with, they read into this statute the same "acting as" or "acting in the capacity of" language that they attempted to add to Rule G-17, *supra*. First Union Br. 48; Cawley Br. 39. But this language is no more present in the statute than it was in the rule. Without repeating the discussion, above, the MSRB has determined that the conduct of a municipal securities business includes acting as financial advisor to issuers, to which their rules should apply. It would be improper not to defer to a reasonable determination by that entity, which had been established to provide its expertise in devising rules to apply the statute. Their reasonable interpretation of the statute, as reflected in their proposed rules, that were also reviewed and adopted by the Commission in applying its own expertise, must be accorded some deference in interpreting the statute that they were appointed apply. Respondents have offered no persuasive reason why, contrary to the interpretation of the MSRB and Commission, as reflected in the MSRB rules, we should read into the statute words of restriction that would immunize any part of a municipal securities business from the ethical standards adopted to govern practitioners of that business.

Respondents further contend that Section 15B(c)(1) does not apply because it requires that the municipal securities dealer "induce or attempt to induce the purchase or sale" of a municipal security, and First Union did nothing to induce the transactions under the FA Agreement. First Union Br. 49; Cawley Br. 41. In that, they contend that the Broward County staff had already identified the refundings it intended to do before First Union submitted its proposal based on the County's refunding criteria. *Id.* And, even if First Union could be considered as having induced the refunding transactions, First Union further contends that there was a "disconnect" between the alleged violation of Rule G-17, the alleged false warranting, and its role in the inducement of the transaction, which should not be subject to the prohibitions of Section 15B(c)(1). First Union Br.50.
In centering on the "induce or attempt to induce" language in the statute, Respondents ignore the prior phrase "effect any transaction in," which broadens the coverage of the statute. Even if First Union had not induced or attempted to induce the transactions, it would be covered by the statute if it had "effected" the transactions. As financial advisor under the FA Agreement, it assisted the County in effecting the transactions and must also be considered as effecting them, bringing it within the ambit of the statute.

Furthermore, despite Cawley's testimony to the contrary, the facts establish that First Union played a substantial role in inducing the refunding transactions under the FA Agreement. First Union's "Proposal to Provide Financial Advisory" services in response to the Request for Letters of Interest issued by Broward County set forth its "Recommended approach for Broward County" and stated that First Union "currently recommend[ed]" refunding five separate bond issues, all of which could, in First Union's view, be advance refunded under applicable federal tax laws. Ex. DX 6 at 6357. First Union's proposal then discussed each of the five issues in detail and the savings to be achieved by Broward in refunding the bonds. *Id.* at 6357-6362. Each of the refunding transactions eventually consummated under the FA Agreement had been recommended by First Union in its proposal to provide the financial advisory services. Tr. 792-3; *compare* Ex. DX 6 at FUMC 6357, 6361 *with* Ex. DX 114. First Union's recommendations regarding the refunding transactions were its main function under the agreement, for which it eventually received $175,000 in fees, and it cannot seriously contend that it did not have a major role in the selection of the transactions.
Moreover, under the FA Agreement First Union was paid only on the basis of the transactions consummated. Consequently, it was in its interests to induce as many refunding transactions as possible, which presumably it did in its proposal, within the guidelines formulated by the County. Merely by having the County select its proposal to become the financial advisor, it induced the transactions it recommended. In that it hired Book to solicit the FA Agreement, its employment relationship with him, which was the subject of its wrongful acts of non-disclosure, was material to the inducement of the transactions. He, in effect, was soliciting the transactions by soliciting the agreement and the County's retention of First Union as financial advisor. The acts of non-disclosure fall squarely within the ambit of Section 15B(c)(1).

Finally with regard to the statutory coverage, perhaps out of an overabundance of caution, the Division points out that Cawley's actions satisfied the three elements of aiding and abetting liability, to wit: (1) a violation Section 15B(c)(1) by a primary party;

(2) a "general awareness" by the aider and abettor of his role in the violation; and (3) "substantial assistance" knowingly rendered by the aider and abettor. *See*, Division Opening Br. at 67-68, and cases cited therein.

While those are assuredly the rules governing aiding and abetting liability and there can be no doubt that Cawley easily meets the test on the facts found above, one wonders why it is necessary to rely on aider and abettor liability in that she was, along with First Union, a primary party in the violations. As she testified at hearing, she was the designated municipal securities principal under the Exchange Act for First Union's South Florida office (Tr. 895), and was the principal actor on behalf of First Union in all of the violations found against her, above. Under MSRB Rule D-11, she was an "associated person" of First Union and, as such, would also be considered a "municipal securities dealer" subject to the MSRB rules. Under any reasonable interpretation, she should also be considered a primary party under Section 15B of the Exchange Act. I find her to be in violation of the statute and rule as a primary party. If, on review, she is determined not to be a primary party, I find her in violation as an aider and abettor.

D. The Statute of Limitations

Even if Respondents violated the statute and rule by entering into the false warranty, they contend that enforcement of penalties against them is barred by the statute of limitations. They cite Section 2462 of Title 28 of the U.S. Code, which states as follows:

Except as otherwise provided by Act of Congress, an action, suit, or proceeding for the enforcement of any civil fine, penalty, forfeiture, pecuniary or otherwise, shall not be entertained unless commenced within five years from the date when the claim first accrued if, within the same period, the offender or the property is found within the United States in order that proper service may be made thereon.

28 U.S.C. § 2462.
Johnson v. SEC, 87 F.3d 484 (D.C. Cir 1996) and *In the matter of Chema*, AP No. 3-8505, 1998 SEC LEXIS 2592 (1998), make it clear that 28 U.S.C. § 2462 applies to SEC proceedings seeking to assert penalties against respondents, as in the instant proceeding. The statute begins to run when the "offense is completed." *Carroll v. United States*, 326 F.2d 72, 86 (9th Cir. 1963). Here, the FA Agreement containing the anti-lobbyist warranty was executed by First Union on June 8, 1993. The action against First Union was not brought until August 27, 1998, more than five years later. Similarly, the statute of limitations was tolled by agreement against Cawley on September 2, 1998, also more than five years after the FA Agreement had been executed. If the execution of the FA Agreement had completed the act of deception, the statute has run.

The Division contends, however, that the statute did not begin to run when the agreement was executed because the warranty was "forward looking," and that Respondents continued to violate MSRB Rule G-17 by continuing this course of unfair conduct in paying Book with fees generated under the FA agreement without disclosing this fact to Broward. Div. R. Br. 21. With regard to the continuing non-disclosure, the Division relies, in particular, on Respondents' failure to apprise Broward of the arrangement with Book at the time of the transactions under the agreement so as to include that information as requested in the BF Forms executed in connection with each transaction. *Id.*
The language of the warranty does not support this position. The warranty states, in pertinent part, as follows:

ADVISOR [First Union] warrants that it has not employed or retained any company or person, other than a bona fide employee working solely for ADVISOR, to solicit or secure this Agreement and that they have not paid or agreed to pay any person, company, corporation, individual or firm, other than a bona fide employee working solely for ADVISOR, any fee, commission, percentage, gift, or other consideration contingent upon or resulting from the award or making of this Agreement.

Ex. DX 9, Article 9.3.

Whichever other provisions of the FA Agreement may have been forward looking, this provision is not. It required First Union to warrant that "it has not employed" and "that they [sic] have not paid or agreed to pay." Nothing in this warranty can be construed as imposing a continuing obligation of either informing the County of Book's continuing employment or refraining from continuing his employment. When First Union executed

the agreement, it completed the act of deception and began the running of the statute of limitations. When the Division brought this action against First Union and reached agreement to toll the statute against Cawley, the statute of limitations had already run against each of them on the execution of the false warranty, and no future act of omission revived it based on the warranty that had been executed
On September 2, 1993, and June 30, 1994, respectively, however, the first and third refunding transactions under the FA Agreement closed, and Book thereafter received payments based on First Union's fees from those transactions, as found above. As part of the closing documents, Broward's bond counsel was required to complete bond disclosure forms (BF Forms) containing information supplied by the parties to the transactions, including the financial advisor. Item 11 of that form requested a listing of "Any fee, bonus, or gratuity paid in connection with the bond issue, by any underwriter or financial consultant to any person not regularly employed or engaged by such underwriter or consultant." Exs. DX 109, 111, 114. The BF Forms stated that they were to be filed as required by Section 218.38(1)(c)1 of the Florida Statutes. *Id.* Subsection e of Section218(1)(c)1 contained language identical to Item 11 of the BF Form. On the first two refunding transactions, Item 11was left blank. Exs. DX 109, 111. On the third refunding transaction, two firms engaged by the underwriter were listed, but Book was not. Ex. DX 114. As further found above, Respondents did not intend to, and did not, pay Book any fees arising from the second refunding transaction.

Cawley, who represented First Union in the first refunding transaction, took item 11 of the BF forms at face value and understood it to ask whether the Financial Advisor for the refunding transactions had paid anyone in connection with the transaction who didn't work for it. Tr. 801-02. She testified that the sole reason she did not have Book listed as receiving payment on the closing of the first refunding transaction, or even mention Book to First Union's attorney for the closing, was that Book had done nothing on the deal. Tr. 802-03. Kenneth M. Myers, Bond Counsel for Broward County on the first refunding transaction under the FA Agreement, testified that he was not aware of any relationship between First Union and Book on that transaction and that if he had known of one that fit the literal terms of item 11, he would have reported it to the state on the form as requested in Item 11 and in compliance with the language of Section 218.38 of the Florida Statutes on which Item 11 was based. Tr. 1170-73.

Orlando Cruz, who had succeeded to Cawley's position when she left First Union, and his supervisor in Orlando, Phil Roberts, represented First Union at the closing of the third refunding transaction. Neither of them notified the Broward County officials that Book was involved in the transaction or that he had recently requested to be paid out of First Union's fees from the transaction. Tr. 219. Cawley, who had left First Union two months earlier, represented Smith Mitchell, the underwriter on that transaction. She signed the Bond Purchase Agreement on behalf of Smith Mitchell and all other documents for that transaction unless she happened to be unavailable when they needed to be signed. Tr.994-97.

It would appear that First Union and Cawley again deceived Broward County by not reporting to its representatives the fees being paid to Book on the first and third refunding

transactions, according to the literal words of Item 11 of the BF Forms and the Florida statute on which it was based. First Union was Broward's financial advisor under the FA Agreement and owed it a fiduciary obligation to disclose material matters, including the explicit information required in the closing documents. Its act of omitting mention of Book was especially egregious in the context of its having initially misled Broward as to Book's role when it executed the FA Agreement containing the false warranty. Cawley was First Union's representative on the first refunding transaction and, similarly, owed Broward that fiduciary obligation of disclosure. On the third refunding transaction, however, she represented the underwriter, rather than First Union, and owed no obligation to disclose matters pertaining to First Union relationship with the County.

These acts of non-disclosure were not acts of deception arising out of the execution of the false warranty, which was an act of deception that was completed when the FA Agreement was executed, but are independent acts of omission based on First Union's fiduciary obligations at the closing of the transactions. Consequently, they do not revive actions based on the false warranty that were already barred, but are further acts of deception that are actionable in their own right. In that the statute of limitations had not run on actions arising from the closings on the first and third refunding transactions against either respondent, the Division is not barred from pursuing this action against First Union for its acts of omission on the first and third refunding transactions, and against Cawley for its act of omission on the first refunding transaction.

In response, Respondents assert, first, that Book was "regularly . . . engaged" by First Union and, hence, was not required to be reported in Item 11, according to its language or the language of Section 218.38 of the Florida statutes. *See, e.g.*, First Union Br.45-46. Respondents rely for this on the written agreement (Ex. DX 3) drafted by Haas, under which they allegedly retained Book. *Id.* Secondly, they assert that a Florida administrative rule relieved them of any responsibility for disclosing fees paid to Book because he was not a "finder" under Florida statutes, and First Union was not an "underwriter," either of which was a necessary prerequisite to having his fees reported in Item 11 of the BF Forms. *Id.* at 46-48.

There is no basis for Respondents' reliance upon the written agreement with Book. As determined above, that was a bogus agreement that was drafted and executed after the fact, for the purpose of disguising First Union's actual, informal agreement under which he had already been retained. Under that informal agreement, he was specially employed to solicit business from municipal governments, including Broward, and was to be paid a monthly retainer, plus a fee of 20% of First Union's fees on any transaction consummated from the business he solicited. At the time the bogus written agreement was executed, First Union had already been awarded the FA Agreement, which Book had been "instrumental in securing." *See*, Ex. DX 70. The evidence, discussed at length above, was clear that Book had not substantially performed any of the tasks supposedly assigned him under the written agreement, and that the provision contained therein for increasing the monthly retainer, allegedly based on increased time he spent on First Union business, was a sham, meant to disguise his receipt of a percentage of First Union's fees.

Based on the actual, informal agreement, Book was not a regular employee of First Union, but a special employee, employed only to bring in municipal securities business and paid on the basis of that business, exactly the arrangement that the Florida statute and Item 11 of the BF Form were intended to disclose. Moreover, as the Division points out, the alleged written agreement (Ex. DX 3) does not purport to retain Book, the individual, but rather, Ronald Book, P.A., the "firm" and, consequently, is meaningless for characterizing Book's (the individual's) employment capacity with First Union. Div. R. Br. 25. Accordingly, the literal language of Item 11 of the BF Forms and the Florida statute required that First Union disclose Book's fees on the transactions.
Although Item 11 of the BF Forms and Section 218.38 of the Florida Statutes, cited above, required that fees paid by either the underwriter or financial consultant be reported, Respondents rely upon an administrative rule issued by the Florida Division of Bond Finance, which they contend narrowed the coverage and exempted fees paid by financial advisors, such as First Union, to their consultants, from the reporting requirement. First Union Br. 46-48; Cawley Br. 64-67. They cite Rule 19A-1.002(2), Fla. Admin. Code Ann. R. 19A-1.002 (1998), which purports to define the terms used in statutory Section 218.38, and states, "'Fee, Bonus, or Gratuity' shall mean any Finder's Fee, as defined herein, and any fees paid by the underwriter." In that First Union was not the underwriter, but the financial advisor, any fee paid by it to Book would not be covered unless it was considered a Finder's Fee. The next subsection of the rule, Rule 19A-1002(3), defines "Finder's Fee" as compensation paid to a "finder," as defined in Section 218.386(1)(a), Florida Statutes, by an underwriter, commercial bank, investment banker, or financial consultant or advisor. Section 218.386(1)(a), in turn, restricts the definition of a "finder" to one "who enters into an understanding with either the issuer or the managing underwriter, or both . . . to act solely as an intermediary between such issuer and managing underwriter."

In sum, if we refer only to the reporting statute, Section 218.38, any fees paid by the underwriter or financial advisor in connection with a bond issue to anyone not regularly employed by it would have to be reported. If we adopt the pattern of the administrative rule, fees paid by an underwriter would still be covered, but fees paid by a financial advisor would not be covered unless the recipient had entered into an understanding with the issuer or the managing underwriter to act solely as an intermediary between such issuer and managing underwriter. What scenario could possibly be imagined to fit the latter category, where a recipient of fees from the financial advisor had entered into such an agreement with the issuer or underwriter, is not further illuminated by the administrative rule. In that Book had not entered into an agreement with either the issuer, Broward County, or the underwriter, Respondents contend that, under the administrative rule, his fees from First Union were not subject to disclosure and Respondents committed no wrongdoing by not reporting them to Broward's representatives.

In relying on the administrative rule, Respondents point out that Section 218.37(3) of the Florida Statutes authorizes the Division of Bond Finance to issue rules implementing Section 218.38. Cawley Br. 64-65; First Union 46. They also cite Florida cases that establish that an administrative rule is operative and binding until it is modified or superceded by subsequent legislation or regulation, or the statute from which it was

initiated is repealed or expired. Cawley Br. 66; First Union Br. 48. In that regard, First Union notes that the Division of Bond Finance had to provide the Administrative Procedures Committee a listing of each rule which exceeds its rulemaking authority, and did not report Rule 19A-1.002. *Id.* at 47, n.54.

Respondents are correct that the Division of Bond Finance was authorized to issue rules to implement Section 218.38. But it was not given authority to issue rules to interpret it, or more important, to nullify, repeal, contradict, or modify it, or any portion of it, as it appears to have done in this instance. And, where an administrative rule is contrary to the clear terms of a statute, it is a nullity unentitled to any weight. For example, in *Demarest v. Manspeaker*, 111 S.C. 599 (1991), the Supreme Court reversed a decision where the lower courts had denied witness fees to a state prisoner based on a longstanding administrative construction of the relevant statute, ruling that an "administrative interpretation of a statute contrary to language as plain as we find here is not entitled to deference." *Id.* at 603. The Court went on to explain that when the terms of a statute are found to be "unambiguous, judicial inquiry is complete except in rare and exceptional circumstances." *Id.* at 604 (citations omitted).

The Florida courts have been equally consistent in rejecting administrative constructions or rules that conflict with a statute. *See, e.g., City of Safety Harbor v. Communications Workers of America*, 715 So. 2d 265 (Fla. 1998) "[a]n agency's construction of a statute is not entitled to deference where the agency has erroneously interpreted a provision of law." As the Florida appellate court has correctly recognized:

[A]n administrative agency has no power to declare a statute void or otherwise unenforceable and there is no obligation to defer to an agency interpretation that results in a statute being voided by administrative fiat.

Secretary of State v. Milligan, 704 So.2d 152, 157 (Fla. 1997) (overturning administrative construction of statute).

While the cases cited by Respondents do support the position that a rule remains operative and binding until modified or superceded, none of them permits a rule to negate a portion of a statute as Rule 19A-1.002 appears to do to Section 218.38. The closest case for that proposition is *Florida Livestock Bd. v. Gladden*, 76 So.2d 291 (Fla. 1954), in which a hog owner was permitted to recover compensation for the destruction of his diseased hogs that he had fed uncooked garbage until two days before August 15, 1953, the date fixed by the State Live Stock Sanitary Board to comply with its rules on cooking garbage. The effective date of the authorizing statute had been August 4, 1953. In permitting the effective date to be extended by the rule the court stated, "It would not have been possible for [the hog owner] to cook garbage to comply with said regulations as to the manner and time of cooking, temperature, etc., before he was apprized of the provisions of said regulations, and it appears that he was not required to comply with these regulations before the effective date thereof." *Id.* at 292. In conclusion, the court stated: "This Court has on numerous occasions recognized that equitable estoppel will be invoked against the State when justified by the facts. *Id.* at 293.

In the instant proceeding, the statute was clear and complete on its face and required the reporting of Book's fees on the BF Forms. Using identical language, Item 11 of the BF Forms required the same disclosure. And, in accordance with both, the bond counsel for the County would have reported Book's fees had he been told of them by Respondents. Tr. 1170-73. No rules were necessary to interpret or apply the statute, as in *Florida Livestock v. Glidden, supra*, and, in fact, bond counsel applied it as written and incorporated verbatim in the BF Forms, not as narrowed by the administrative rule. As the rule issued was in conflict with the statute, it is a nullity.

It was, perhaps, because the Bond Division did not list Administrative Rule 19A-1.002 with the Administrative Procedures Committee that it was allowed to stand. The Rule serves no useful purpose in implementing the statute, the extent of the Bond Division's mandate, in that the statute is clear on its face. It requires a listing of all fees paid by the underwriter or financial advisor in connection with the bond issue to persons not regularly employed by them, not merely fees paid for the purposes specified in the rule. Had the Bond Division recognized that the rule, if applied, would diminish the coverage of the statute, it might have withdrawn it of its own volition, much less submitted it to the Administrative Procedures Committee. But having been untested by that Committee or the courts, the rule's continued existence is no endorsement of its validity.

That is not to say that, if Respondents had actually relied upon the administrative rule in not reporting Book's fees to the County's representatives, it might not have justified its failure to disclose. But we are not asked to decide that issue here, because that did not happen. The record is clear that the only reason that Respondents did not report Book's fees was that they were continuing the deception that Book had not been retained to solicit business from Broward and that he was not going to receive compensation based on First Union's fees from the transactions under the FA Agreement. These acts of omission were actionable under MSRB Rule G-17 and Section 15B(c)(1), and occurred within the time specified in the statute of limitations.

The Division also contends that, under prevailing authority, the statute of limitations does not apply to this proceeding, so as to bar action on the execution of the false warranty, because it seeks an order of disgorgement in addition to civil penalties. I do not agree, and explore this issue in the next Part, in discussing disgorgement.

IV. Penalties

A. Civil Money Penalties

Having determined that First Union and Cawley violated Section 15B(c)(1) of the Exchange Act and MSRB Rule G-17 with regard to the first refunding transaction under the FA Agreement, and First Union also did so with the third refunding transaction, we must now consider possible penalties and other remedial action.

Section 21B of the Exchange Act, 15 U.S.C. § 78u-2, provides for three tiers of monetary penalties in an administrative action where the respondents have willfully violated the securities statutes, regulations thereunder, or the MSRB rules, and the penalty is in the public interest. The first tier covers basic violations and sets minimal penalties, the maximum being $5,000 for a natural person and $50,000 for any other person. 15 U.S.C. § 78u-2(b)(1). The second tier covers violations that also involve "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement." 15 U.S.C. 78u-2(b)(2). The maximum penalties for the second tier are $50,000 for a natural person and $250,000 for any other person. *Id.* The severest penalties are imposed under the third tier, covering violations that not only involve the characteristics required for second tier violations, but which also resulted in substantial losses or created significant risks to other persons, or resulted in substantial pecuniary gain to the violator. 15 U.S.C.§ 78u-2(b)(3). Here, the Division asks for second tier penalties against First Union in the amount of $175,000, and against Cawley in the amount of $35,000. Div. Open. Br. 71. Clearly, the violations of MSRB Rule G-17 by First Union and Cawley fit the characteristics required for second tier violations. The deliberate non-disclosure of Book's fee arrangement to Broward County's representatives by First Union and Cawley on the first refunding transaction, and by First Union on the third refunding transaction were deceitful and manipulative acts that continued their initial overt acts of deceit and manipulation of Broward County officials of entering into the false anti-lobbyist warranty in the FA Agreement and attempting to disguise their lobbying arrangement with a disingenuous, after-the-fact employment agreement. Moreover, the deceit and manipulation continued throughout the evidentiary hearing on the part of Cawley, whose testimony was replete with falsehoods, self-contradictions, and inaccuracies (*see, e.g.*, Tr. 503-07, 534, 570-78, 597-98, 600, 623, 635-641, 645-48, 683, 713, 715, 718-19, 730-33, 743, 757-62, 833-37, 844, 850, 853-54, 860-62, 865-72, 883-91, 896-98, 901-06, 926-27, 930, 953, 989-90, 999) and, to only a lesser extent, on the part of First Union's (i.e., its successor's or affiliate's) current employees, whose testimony was also deficient in credibility (*see, e.g.*, Tr. 75-77, 81-87, 90, 94, 101-03, 108-09, 114, 122-24, 138-40, 149-51, 190-91, 197-201, 221-24, 275-76, 402-03, 407-10).

On the other hand, the violation did not reach the level of typical violations of the securities laws, in which investors are directly defrauded of money. While the deceitful acts of First Union and Cawley permitted them to secure and retain profitable business from Broward County that otherwise might have gone, more fairly, to others, one would not necessarily conclude that either Broward County or any of First Union's competitors had suffered an actual and direct loss on the transactions by virtue of the deceit. There is no evidence to suggest that Broward County would have paid any less on the refunding

transactions to First Union or a competitor had First Union not retained an outside lobbyist, or that any particular competitor suffered monetary loss by not being able to compete fairly and openly for the business. The direct harm to them on these particular transactions, if any, may have been minimal.

Moreover, from all accounts, Cawley was a competent, knowledgeable and energetic manager who could have established a successful municipal bond business for First Union by merit, on a level playing field. But in attempting to penetrate the municipal securities bond market, and do it in a hurry, she chose to manipulate the system. Beginning a municipal bond business in southern Florida would have been difficult without hiring lobbyists, in a system characterized as "unique" because of its reliance on lobbyists. *See, e.g.* Tr. 95-96. The newspaper articles documenting the influence of lobbyists in securing business and enacting legislation, even on behalf of municipalities, are proof enough of this difficulty. *See,* Exs. DX 1, 1A-1G. As Cawley understood it, it was fairly commonplace to hire consultants in Florida, and chances of succeeding in building a business without them were not good. Tr. 1047. And disclosing their hiring, as required under the standard warranty and Florida statutes, which were intended to illuminate the process of awarding public contracts, might have prevented First Union from securing business, either as underwriter or financial advisor.

The primary fault for creating and perpetuating this system under which it is influence rather than merit that lands the contracts however, lies with the public officials and public-officials-turned-lobbyists. The result is not merely that competence is downgraded; there is also the added costs of the lobbyists' compensation. While the successful recipient of the government contract pays the direct cost of the lobbyist's commission, it is the public that ultimately bears the costs by paying inflated awards that include these lobbying fees. Moreover, the electoral system is undermined by the lobbyists' funneling of a portion of their fees to the political campaigns of incumbent officials who accord them influence. Obviously, those officials who are beholden to the lobbyists are unlikely to be the most meritorious of candidates. This is the type of lobbying arrangement that the warranty and disclosure requirements of the Florida statutes are designed to prevent.

Cawley and First Union, although willing participants, were but recent entrants into a well-established system in obvious need of reform. But they exploited the system to the hilt, hiring a bevy of lobbyists to solicit municipal securities business in various municipalities in South Florida, and concealing that practice when required to disclose. Holding them accountable under the ethics rules of the MSRB and the penalty provisions of the Exchange Act for their violations is a necessary first step in reforming the system and deterring them from future violations. Taking all this into consideration, together with the facts that this is a first time violation by Cawley and that she has not been directly enriched by her behavior, I determine that a second tier penalty for Cawley in the amount of $15,000 is appropriate.

Taking also into consideration that this is also a first time violation by First Union that was perpetrated by a short term employee who had left its employ even before the

violation was discovered, and that First Union is also being ordered to disgorge its ill-gotten gains on the actionable violations, below, I determine that the addition of a second tier penalty for First Union in the amount of $20,000 is appropriate to reflect the degree of its turpitude and deter it from future wrongdoing.

B. Disgorgement

Sections 21B(e) and 21C(e) of the Exchange Act, 15 U.S.C. § § 78u-2(e) and 78u-3(e), provide for the entry of disgorgement, plus prejudgment interest. Disgorgement is designed primarily to deprive a wrongdoer of his unjust enrichment and to deter others from violating the securities laws. *SEC v. First City Financial Corp.*, 890 F.2d 1215, 1230 (D.C. Cir. 1989); *SEC v. Tome*, 833 F. 2d 1086, 1096 (2d Cir. 1987). It also provides a fund for the return of ill-gotten gains to those illegally deprived of their assets. *See,* Rules 610-614 of the Commission's Rules of Practice (adopted July 1995), which now provide a uniform method by which disgorgement funds may be distributed to injured investors.

The Division asks that First Union be ordered to disgorge the $175,653 it earned under the FA Agreement, plus prejudgment interest thereon in the amount of $97,652. Div. Open. Br. 70. This apparently assumes that all profits earned under the FA Agreement from all three refunding transactions are tainted and subject to disgorgement. But we have already determined that the statute of limitations has run on the execution of the false warranty and that only the acts of withholding information concerning Book from Broward County on the first and third refunding transactions were within the statutory period and actionable. Consequently, only the $92,740.31 received by First Union on the first refunding transaction, and the $21,753 received by it on the third refunding transaction, rather than the total fees received by First Union under all the refunding transactions, should be subject to disgorgement.

As the Division points out (R. Br. 29), it would be proper to consider actions taken by respondents outside the limitations period in determining their states of mind and intent in evaluating their activities within the statutory period. *See*, *In the matter of Barbato*, 69 SEC Docket 169, 1999 WL 58922 (Feb. 10, 1999); *In the matter of Wonsover*, 69 SEC Docket 608, 1999 WL 100935 (Mar. 1, 1999). However, we would be overreaching to consider a violation within the statutory period, involving only the first and third refunding transactions, as reviving the statute as to other refunding transactions covered by the FA Agreement, when they are not within the confines of the actionable violation. Once the bar has fallen on matters arising from the execution of the false warranty in the FA Agreement, they are not actionable unless specifically embraced by a further violation within the statutory period. Respondents have committed no violations with regard to the second refunding transaction within the statutory period and that refunding transaction should not be considered in determining the amount ordered to be disgorged. But the Division also contends that the statute of limitations is no bar to the imposition of the remedial sanctions of disgorgement and cease-and-desist orders so as to permit ordering the disgorgement of fees paid to First Union on all of the refunding transactions attributable to the FA Agreement containing the false warranty. It relies upon *Johnson v. SEC*, *supra*, and *In the matter of Roche*, 64 SEC Docket 1973 (June 17, 1997) for the

proposition that the statute of limitations does not apply to orders of disgorgement. Div. R. Br. 30.

The Division, however, reads those cases too broadly when it suggests that they exempt all orders of disgorgement from the statute of limitations, including the one requested here. In *Johnson*, the SEC had imposed sanctions of censure and a six-month suspension on Johnson for failing to adequately supervise an employee who had stolen money from a client. Because over five years had passed since the unlawful acts, the Court of Appeals held that the five-year statute of limitations of 28 U.S.C. § 2462 barred the action. In explaining its decision, the court distinguished between penalties, which are covered by § 2462, and remedial sanctions, which are not. It relied upon two early Supreme Court cases, *Huntington v. Attrill*, 146 U.S. 657 (1892) and *Meeker v. Lehigh Valley R.R. Co.*, 236 U.S. 412 (1915), on which to base its definition of "penal," to determine if a law should be so characterized so as to fall within the embrace of the statute.

In *Huntington*, the Court had defined a penal law as one that redresses a wrong to the public, rather than a wrong to the individual. 146 U.S. at 667-68. Or, as it put another way, the question of whether a law is penal depends on whether its purpose "is to punish an offense against the public justice of the State, or to afford a private remedy to a person injured by the wrong." 146 U.S. 673-74.

Meeker, supra, involved a suit against a railroad seeking a refund of alleged overcharges under a federal commerce statute. In holding that the predecessor of §2462 did not apply to bar the action, the Court stated: "The words 'penalty or forfeiture' in this section refer to something imposed in a punitive way for an infraction of a public law, and do not include a liability imposed solely for the purpose of redressing a private injury, even though the wrongful act be a public offense, and punishable as such. Here, the liability sought to be enforced was not punitive, but strictly remedial." 236 U.S. at 423.
In *Johnson*, the Court of Appeals applied these Supreme Court pronouncements to the SEC sanctions before it, to hold that the proposed censure and six months suspension fell on the side of punishment because they were "certainly not 'remedial' in the sense that term is used in *Meeker* and its progeny, for they are not directed toward correcting or undoing the effects of Johnson's allegedly faulty supervision." 87 F.3d at 491. "Unlike restitution or disgorgement," the court added, "the sanctions here do not attempt to restore the stolen funds to their rightful owner." *Id.* at 491-92. The court concluded by embracing what it understood to be the "ordinary, contemporary, common meaning" of the word "penalty," to which the statute of limitations applies, "as a sanction imposed by the government for unlawful or proscribed conduct which goes beyond remedying the damage caused to the harmed party." *Id.* at 492. Concerning a contrasting type of sanction, however, the court had stated, "[W]here the effect of the SEC's action is to restore the *status quo ante*, such as through a proceeding for restitution or disgorgement of ill-gotten profits, § 2462 will not apply." *Id.* at 491.

In *Barbato, supra,* and *Roche*, *supra*, the Commission was faced with exactly the latter situation. There, salesmen of broker-dealers who had defrauded investors were ordered by administrative law judges to disgorge their ill-gotten gains. In reviewing each

decision, the Commission recalculated downward the amounts of the disgorgement orders to include only the amounts by which each investor was actually defrauded, and affirmed the orders of disgorgement only as to those amounts. It determined that the orders of disgorgement were not subject to the statute of limitations according to the test in *Johnson, supra*, because they merely restored the *status quo ante*.
The situation before us is quite different. Unquestionably, First Union's profits from the transactions under the FA Agreement were ill-gotten gains because First Union would not have been awarded the agreement had it disclosed its retention of lobbyist Book. But Broward County cannot be considered as having been defrauded of those profits, because it would have paid them to an alternate financial advisor if First Union had been disqualified, and there is no indication that First Union did not perform its functions under the agreement as well as would have any alternate financial advisor. Consequently, Broward County cannot be eligible for restitution out of the disgorgement proceeds, and they must be considered solely as penal, rather than remedial.

While Broward has the right to recover all fees paid to a lobbyist in violation of the false warranty under the terms of the FA Agreement through a breach of contract action in state court, that right is independent of this proceeding and can be pursued separately by Broward if its officials so desire. Here, disgorgement would go well "beyond compensation to the wronged party," as did the sanctions in *Johnson, supra* (*see*, 87 F.3d at 491), and would similarly be subject to 28 U.S.C. § 2462, the federal statute of limitations on penalties, which had run on all but the first and third refunding transactions.

Accordingly, only First Union's fees from the first and third refunding transactions are within the statutory period and remain subject to disgorgement. But even as to those fees, First Union raises a suggestion of impropriety in the Division's asking for disgorgement of the entire amount of its fees on each refunding transaction as "illegally obtained profits," rather than recognizing them as being in part "legally earned revenue." First Union Br. 24. First Union raises this point merely in the context of asserting the requested disgorgement to be punitive, rather than remedial, so as to be subject to the statute of limitations, a position with which I agree, as discussed above.

Lest its assertion be carried farther, however, so as to challenge the Division's calculation of the amount requested for disgorgement because it included First Union's entire fee, not just its profits, it is clear that the Division's request is proper insofar as it pertains to the fees for the first and third refunding transactions. Although the amount requested is First Union's revenues, and its profits would be lesser, by the sum of its expenses, any risk of uncertainty in calculating disgorgement should fall on the wrongdoer whose illegal conduct created that uncertainty. *SEC v. Patel*, 61 F.3d 137, 140 (2d Cir. 1995); *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1232 (D.C. Cir. 1989). First Union has failed to substantiate, or even calculate, any reductions that should be made to its revenues from the refunding transactions to arrive at a more realistic profit figure. And, if we were to accept at face value the testimony of Cawley as to only minimal efforts having been made by First Union to service the FA Agreement (*see*, *e.g.,* Tr. 496-504, 735-36, 783-89), the fees First Union received were almost entirely profit.

Accordingly, I grant orders of disbursement against First Union in the amounts of $92,740.31 and $21,753, plus prejudgment interest thereon according to law, calculated from October 18, 1993 and July 29, 1994, respectively, the dates First Union received fees from Broward County in those amounts from the first and third refunding transactions.

C. Cease-and-Desist Order and Suspension

Section 21C of the Exchange Act, 15 U.S.C. § 78u-3, also authorizes the Commission, where it has found that a person "is violating, has violated, or is about to violate any provision of the security laws or any rule or regulation thereunder," to issue an order requiring that person "to cease and desist from committing or causing such violation and any future violation of the same provision, rule, or regulation." As determined above, Respondents have violated Section 15B of the Exchange Act and MSRB Rule G-17 promulgated thereunder, and are already subject to cease-and-desist orders. 2/ The Division requests that both First Union and Cawley be ordered to cease and desist from any future violations, primarily because "[b]oth remain active in the municipal securities business and neither has shown any indication that they recognize that their actions with respect to Broward were, at best, unfair." Opening Br. 70. The Division suggests no limitations with regard to the cease-and-desist orders. It also requests that Cawley be subjected, at a minimum, to a six month suspension from association with any broker, dealer, or municipal securities dealer. *Id.* at 68.

Taking into account on the one hand that the main impetus for the deceitful conduct came from Cawley, who is no longer with First Union, and that First Union will be paying substantial sanctions in the form of a civil penalty and disgorgement, and on the other hand that its current managerial employees are not averse to using deceitful practices, as demonstrated at hearing, a cease-and-desist order of limited duration would appear to be appropriate to deter it from repeating its violative actions. Accordingly, I order that it cease and desist from further violations of Section 15B of the Exchange Act and MSRB Rule G-17, said order to remain in effect for a period of three years from the date of entry of the Commission's final order in this proceeding.

Cawley continued her deceitful conduct in testifying at hearing. Her continued activities in the municipal securities business and her carelessness with the truth call for some external restraint. A cease-and-desist order is clearly merited. Taking into account her youthfulness (30 years of age when the violation occurred, and 36 at hearing) and the detrimental effect that the publication of this decision may have on her budding career in the municipal securities business, I order that Cawley cease and desist from further violations of Section 15B of the Exchange Act or MSRB Rule G-17, but also limit the period within which said cease-and-desist order is to remain in effect to three years from the date of the Commission's final decision in this proceeding. Taking into account the same considerations, I further order her suspended from association with any broker, dealer, or municipal securities dealer for a period of three months from the date of final decision.

V. Lack of Merit to Respondents' Evidentiary and Procedural Objections

A. Admissions by Party-Opponents

In addition to questioning the competency of Orlando Cruz's testimony, discussed above, Respondents also challenge the introduction into evidence of his memoranda concerning Book's arrangement with First Union (Exs. DX 70, 80), as inadmissible hearsay. First Union Br. 37-40; Cawley Br. 61-63. They are in error. Cruz's memoranda were written by an employee of First Union concerning a matter within the scope of his employment, and are admissions by a party-opponent. Admissions by a party-opponent have historically been excepted or excluded from hearsay, as they continue to be under Rule 801(d)(2) of the Federal Rules of Evidence. Similarly, Cawley's out-of-court statement to Cruz confirming the arrangement between First Union and Book, having been made by Cawley, an adverse party, is also admissible by the Division as an admission by a party-opponent. Cruz's testimony that Cawley made the statement was given at hearing and is not subject to challenge as hearsay. As admissions by a party-opponent, Cruz's memoranda and Cawley's statement to Cruz are fully admissible and can be used to prove the truth of their contents.

Furthermore, although Book's statement to Cruz concerning his percentage arrangement with First Union would be hearsay if it stood by itself, it has also become an admission by a party-opponent because of its adoption by First Union and Cawley. Rule 801(d)(2)(B) of the Federal Rules of Evidence includes as an admission by a party-opponent "a statement of which the party has manifested an adoption or belief in its truth." According to Cruz, Cawley directly confirmed the truth of Book's claim, making Book's statement part of her admission. And First Union manifested both an adoption and belief in its truth by the memorandum of its employee Cruz, acting within the scope of his employment, who agreed with Book's claim, and by paying Book the exact amount of his requested 20 percent of the fees from the third refunding transaction under the FA Agreement, pursuant to his claimed arrangement and Cruz's memoranda. Consequently, Book's statement to Cruz is fully admissible against both Respondents and can be used to prove its contents. The evidentiary basis for admitting these statements and memoranda as admissions by a party-opponent was made known to the parties and discussed at length on a number of occasions at the evidentiary hearing. *See, e.g.*, Tr.196-197, 1037-38

That is not to say that these statements and memoranda are *judicial admissions* and binding on the parties against whom they were admitted. They are not. A judicial admission, such as is made in a pleading, in answer to a request for admission, or in a stipulation between the parties, is ordinarily conclusive unless a party is relieved of the admission by the presiding judge for due cause shown. An admission by a party-opponent, on the other hand, is simply an evidentiary admission that can be introduced into evidence by the opposing party to prove the truth of its contents and, once admitted, given whatever weight the trier of fact finds proper. It is excluded from the hearsay rule for the same reason that it would be admitted into evidence even if it were considered hearsay: by virtue of the declaration's being made or adopted by a party, when used against that party it assumes the mantle of reliability that is the threshold measure of admissibility and becomes the burden of that party to explain away.

In this case, Cruz's memoranda and Cawley's confirmation of the Book arrangement were given considerable weight because they were consistent with other reliable evidence, including payments made to Book which appeared to reflect the professed arrangement. In that respect, however, Cawley and First Union contend that the total payments made to Book do not amount to 20 percent of the fees received by First Union under the FA Agreement, plus his monthly retainers. First Union points out that his payments amounted to only 13 percent of revenues, plus his monthly retainers. Br. 43, n. 48. And Cawley points out that the $17,100 (actually $17,150) that Book received in addition to his monthly retainers for October, November and December of 1993, only amounted to 11 percent of the first two refunding transactions under the FA Agreement. Br. 60, n.82. But these figures assume that the second refunding transaction, which closed on October 5, 1993, on which First Union received a fee of $61,160.69, was made known to Book so that he would have received or could have demanded his commission, as he did of Cruz with regard to the third refunding transaction. In fact, it appears that he was not informed of that refunding transaction and knew nothing of it even at the time of the evidentiary hearing in this proceeding. On two separate occasions, Book testified that he knew of only two "deals" that First Union transacted with Broward, apparently referring only to the first and third refunding transactions. Tr. 1357-58, 1392. As detailed above, the $17,150 that he received in early 1994 amounted to 18.5% of the first refunding transaction, for which Book dated the first invoice for the day after First Union was paid its fee. And on the third refunding transaction, he received the entire 20 percent from First Union that he had demanded from Cruz. What minor adjustment Cawley made to reduce the Book's commission from 20 percent to 18.5 percent of the first refunding transaction fee is not disclosed by the record, but the commission was substantially what was promised in their informal agreement, found to be extant, above.

B. No Broward County Testimony

Respondents further contend that the Division's proof is deficient in that it has failed to prove that Book actually influenced the awarding of the FA Agreement to First Union, and that, therefore, it has failed to carry its burden of proving the breach of warranty. Cawley complains that "[t]he Division did not attempt to call any Broward Commissioners or staff members from the financial advisory selection committee as witnesses." Cawley Br. 50. First Union similarly complains that "not one of [the Division's] witnesses was a Broward County official; not a single person said that he or she was lobbied or deceived, before or after the execution of the financial advisory contract." First Union Br. 3.

What is material, however, is not whether Book actually influenced the award, but whether Respondents retained him to do so or agreed to pay him for doing so. These they clearly did, in violation of the warranty that they had not. Moreover, in view of First Union's having paid Book approximately the agreed percentage on the first and third refunding transactions, it would be naive to believe that his close relationships with the members of the selecting committee did not actually influence the award. At least First Union and Cawley, by paying him, apparently believed that they had.

What we have before us is the classic case of what the warranty and the Florida statutes on which it is based were designed to prevent: an award based not on merit and fair

competition, but on representation by an outside lobbyist. The lobbyist funnels money to officeholders in the form of campaign contributions. The officeholders, in turn, reward the lobbyist by approving contracts with his clients, who pay him a fee for the business. To show a violation of the warranty and the Florida statutes, designed to thwart this type of arrangement, it is not necessary to prove that the awarding of a covered contract was surreptitiously influenced by the lobbyist, an almost impossible task, but only that the contractor had failed to disclose that he had retained an outside lobbyist, or had paid or promised him a fee based on the awarded contract.

C. Inadmissibility of Second-Hand, Backdoor Testimony

Respondents raise certain other procedural objections which relate in some manner to the testimony of Nick Monaco, an SEC investigator, called as an adverse witness by First Union. The entire purpose for calling Monaco was to elicit testimony that none of the Broward public officials he had interviewed had admitted to being influenced by Book in awarding the FA Agreement to First Union. First Union challenges my ruling that no questioning along those lines would be permitted because the unsworn, out-of-court, statements made to Monaco were inadmissible hearsay. First Union Br. 54-55. There is no merit to First Union's position.

The Broward officials reviewing and deciding First Union's application were well known to all of the parties and were subject to subpoena. While it might be expected that they would not admit to wrongdoing in unsworn testimony given to an investigator, whatever the case, testimony given under oath in a courtroom and subject to critical cross-examination is yet another matter. It would have been error to allow any party to introduce into evidence, through the backdoor, statements of the public officials, in the form of second hand testimony by an investigator, instead of calling the officials as witnesses and eliciting their testimony, first hand, under oath, and subject to cross-examination. *See*, discussion at Tr.1607. The option of calling them was offered to all of the parties, and none of them chose it. *Id.*

D. Party-Witnesses Conferring With Counsel

First Union also contends that it was error to permit the Division's attorney to confer with its agent Monaco after Monaco was questioned on direct by Respondents, before the Division's cross-examination. Br. 56-58. At a prehearing conference held on February 24, 1999 (Transcript at 52-53), and early in the evidentiary hearing (Tr. 183-84, 267-270), I indicated my intention of allowing counsel to confer with their party-witnesses after they had been examined by adverse parties and before counsel began conducting their friendly examination. The purpose was clearly stated, to wit, to prevent the possibility of losing important evidence that would explain away seemingly critical admissions given under the adverse examination, because the witness's counsel might be uninformed and could not ask the right questions. *See*, Tr. 267. I did, however, restrict counsel from discussing other witnesses' testimony from which the party-witness might have been excluded. Tr. 269. On the other side, of course, is the possibility that the party-witness would be coached for his further examination by his own counsel. But changing one's testimony after conferring with counsel is something that the trier of fact can evaluate in making his factual findings; absent testimony, which may be critical to the case, is something that he cannot.

In any event, these were ground rules set at the inception of the hearing, to be applied to all the parties. Only the Division objected. Tr. 183-84, 267-270. First Union's counsel understood the ruling and did not object. Tr. 270. Nor did Cawley's counsel. It was only after that procedure had been put into effect for the course of the hearing, that First Union objected, on the last day of hearing, when the Division sought to confer with its agent Monaco. Tr.1570. First Union's objection was too late. At that juncture, it would have been improper to deny the Division the same right to confer with its party-witness as had already been extended to its adversary parties during the entire course of the hearing. The procedure adopted was within the discretion of the trial judge, but once adopted, was required to be applied uniformly to all parties.

Nor is there any merit to First Union's claim (First Union Br. 57), that the Supreme Court, in *Perry v. Leeke*, 488 U.S. 272 (1989), has found the practice of conferring with one's counsel before his examination by that counsel, but after examination by adverse counsel, to be improper. In that case, the Court affirmed that it was within the discretion of the trial judge to determine whether conferring with counsel was permissible. The Court merely held that it would not be a constitutional violation of the Sixth Amendment's right-to-counsel provision for the trial judge to deny a criminal defendant the right to confer, a ruling that was within the scope of the trial judge's discretion.

Here, in addition to the practice's being within the judge's discretion and having been accepted by First Union when first adopted, First Union could not have been harmed by Monaco's conferring with the Division's counsel. Monaco had no first-hand knowledge of any of the probative facts in the case and was called as a witness only in an attempt to bring in second-hand testimony of witnesses whom First Union was reluctant to call directly. This attempt was ruled improper and disallowed, as discussed above. There was no probative evidence solicited from Monaco on direct-, cross-, or re-direct examination, because Monaco had none to offer. Whatever coaching he may have been given by the Division's counsel had no effect on the proceeding or on my findings in this decision.

E. Characterization as Rebuttal Witness

Respondents also contend that it was improper to permit the Division to call AJ, Cawley and First Union's secretary, as a rebuttal witness after the Division had rested its case-in-chief and First Union had called Monaco as Respondents' sole witness. First Union Br. 58-59; Cawley Br. 69-73. Whether the Division should have been required to call AJ in its case-in-chief, rather than in its rebuttal case, again, is a matter within the scope of a trial judge's discretion. The critical factors to consider are the anticipated nature of the testimony, *i.e.*, whether it is expected to be rebuttal of prior testimony or new matter, and the opening party's (in this case, the Division's) right to have the final word, in the form of evidentiary offerings, on the matters already placed in issue. *See,* my discussion at Tr. 1582-83. Here, I exercised my discretion to allow the testimony in the Division's rebuttal case because it appeared that AJ was being called primarily to rebut testimony given by Cawley concerning her claimed lack of responsibility for certain First Union actions, a determination that was fully vindicated by AJ's testimony. She was questioned solely in rebuttal of matters testified to by Cawley. And, in allowing the Division to call Cawley as a rebuttal witness, I took pains to safeguard Respondents' rights by permitting them to

offer testimony in response, if AJ's testimony were to offer surprises or go beyond matters covered in the original testimony that it purported to rebut. Tr. 1582-83.

Furthermore, Respondents have not been harmed by permitting the calling of AJ after the presentation of their sole witness, Monaco, because AJ's testimony was unrelated to his testimony and, as discussed above, Monaco's testimony had no probative value. While it was clearly within my discretion to determine whether AJ's anticipated testimony should be characterized as testimony-in-chief or rebuttal testimony, what Respondents sought at hearing and continue to seek here goes beyond that discretion. They sought a ruling that would have prevented the Division from calling AJ because it had already rested its case-in-chief and Respondents had presented their sole witness, Monaco. But the Division had given Respondents ample notice *before* it rested its case that it intended to call AJ in rebuttal (Tr. 1000, 1187, 1189, 1239-40, 1469), and it was incumbent upon Respondents to object then and solicit a ruling on whether the testimony had to be presented as part of the Division's case-in-chief or could be deferred to its rebuttal case. Only in the event that the Division had received a ruling that the testimony would only be permitted as part of its case-in-chief and persisted, nonetheless, in waiting to present it in its rebuttal case would it be proper to preclude its presentation.

Finally, there is some irony in Respondents' complaints about the Division's presenting AJ so late in the hearing. Early in the hearing, Cawley claimed that the last time she had spoken to AJ was "a couple of years ago" and had "lost track" of her. Tr. 534. Then, she testified that she had spoken to her recently but had thrown her telephone number away. Tr. 953, 999. It was only after that testimony that the Division was finally supplied with her location. *See*, Tr. 1000.

VI. Certification of Record

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), I certify that the record includes the items set forth in the record index issued by the Secretary of the Commission on May 11, 1999.

VII. Order

Based on the findings and conclusions set forth above,

It is ordered that, First Union cease and desist from further violations of Section 15B of the Exchange Act and MSRB Rule G-17 for a period of three years from the date of entry of the Commission's final order in this proceeding.

It is ordered that, Teressa Cawley cease and desist from further violations of Section 15B of the Exchange Act and MSRB Rule G-17 for a period of three years from the date of entry of the Commission's final order in this proceeding. In addition, Teressa Cawley is suspended from association with any broker, dealer, or municipal securities dealer for a period of three months from the date of the final decision.

It is ordered that, pursuant to Section 21B(e) and 21C(e) of the Exchange Act that First Union shall pay disgorgement in the amounts of $92,740.31 and $21,753, plus prejudgment interest, calculated from October 18, 1993 and July 29, 1994, respectively.

It is ordered that, pursuant to Section 21B of the Exchange Act, First Union shall pay civil money penalties in the amount of $20,000.

It is ordered that, pursuant to Section 21B of the Exchange Act, Teressa Cawley shall pay civil money penalties in the amount of $15,000.

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.

Herbert Grossman
Administrative Law Judge

Footnotes

1 / Two other fees paid by First Union to Book merit only brief discussion to make the record complete. Each was submitted as an "additional retainer," in the amounts of $1750 each, for the months of February and March, 1994, and paid on March 31, 1994. Exs. DX 93, 94. Together with invoices Book submitted in those same amounts for the months of April and May, 1994 (Ex. RX 7 (also DX 54)), which remained unpaid after Cawley left First Union, they were to be Book's share of fees paid lobbyists on a $13 million City of North Miami Beach deal. Tr. 142-45; Exs. DX 47, 60, 159. Sharing the lobbyist fees on that transaction with Book was the firm of JGR, which received three fees in the amounts of $2,346 each for the months of January, February and March, 1994. Exs. DX 88, 96, 97A.

Although I find those fees paid to Book to be unrelated to the Broward FA Agreement, if they were added to the $17,150 he received from the first refunding transaction, they would bring the percentage he received of First Union's fee on that transaction from

18.5%, to 22.2%, still approximately the 20% of First Union's fees informally agreed to be paid him by Cawley and First Union.

2 / There is no basis for First Union's assertion that Section 21C(a) of the Exchange Act does not include a violation of the MSRB rules as a basis for a cease-and-desist order. Section 15B(b)(1), of the Exchange Act, 15 U.S.C. § 78o-4(b)(1), provided for the establishment of the MSRB, and Section 15B(b)(2) of the Act, 15 U.S.C. § 78o-4(b)(2), required the MSRB to adopt rules to effect the purposes of the Act. Section 21 of the Exchange Act, 15 U.S.C.§ 78u-3, applies cease-and-desist orders to violations of the Act or "any rule or regulation thereunder," so as to include MSRB rule violations. Moreover, Cawley is also being ordered to cease and desist from further violations of Section 15B of the Exchange Act, of which she has also been found in violation here.

YIELD BURNING CASES

COMMISSION ORDERS – SETTLED ADMINISTRATIVE PROCEEDINGS

In the Matter of Rauscher Pierce Refsnes, Inc., Dain Rauscher Inc., and James R. Feltham, Securities Act Release No. 7844, Exchange Act Release No. 42644, A.P. File No. 3-10182 (April 6, 2000).

See "UNDERWRITERS" Section.

In the Matter of William R. Hough & Co., Securities Act Release No. 7826, Exchange Act Release No. 42632, A.P. File No. 3-10176 (April 6, 2000).

See "UNDERWRITERS" Section.

In the Matter of Paschal Gene Allen, Exchange Act Release No. 42204, A.P. File No. 3-10110 (December 6, 1999).

I.

The Commission deems it appropriate and in the public interest to institute public administrative proceedings pursuant to Sections 15(b)(6), 15B(c)(4) and 19(h)(3) of the Securities Exchange Act of 1934 ("Exchange Act") [15 U.S.C. §§ 78o(b)(6), 78o-4(c)(4) and 78s(h)(3)] to determine what action, if any, is necessary in light of the entry of a permanent injunction against Paschal Gene Allen on November 30, 1999, by the United States District Court for the Northern District of Georgia.

II.

In anticipation of the institution of these proceedings, Allen has submitted an Offer of Settlement ("Offer"), which the Commission has determined to accept. Solely for the purpose of these proceedings, and any other proceedings brought by or on behalf of the Commission or to which the Commission is a party, and without admitting or denying the findings or conclusions contained herein, except for those contained in Sections III.A., B.

and C., which are admitted, Allen consents to the issuance of this Order, the entry of the findings contained herein, and the imposition of the sanction set forth below.

III.

The Commission finds that:

A. From September 1990 through early August 1997, Allen was associated with Stephens Inc. ("Stephens"), a broker-dealer and municipal securities dealer registered with the Commission pursuant to Sections 15 and 15B(a) of the Exchange Act.

B. Allen is permanently enjoined by judgment of the United States District Court for the Northern District of Georgia, in the action styled Securities and Exchange Commission v. P. Gene Allen ("SEC v. Allen"), Civil Action No. 1 99-CV-2987-MHS (N.D. Ga., judgment entered November 30, 1999), from violating Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Section 15B(c)(1) of the Exchange Act and Rule G-17 of the Municipal Securities Rulemaking Board ("MSRB").

C. With respect to Allen, the Commission's complaint in SEC v. Allen alleges as follows: While serving as a public finance banker in the Atlanta office of Stephens, Allen: (i) took undisclosed payments in connection with a securities transaction he recommended to his financial advisory client, Fulton County, Georgia; and (ii) took undisclosed compensation from underwriter's counsel in connection with five municipal securities offerings by various Georgia municipalities. The complaint further alleges that Allen's failure to disclose the payments he received violated Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and Rule 10b-5 thereunder [17 C.F.R. § 240.10b-5]. In addition, the complaint alleges that in the five municipal offerings, Allen's failure to disclose his compensation arrangement with underwriter's counsel, and his failure to include his compensation from underwriter's counsel in the offering documents, violated Section 15B(c)(1) of the Exchange Act [15 U.S.C. § 78o-4(c)(1)] and MSRB Rule G-17.

IV.

Based on the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions that are specified in Allen's Offer.

Accordingly, it is hereby ordered that, effective immediately, Allen be, and he hereby is, barred from association with any broker, dealer, or municipal securities dealer.

By the Commission.

Jonathan G. Katz
Secretary

In the Matter of BT Alex Brown Incorporated, Securities Act Release No. 7772, Exchange Act Release No. 42145, A.P. File No. 3-10097 (November 17, 1999).
See "UNDERWRITERS" Section.

In the Matter of Douglas E. Carter, Securities Act Release No. 7774, Exchange Act Release No. 42147, A.P. File No. 3-10099 (November 17, 1999).

I.

The Securities and Exchange Commission (the "Commission") deems it appropriate and in the public interest that public administrative proceedings be, and they hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 15(b)(6) of the Securities Exchange Act of 1934 ("Exchange Act") against Douglas E. Carter ("Carter").

II.

In anticipation of the institution of these proceedings, Carter has submitted an offer of settlement, which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceeding brought by or on behalf of the Commission or in which the Commission is a party, and prior to a hearing pursuant to the Commission's Rules of Practice and Procedure, 17 C.F.R. @ 201.100 et seq., Carter, without admitting or denying the findings contained herein, except that he admits to the jurisdiction of the Commission over him and over the subject matter of these proceedings, consents to the entry of the findings, the institution of the cease-and-desist order, and the imposition of the remedial sanctions set forth below.

Based on the foregoing, the Commission finds as follows. n1

- - - - - - - - - - - - - - - - - -FOOTNOTES- - - - - - - - - - - - - - - - - -

n1 The findings herein are not binding on anyone other than the Respondent.

- - - - - - - - - - - - - - - - - -END FOOTNOTES- - - - - - - - - - - - - - - - - -

A. Respondent

Douglas E. Carter, age 51, is a resident of Charlotte, North Carolina and was employed by Alex. Brown & Sons, Inc. ("Alex. Brown") from May 1990 until July 1997. From approximately March 1, 1994 until his departure from the firm, Carter served as head of Alex. Brown's Public Finance Department. n2

- - - - - - - - - - - - - - - - - -FOOTNOTES- - - - - - - - - - - - - - - - - -

n2 Alex. Brown has since merged with BT Securities Corporation, and changed its name to BT Alex. Brown Incorporated.

- - - - - - - - - - - - - - - - -END FOOTNOTES- - - - - - - - - - - - - - - - -

B. Summary

This matter arises out of two municipal bond refunding transactions by the Commonwealth of Pennsylvania in 1994 (referred to jointly as the "Pennsylvania Refundings"). n3 In each of the refundings. Alex. Brown sold United States Treasury securities to the Commonwealth to fund defeasance escrows. Carter did not participate in the first refunding, but was the lead Alex. Brown banker on the second refunding. Carter knew or should have known that Alex. Brown had overcharged the Commonwealth for the escrow securities on the first refunding, and he failed to disclose this fact to the Commonwealth.

- - - - - - - - - - - - - - - - - -FOOTNOTES- - - - - - - - - - - - - - - - - -

n3 For a discussion of advance refunding bond issues and defeasance escrows used in such transactions see In the Matter of Lazard Freres & Co, LLC, Exchange Act Release No. 41318 (April 21, 1999).

- - - - - - - - - - - - - - - - -END FOOTNOTES- - - - - - - - - - - - - - - - -

C. Facts

In September 1993, Alex Brown was selected as the financial adviser to the Office of the Treasurer of the Commonwealth of Pennsylvania. Alex. Brown's lead banker working with the Treasurer's office was Carter's predecessor as head of Alex. Brown's Public Finance Department (the "Predecessor"). On behalf of Alex. Brown, Carter's Predecessor entered into a financial advisory contract with the Treasurer's office which provided, among other things, that "The contractor [Alex. Brown] shall maintain the highest standards of integrity in the performance of this agreement and shall take no action in violation of state or federal laws, regulations, or other requirements that govern contracting with the Commonwealth."

In 1993, the Commonwealth began consideration of a series of refunding bond issues. Ultimately, two issues resulted: (1) the Commonwealth of Pennsylvania $494,145,000 General Obligation Bonds First Series, which closed in March 1994 (the "March Refunding") and (2) the Commonwealth of Pennsylvania $469,616,337.34 General Obligation Bond Second Series 1994, which closed in June 1994 (the "June Refunding"). As the department responsible for investing the Commonwealth's funds, the Treasurer's office was responsible for purchasing the defeasance escrow securities for the Pennsylvania Refundings.

Alex. Brown was selected by the Treasurer's office to sell to the Commonwealth the U.S. Treasury securities to be placed in the defeasance escrow for the March Refunding. In connection with this transaction, the Predecessor and the Treasurer's office agreed that Alex. Brown would be permitted to charge a markup of 4.5 basis points in price on the

escrow portfolio. n4 The Predecessor, however, instructed his staff to mark up the defeasance escrow securities by a factor of 0.0045, which is a 45 basis point markup, or .45%.

- - - - - - - - - - - - - - - - - -FOOTNOTES- - - - - - - - - - - - - - - - - -

n4 A basis point is 1/100th of 1% or 0.0001. Correspondingly, 4.5 basis points means 0.045%, or 0.00045.

- - - - - - - - - - - - - - - - -END FOOTNOTES- - - - - - - - - - - - - - - - -

The Predecessor departed Alex. Brown after the March Refunding. Carter, who had headed Alex. Brown's office in Charlotte. North Carolina, succeeded the Predecessor as head of Alex. Brown's Public Finance Department and became the senior person at Alex. Brown responsible for dealings with the Pennsylvania Treasurer's office. Soon after Carter assumed this role, senior staff within the Treasurer's office told Carter that they believed Alex. Brown had charged a 45 basis point markup on the sale of the escrow securities in the March Refunding instead of the agreed 4.5 basis point markup. Carter told the senior staff members that he would look into the matter.

Carter reviewed Alex. Brown's file relating to the March Refunding and spoke to a quantitative analyst who had worked with Carter's Predecessor on the transaction. Carter learned from the analyst that Alex. Brown had taken a markup of 45 basis points on the March Refunding escrow. In the transaction file, Carter saw handwritten notes that said "4.5 basis points." Carter believed that these notes were probably his Predecessor's. The analyst told Carter, however, that the Predecessor had instructed that the escrow be marked up by a factor of 0.0045.

D. Legal Analysis

Section 17(a) of the Securities Act prohibits materially false or misleading statements, or material omissions when there is a duty to speak, in the offer or sale of any security. Section 17(a)(1) requires a showing of scienter; however, Sections 17(a)(2) and 17(a)(3) do not require such a showing. Aaron v. SEC, 446 U.S. 680, 697 (1980). Violations of Sections 17(a)(2) and 17(a)(3) may be established by showing negligence. SEC v. Hughes Capital Corp., 124 F.3d 449, 453-54 (3rd Cir. 1997); SEC v. Steadman, 967 F.2d 636, 643 n. 5 (D.C. Cir.1992).

A duty to speak arises, and material omissions become fraudulent, when a person or entity has information that another is entitled to know because of a fiduciary or similar relationship of trust and confidence. See Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-55 (1972); Chiarella v. United States, 445 U.S. 222, 228 (1980); In re Arleen W. Hughes, 27 S.E.C. 629 (1948), aff'd, 174 F.2d 969 (D.C. Cir. 1949). A fiduciary violates the antifraud provisions of the securities laws when it sells securities as principal to its fiduciary client without disclosing "all material circumstances fully and completely." Arleen W. Hughes, 27 SEC at 636; see also Restatement 2d of Agency,

section 390, comment a.

As financial adviser to the Treasurer's office, Alex. Brown acted as a fiduciary in the Pennsylvania refundings. The Treasurer's office reposed trust in the skill and integrity of Alex. Brown, and placed the Commonwealth's pecuniary interest in Alex. Brown's charge with respect to the refundings. The Treasurer's office also had a "just foundation for belief" that Alex. Brown was acting in the Commonwealth's best interest. See Antinoph v. Laverell Securities, 703 F. Supp. 1185 (E.D. Pa. 1989); Lazin v. Pavilion Partners, 1995 U.S. Dist. LEXIS 15255, Civ.A. No. 95-601, 1995 WL 614018 (E.D. Pa. Oct. 11, 1995). By the express terms of its financial advisory contract, Alex. Brown was bound to act according to "the highest standards of integrity." As the head of Alex. Brown's Public Finance Department, and the senior Alex. Brown official responsible for dealings with the Pennsylvania Treasurer's office during the June Refunding. Alex. Brown's disclosure duties devolved upon Carter.

Carter knew or should have known that Alex. Brown had overcharged the Commonwealth on the escrow portfolio for the March Refunding. Carter was told by the Treasurer's staff that the agreement had been for a markup of 4.5 basis points, and he learned from the analyst that Alex. Brown had charged 45 basis points. Carter failed to make any disclosure of the overcharge during the period when he was working with Commonwealth officials on the planning for the June refunding. It was material to the Commonwealth in connection with the purchase of the escrow portfolio for the June Refunding to know that Alex. Brown had overcharged the Commonwealth on the March Refunding Portfolio. Carter's nondisclosure was in the offer or sale of the escrow securities for the June Refunding because it facilitated Alex. Brown's selection as escrow provider for that refunding.

III.

On the basis of the foregoing, the Commission finds that Carter willfully violated Sections 17(a)(2) and (3) of the Securities Act. n5

- - - - - - - - - - - - - - - - - -FOOTNOTES- - - - - - - - - - - - - - - - - -

n5 In applying the term "willful" in Commission administrative proceedings instituted pursuant to Sections 15(b), 15B, 15C, 17A and 19(h) of the Securities Exchange Act, Section 9 of the Investment Company Act, and Section 203 of the Investment Advisers Act, the Commission evaluates on a case-by-case basis whether the respondent knew or reasonably should have known under the particular facts and circumstances that his conduct was improper. In this case, as in all Commission administrative proceedings charging a willful violation under these statutory provisions; the Commission applies this standard to persons -- specifically, securities industry professionals -- who are directly subject to Commission jurisdiction and who have a responsibility to understand their duties to the investing public and comply with the applicable rules and regulations which govern behavior.

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IV.

Carter has submitted an Offer of Settlement in which, without admitting or denying the findings herein, he consents to the Commission's entry of this Order, which: (1) makes findings, as set forth above; (2) censures Carter; (3)
orders Carter to cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and (3) of the Securities Act; and (4) orders Carter to pay a civil penalty in the amount of $ 35,000.

V.

In view of the foregoing, the Commission deems it appropriate and in the public interest to accept the Offer of Settlement submitted by Carter.
Accordingly, IT IS ORDERED, pursuant to Section 8A of the Securities Act and Section 15(b)(6) of the Exchange Act, that;

1. Carter is censured.

2. Carter shall cease and desist from committing or causing any violation and any future violations of Sections 17(a)(2) and (3) of the Securities Act.

3. Carter shall, within thirty (30) days of the date of this Order, pay a civil money penalty in the amount of $ 35,000 to the United States Treasury. Such payment shall be: (1) made by United States postal money order, certified check, bank cashier's check or bank money order; (2) made payable to the United States Securities and Exchange Commission; (3) hand-delivered or mailed to the Comptroller, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and
(4) submitted under cover letter that identifies Carter as a Respondent in these proceedings, and states the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Brian A. Ochs, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0805.

By the Commission.

<u>In the Matter of Arthurs Lestrange & Company, Inc., and Michael P. Bova</u>, Securities Act Release No. 7775, Exchange Act Release No. 42148, A.P. File No. 3-10100 (November 17, 1999).

I.

The Securities and Exchange Commission (the "Commission") deems it appropriate and in the public interest that public administrative proceedings be, and they hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Sections 15(b) and 15B(c) of the Securities Exchange Act of 1934 ("Exchange Act") against Arthurs Lestrange & Company, Inc. (" Arthurs Lestrange") and Michael P. Bova ("Bova").

In anticipation of the institution of these proceedings, Arthurs Lestrange and Bova have each submitted an offer of settlement, which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceeding brought by or on behalf of the Commission or in which the Commission is a party, and prior to a hearing pursuant to the Commission's Rules of Practice, 17 C.F.R. @ 201.100 et seq., Arthurs Lestrange and Bova, without admitting or denying the findings contained herein, except that each admits to the jurisdiction of the Commission over them and over the subject matter of these proceedings, consents to the entry of the findings, the institution of the cease-and-desist order, and the imposition of the remedial sanctions set forth below.

II.

Based on the foregoing, the Commission finds as follows: n1

- - - - - - - - - - - - - - - - - -FOOTNOTES- - - - - - - - - - - - - - - - - -

n1 The findings herein are not binding on anyone other than the Respondents.

- - - - - - - - - - - - - - - - -END FOOTNOTES- - - - - - - - - - - - - - - - -

A. Respondents

1. Arthurs Lestrange & Company, Inc. (" Arthurs Lestrange") is a Pennsylvania corporation with its principal place of business in Pittsburgh, Pennsylvania. At all relevant times, Arthurs Lestrange was a broker-dealer and municipal securities dealer registered with the Commission pursuant to Sections 15(b) and 15B(a)(2) of the Exchange Act.

2. Michael P. Bova, 51, is a resident of Upper St. Clair Township, Pennsylvania. At all relevant times, Bova was Senior Vice President and head of municipal finance for Arthurs Lestrange.

B. Other Relevant Person

Dennis E. "Harvey" Thiemann ("Thiemann"), age 55, is a resident of Shermans Dale, Pennsylvania. Thiemann is the founder of a privately held consulting firm called HDI, Inc. Thiemann and his wife are HDI's only shareholders and employees.

Summary

This matter arises out of two municipal bond refunding transactions by the Commonwealth of Pennsylvania in 1994 (hereinafter referred to jointly as the "Pennsylvania Refundings"). n2 Arthurs Lestrange served as financial adviser to the Commonwealth for the refundings. With Bova's and Arthurs Lestrange's authorization, Thiemann, a consultant to Arthurs Lestrange, helped arrange for Arthurs Lestrange to split fees with another broker-dealer, Alex. Brown & Sons, Inc. ("Alex. Brown"), which was selected to sell United States Treasury securities to the Commonwealth to fund defeasance escrows for the refundings. As financial adviser, Arthurs Lestrange and Bova occupied a position of trust and confidence on the Pennsylvania Refundings. Bova was thus required to disclose all material facts to the Commonwealth fully and completely. Bova disclosed the existence of the fee-splitting agreement in a letter to the Commonwealth, but his letter contained material misstatements and omissions concerning the nature and extent of the agreement, and Arthurs Lestrange's payments to Thiemann's firm, HDI.

- - - - - - - - - - - - - - - - - -FOOTNOTES- - - - - - - - - - - - - - - - - -

n2 In a refunding, the municipality issues new "refunding" bonds and immediately invests the proceeds in a portfolio of U.S. Treasury or agency securities structured to pay the principal and interest obligations on older, higher interest rate, bonds until the call date and then to pay off the outstanding principal and any call premium. The portfolio of government securities is normally placed in a defeasance escrow to guarantee repayment of the old bonds. For a further discussion of refunding bond issues and defeasance escrows used in such transactions see In the Matter of Lazard Freres & Co. LLC, Exchange Act Release No. 41318 (April 21, 1999).

- - - - - - - - - - - - - - - - -END FOOTNOTES- - - - - - - - - - - - - - - - -

C. Facts

In 1993, Arthurs Lestrange proposed to Commonwealth officials refundings of up to $ 2 billion worth of bonds. Ultimately, two refundings resulted: (1) the Commonwealth of Pennsylvania $ 494,145,000 General Obligation Bonds First Series, which closed in March 1994 (the "March Refunding") and (2) the Commonwealth of Pennsylvania $ 469,616,337.34 General Obligation Bond Second Series 1994, which closed in June 1994 (the "June Refunding"). Arthurs Lestrange was appointed financial adviser to the Commonwealth for the transactions.

As financial advisor, Arthurs Lestrange reported to the Governor's Budget Office. Based on his knowledge of a previous Commonwealth bond refunding, Thiemann understood that a different office -- the Pennsylvania Treasurer's Office -- had in the past selected securities dealers to sell open market Treasury securities to the Commonwealth, and he believed the Treasurer's Office would be selecting a securities dealer to sell open market Treasury securities to the Commonwealth for the 1994 Pennsylvania Refundings. Thiemann and Bova believed that the assignment could be lucrative for the dealer. In January 1994, Thiemann approached Bova with the idea of having Arthurs estrange share in the revenues on the sale of the escrow securities. Thiemann and Bova believed, however, that Commonwealth officials would view Arthurs Lestrange as too small a firm to handle the purchase and sale of hundreds of millions of dollars in U.S. Treasury securities.

Accordingly, Thiemann proposed to Bova that he would try to find a larger broker-dealer that could be selected to provide the escrow securities and would agree to split its revenues on a 60/40 basis with Arthurs Lestrange, with Arthurs Lestrange receiving the 60 percent share. Thiemann further proposed that, if he were successful, Arthurs Lestrange would pay him one-third of its share of the refunding revenues. Bova agreed to Thiemann's proposal.

Shortly thereafter, Bova was contacted by a senior public finance banker (the "Senior Banker") at Alex. Brown. During the course of their initial contacts, the Senior Banker informed Bova that his firm had been selected to sell the defeasance escrow securities in the upcoming refunding. The Senior Banker offered that Alex. Brown and Arthurs Lestrange would pool their respective revenues from the transaction and split the revenues on a 60/40 basis, with Arthurs Lestrange receiving 60 percent of the pool. Prior to these contacts, Bova did not know the Senior Banker and had never worked with him. However, Bova believed Alex. Brown to be a well-known and well-capitalized broker-dealer.

In early discussions, Bova and the Senior Banker went over revenues that they expected Alex. Brown and Arthurs Lestrange to contribute to the pool from their anticipated fees on the March Refunding. The revenues related to the sale of the escrow securities were expected to substantially exceed the revenues from Arthurs Lestrange's financial advisory fee.

On or about February 18, 1994, Bova sent a letter to Commonwealth officials which stated:

This is to inform you that Arthurs Lestrange as Financial Adviser, and Alex Brown, as Escrow Agent, intend to pool and then mutually apportion their respective compensation for serving as Financial Adviser and Escrow Agent on the upcoming refunding. The efforts so far by each firm have been so inextricably integrated with the other firm that we are, in effect, working as partners on a day-to-day basis.

On a deal this size, with its significant complexity and critical-timing issues, close professional cooperation by the entire Commonwealth team (the issuer's overall financial adviser and the issuer's technical support --the escrow agent) will only serve to maximize the benefits for the issuer.

After the March Refunding closed, Alex. Brown and Arthurs Lestrange combined and allocated their pooled fees in accordance with their 60/40 fee-splitting agreement. The total pooled fees from the transaction were $2,604,457.10. Arthurs Lestrange contributed $ 210,000 to the pool, which was its fee for serving as the Commonwealth's financial adviser. Alex. Brown contributed $ 2,394,457.10 in revenues related to the sale of the defeasance escrow securities. In accordance with the split formula, Arthurs Lestrange received $1,562,674.26 and Alex. Brown received $ 1,041,782.84. Pursuant to its agreement with Thiemann, Arthurs Lestrange thereafter paid Thiemann's company, HDI, one-third of its share of the pooled revenues, or $520,891.42.

Thiemann played no substantive role in the transactions other than helping to arrange for Arthurs Lestrange to share in the revenues resulting from the sale of the defeasance escrow securities. Arthurs Lestrange paid Thiemann's company, HDI, one-third of its revenues because Arthurs Lestrange would not have shared in the revenues related to the sale of the defeasance escrow securities without Thiemann's involvement.

Thiemann's company, HDI, made certain payments from its share of the refunding revenues in connection with efforts to arrange for Alex. Brown to be appointed to provide the escrow securities and to split its revenues with Arthurs Lestrange. (Bova has attested that, at the time of the March Refunding, he asked Thiemann whether he was sharing his fees with anyone, and Thiemann told him that he was not.) Patrick H. McCarthy, an attorney who wielded a high degree of influence at the Treasurer's office, suggested to the Senior Banker that Alex. Brown could be appointed escrow provider if it would agree to split fees 60/40 with Arthurs Lestrange. The Senior Banker agreed and thereafter telephoned Bova, as described above. McCarthy then used his influence within the Treasurer's Office to have Alex. Brown named as escrow provider for the March Refunding. McCarthy's law firm received payments from HDI for McCarthy's role in the transaction.

D. Legal Discussion

Section 17(a) of the Securities Act prohibits materially false or misleading statements, or material omissions when there is a duty to speak, in the offer or sale of any security. Section 17(a)(1) requires a showing of scienter; however, Sections 17(a)(2) and 17(a)(3) do not require such a showing. Aaron v. SEC, 446 U.S. 680, 697 (1980). Violations of Sections 17(a)(2) and (3) may be established by showing negligence. SEC v. Hughes Capital Corp.,124 F.3d 449, 453-54 (3d Cir. 1997); SEC v. Steadman, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992). A duty to speak arises, and material omissions become fraudulent, when a person or entity has information that another is entitled to know because of a fiduciary or similar relationship of trust and confidence. See Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-55 (1972); Chiarella v. United States, 445 U.S. 222, 228

(1980); In re Arleen W. Hughes, 27 S.E.C. 629 (1948), aff'd, 174 F.2d 969 (D.C. Cir. 1949).

Generally, a financial adviser to a state or local issuer owes fiduciary obligations to it in connection with bond financings by the issuer. n3 Arthurs Lestrange also was a fiduciary under Pennsylvania law because the Commonwealth reposed trust in the skill and integrity of Arthurs Lestrange as its financial adviser, and the Commonwealth had a "just foundation for belief" that Arthurs Lestrange was acting in the Commonwealth's best interest. See Antinoph v. Laverell Securities, 703 F.Supp. 1185 (E.D. Pa. 1989); Lazin v. Pavilion Partners, 1995 U.S. Dist. LEXIS 15255, Civ.A. No. 95-601, 1995 WL 614018 (E.D. Pa. Oct. 11, 1995). As a fiduciary which earned substantial revenues from the Escrow Provider's sale of the escrow securities to the Commonwealth, Arthurs Lestrange was obligated to disclose all material circumstances fully and completely. Cf. Arleen W. Hughes, 27 SEC at 636; see also Restatement 2d of Agency, section 390, comment a.

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n3 See, e.g., Order Approving Proposed Rule Change of MSRB Relating to Activities of Financial Advisors, Exchange Act Release No. 30258 (Jan. 16, 1992) ("The MSRB . . . believes that the existence of the conflict of interest [faced by a dealer acting as both financial advisor and placement agent on the same issue] is contrary to the fiduciary obligations of municipal securities professionals acting as financial advisors to issuers . . . ."); Notice by MSRB of Proposed Rule G-23, 42 Fed. Reg. 49856, 49859 (Sept. 28, 1977) ("As a financial advisor, the municipal securities professional acts in a fiduciary capacity as agent for the governmental unit . . . ."); cf. In re O'Brien Partners, Inc., Securities Act Release No. 7594 (October 27, 1998) (violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act for failure to make full disclosure in breach of fiduciary duty owed as municipal financial advisor). The term financial advisor is not defined in the federal securities laws. However, Rule G-23(b) of the Rules of the Municipal Securities Rulemaking Board provides that "a financial advisory relationship shall be deemed to exist when a broker, dealer, or municipal securities dealer renders or enters into an agreement to render financial advisory or consultant services to or on behalf of an issuer with respect to a new issue or issues of municipal securities, including advice with respect to the structure, timing, terms and other similar matters concerning such issue or issues, for a fee or other compensation or in expectation of such compensation for the rendering of such services."

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In addition, apart from any fiduciary status, Bova was obligated to make full disclosure of information necessary in order to make the statements made in his February 18 letter not materially misleading. See, e.g., Kline v. First Western Government Securities, 24 F.3d 480 (3d Cir. 1994); Maryland National Bank v. Dauphin Deposit Bank and Trust Co., 647 F.Supp. 908 (M.D. Pa. 1986).

Bova's February 18th letter to the Commonwealth contained material misstatements and omissions. Although the letter disclosed that Arthurs Lestrange and Alex. Brown had agreed to "pool" and "apportion" their respective fees, it failed to disclose that Arthurs Lestrange would receive the largest portion of the pooled revenues notwithstanding that its own contribution would be much smaller than that of Alex. Brown. The letter also failed to disclose that Arthurs Lestrange had agreed to pay one-third of its share to Thiemann's company for bringing a share of the escrow revenues to Arthurs Lestrange. These facts were material because they would have called into question the integrity of the process by which Alex. Brown was selected as escrow provider. n4 The Commonwealth also would have wanted to know if its financial adviser was receiving disproportionate revenues from the sale of the escrow securities because this could have signaled that Arthurs Lestrange had a strong incentive for the refunding to close, and therefore a potential conflict of interest.

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n4 See Statement of the Commission Regarding Disclosure of Municipal Securities Issuers and Others, Securities Act Release No. 7049 (March 9, 1994) ("Information concerning financial and business arrangements among parties involved in the issuance of municipal securities may be critical to evaluating an offering...").

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Bova knew or should have known that the February 18th letter was materially misleading, given his understanding of Arthurs Lestrange's arrangement with Alex. Brown. Further, even if Thiemann told Bova that he was not sharing fees, as Bova has claimed, certain "red flags" should have caused Bova to investigate further what caused Alex. Brown to contact him. These included the facts that the Senior Banker, with whom Bova had had no previous contact, offered to share 60% of Alex. Brown's revenues with Arthurs Lestrange, although Arthurs Lestrange had no relationship with the Treasurer's office, and was expected to generate less revenues in the refundings than Alex. Brown. See In the Matter of Dean McDermott et al., Securities Act Release No. 7502 (Jan. 30, 1998).

For purposes of Arthur Lestrange's violations, the conduct of Bova may be imputed to the firm. See SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1089 n. 3 (2d Cir. 1972); Converse, Inc. v. Norwood Venture Corp., 1997 Fed. Sec.L.Rep. (CCH) @ 90,121 (S.D.N.Y. 1997); Blanchard v. Edgemark Financial Corp., Fed. Sec.L.Rep. (CCH) @ 90,439 (N.D. Ill. 1999).

III.

On the basis of the foregoing, the Commission finds that Bova and Arthurs Lestrange each willfully violated Sections 17(a)(2) and (3) of the Securities Act. n5

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n5 In applying the term "willful" in Commission administrative proceedings instituted pursuant to Sections 15(b), 15B, 15C, 17A and 19(h) of the Securities Exchange Act, Section 9 of the Investment Company Act, and Section 203 of the Investment Advisers Act, the Commission evaluates on a case-by-case basis whether the respondent knew or reasonably should have known under the particular facts and circumstances that his conduct was improper. In this case, as in all Commission administrative proceedings charging a willful violation under these statutory provisions, the Commission applies this standard to persons --specifically, securities industry professionals -- who are directly subject to Commission jurisdiction and who have a responsibility to understand their duties to the investing public and comply with the applicable rules and regulations which govern behavior.

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IV.

Arthurs Lestrange has submitted an Offer of Settlement in which, without admitting or denying the findings herein, it consents to the Commission's entry of this Order, which: (1) makes findings, as set forth above; (2) censures Arthurs Lestrange; (3) orders Arthurs Lestrange to cease and desist from committing or causing any violations and any further violations of Sections 17(a)(2) and (3) of the Securities Act; and (4) orders Arthurs Lestrange to pay a civil penalty in the amount of $ 100,000.

V.

Bova has submitted an Offer of Settlement in which, without admitting or denying the findings herein, he consents to the Commission's entry of this Order, which: (1) makes findings, as set forth above; (2) censures Bova; (3) orders Bova to cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and (3) of the Securities Act; and (4) orders Bova to pay a civil penalty in the amount of $ 35,000.

VI.

In view of the foregoing, the Commission deems it appropriate and in the public interest to accept the Offers of Settlement submitted by Arthurs Lestrange and Bova.

Accordingly, IT IS ORDERED, pursuant to Section 8A of the Securities Act, and Sections 15(b) and 15B(c) of the Exchange Act, that:

1. Arthurs Lestrange is censured.

2. Arthurs Lestrange shall cease and desist from committing or causing any violations and any future violations of Section 17(a)(2) and (3) of the Securities Act.

3. Arthurs Lestrange shall, within thirty (30) days of the date of this Order, pay a civil money penalty in the amount of $ 100,000 to the United States Treasury. Such payment shall be: (1) made by United States postal money order, certified check, bank cashier's check or bank money order; (2) made payable to the United States Securities and Exchange Commission; (3) hand-delivered or mailed to the Comptroller, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (4) submitted under cover letter that identifies Arthurs Lestrange as a Respondent in these proceedings, and states the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Brian A. Ochs, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0805.

4. Bova is censured.

5. Bova shall cease and desist from committing or causing any violations and any future violations of Section 17(a)(2) and (3) of the Securities Act.

6. Bova shall, within thirty (30) days of the date of this Order, pay a civil money penalty in the amount of $ 35,000 to the United States Treasury. Such payment shall be: (1) made by United States postal money order, certified check, bank cashier's check or bank money order; (2) made payable to the United States Securities and Exchange Commission; (3) hand-delivered or mailed to the Comptroller, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (4) submitted under cover letter that identifies Bova as a Respondent in these proceedings, and states the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Brian A. Ochs, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0805.

By the Commission.

ACCOUNTANTS/AUDITORS

COMMISSION ORDERS - SETTLED ADMINISTRATIVE PROCEEDINGS

In the Matter of Albert Adamczak, C.P.A., Exchange Act Release No. 42743, AAE Release No. 1253, A.P. File No. 3-10196 (May 2, 2000).

I.

The Securities and Exchange Commission deems it appropriate that proceedings be, and hereby are, instituted against Albert Adamczak pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 102(e) of the Commission's Rules of Practice.[1]

II.

In anticipation of the institution of these proceedings, Adamczak has submitted an Offer of Settlement ("Offer") that the Commission has determined to accept. Solely for the purpose of these proceedings, and any other proceedings brought by or on behalf of the Commission or in which the Commission is a party, Adamczak, without admitting or denying the findings contained herein, except that he admits the jurisdiction of the Commission over him and over the subject matter of these proceedings, consents to the entry of the findings and the issuance of this Order Instituting Proceedings, Making Findings, Imposing Sanctions and Imposing a Cease-and Desist Order (the "Order").

Accordingly, IT IS ORDERED that proceedings against Adamczak be, and hereby are, instituted.

III.

On the basis of this Order and the Offer submitted by Adamczak, the Commission finds that:[2]

A. Albert Adamczak, age 40, is a certified public accountant licensed in Pennsylvania. He became Vice President of Corporate Support Services (the "Accounting Department") for Allegheny Health Education and Research Foundation ("AHERF") in June 1997, reporting directly to AHERF's Chief Financial Officer ("CFO"). Prior to his promotion in June 1997, he served as a senior director of accounting for AHERF and AHERF's western subsidiaries. Adamczak worked as an accountant for a large accounting firm for eight years prior to joining AHERF. In that position Adamczak participated in one or more audits of the financial statements of public companies, which were included in filings with the Commission.

B. AHERF is a Pennsylvania nonprofit healthcare organization formed in 1983. Until recently, it was the parent holding company and sole member or owner of numerous subsidiaries.[3] On July 21, 1998, AHERF instituted bankruptcy proceedings under Chapter 11 of the United States Bankruptcy Code on behalf of itself and four of these subsidiaries in the U.S. District Court for the Western District of Pennsylvania.

C. From 1987 to 1997, AHERF expanded rapidly, acquiring other non-profit healthcare organizations, including several in the Philadelphia metropolitan area: the Medical College of Pennsylvania, United Hospitals, Inc., Hahnemann University Hospital and the Graduate Health System ("Graduate"). The acquired entities became direct or indirect subsidiaries of AHERF.

D. As an umbrella holding company, AHERF managed and provided centralized corporate support services for the acquired entities, but did not assume liability for their pre-existing debt. The obligation to repay debt within AHERF was placed on collections of one or more of its non-profit subsidiaries known as "obligated groups." By 1997, AHERF had five obligated groups**:** Allegheny General Hospital ("Allegheny General"), Allegheny University Medical Centers, Delaware Valley, Allegheny Hospitals, Centennial ("Centennial"), and Allegheny Hospitals, New Jersey.

E. By the time of the bankruptcy in July 1998, AHERF's obligated groups were responsible for, at least, thirteen bond issues, with outstanding debt of more than $900 million.

F. Pursuant to contractual obligations, the obligated groups, through AHERF as their agent, provided to nationally recognized repositories annual Secondary Market Disclosure Reports ("Disclosure Reports") containing audited financial statements prepared in accordance with Generally Accepted Accounting Principles ("GAAP"), debt coverage ratios and other information with respect to certain of its obligated groups. These Disclosure Reports were made available to the public through these repositories and were the most easily accessible source of information for investors and potential investors in AHERF bonds.

G. From at least June 1997 through July 21, 1998, AHERF's financial reporting function, including the initial preparation of financial statements, was primarily handled by the Accounting Department, which reported to Adamczak. Significant aspects of the financial reporting function also were the responsibility of other departments or entities within AHERF.

H. As a member of AHERF management, Adamczak participated in most, if not all, significant decisions affecting the financial statements of AHERF and its subsidiaries. Subject to AHERF's chief financial officer, he oversaw AHERF's accounting department. He further was responsible for the accuracy of the numbers in the financial statement, and received and reviewed drafts of AHERF's 1997 consolidated Disclosure Report.

I. On or about February 6, 1998, AHERF distributed its 1997 audited consolidated financial statements with consolidating schedules and consolidated Disclosure Report to the nationally recognized repositories and numerous other third parties.

J. AHERF's audited consolidated financial statements with consolidating schedules for the year ended June 30, 1997, purportedly prepared in accordance with GAAP, were materially false and misleading and failed to comply with GAAP in that:

1. they materially overstated AHERF's 1997 consolidated net income; and

2. they materially overstated Delaware Valley's 1997 net income.

K. AHERF's 1997 consolidated Disclosure Report was materially false and misleading in that:

1. it mirrored the numerical misstatements in the AHERF 1997 audited consolidated financial statements and consolidating schedules;

2. it materially misrepresented the condition of Delaware Valley accounts receivable; and

3. it materially misrepresented the financial condition of Centennial.

L. From at least June 1997 through July 21, 1998, Adamczak willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder in that he, directly or indirectly, in connection with the purchase or sale of securities, namely, AHERF bonds, by use of the

means or instrumentalities of interstate commerce, or the mails: (1) employed devices, schemes or artifices to defraud; (2) made untrue statements of material fact and omitted to state material facts necessary to make the statements made, in light of the circumstances under which they were made, not misleading; and (3) engaged in acts, practices and courses of business which operated as a fraud and deceit upon persons, including the purchasers and prospective purchasers of such securities. Such violations include Adamczak's deliberate and/or reckless misrepresentation or failure to disclose, directly or indirectly, to investors:

1. the overstatement of AHERF's consolidated net income at June 30, 1997 because of the failure to adjust Delaware Valley's reserve and expense accounts related to uncollectible receivables in accordance with GAAP;

2. the overstatement of Delaware Valley's net income at June 30, 1997 because of the failure to adjust Delaware Valley's reserve and expense accounts related to uncollectible receivables in accordance with GAAP;

3. the overstatement of AHERF's consolidated net income at June 30, 1997 because of the misclassification of certain restricted funds;

4. the misrepresentation of the condition of Delaware Valley accounts receivable in AHERF's 1997 consolidated Disclosure Report, including the misrepresentation of the reason for the decrease in net patient accounts receivable; and

5. the misrepresentation of Centennial's financial condition in AHERF's 1997 consolidated Disclosure Report, including the misrepresentation of the reasons for certain Centennial restructuring costs and for the change in Centennial intercompany account balances from a receivable position to a payable position.

IV.

On the basis of this Order and the Offer submitted by Adamczak, the Commission finds that Adamczak willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

V.

In view of the foregoing, the Commission deems it appropriate to accept the Offer submitted by Adamczak.
Accordingly, IT HEREBY IS ORDERED pursuant to Section 21C of the Exchange Act, that Adamczak cease and desist from committing or causing any violations and any future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; and IT IS FURTHER ORDERED, effective immediately, that:

A. Adamczak is denied the privilege of appearing or practicing before the Commission as an accountant.

B. After three years from the date of this Order, Adamczak may request that the Commission consider his reinstatement by submitting an application to the Office of the Chief Accountant to resume appearing or practicing before the Commission as:

1. a preparer or reviewer, or a person responsible for the preparation or review, of any public company's financial statements that are filed with the Commission. Such an application must satisfy the Commission that Adamczak's work in his practice before the Commission will be reviewed either by the independent audit committee of the public company for which he works or in some other acceptable manner, as long as he practices before the Commission in this capacity; and/or

2. an independent accountant. Such an application must satisfy the Commission that:

(a) Adamczak, or the firm with which he is associated, is a member of the SEC Practice Section of the American Institute of Certified Public Accountants Division for CPA Firms ("SEC Practice Section");

(b) Adamczak, or the firm, has received an unqualified report relating to his, or the firm's, most recent peer review conducted in accordance with the guidelines adopted by the SEC Practice Section; and

(c) As long as Adamczak appears or practices before the Commission as an independent accountant he will remain either a member of the SEC Practice Section or associated with a member firm of the SEC Practice Section, and will comply with all applicable SEC Practice Section requirements, including all requirements for periodic peer reviews, concurring partner reviews, and continuing professional education.

C. The Commission's review of an application by Adamczak to resume appearing or practicing before the Commission may include consideration of, in addition to the matters referenced above, any other matters relating to Adamczak's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.
D. Adamczak shall comply with his cooperation agreement, as set forth in paragraph IV.C. of his Offer.

By the Commission.

Jonathan G. Katz
Secretary

Footnotes

[1] Paragraph 1 of Rule 102(e) provides in relevant part that:

The Commission may ... deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice and opportunity for hearing in the matter... (iii) [t]o have willfully violated ... any provision of the Federal securities laws or the rules and regulations thereunder.
[2] The findings herein are made pursuant to Adamczak's Offer and are not binding on any other person or entity in this or any other proceeding.
[3] AHERF's underlying entities are referred to as "subsidiaries," although technically AHERF was their sole "member", not a shareholder.

<u>In the Matter of Stephen H. Spargo, C.P.A.</u>, Exchange Act Release No. 42742, AAE Release No. 1252, A.P. File No. 3-10195 (May 2, 2000).

I.

The Securities and Exchange Commission deems it appropriate that proceedings be, and hereby are, instituted against Stephen H. Spargo pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 102(e) of the Commission's Rules of Practice.[1]

II.

In anticipation of the institution of these proceedings, Spargo has submitted an Offer of Settlement ("Offer") that the Commission has determined to accept. Solely for the purpose of these proceedings, and any other proceedings brought by or on behalf of the Commission or in which the Commission is a party, Spargo, without admitting or denying the findings contained herein, except that he admits the jurisdiction of the Commission over him and over the subject matter of these proceedings, consents to the entry of the findings and the issuance of this Order Instituting Proceedings, Making Findings, Imposing Sanctions and Imposing a Cease-and Desist Order (the "Order").

Accordingly, IT IS ORDERED that proceedings against Spargo be, and hereby are, instituted.

III.

On the basis of this Order and the Offer submitted by Spargo, the Commission finds that:[2]

A. Stephen H. Spargo, age 42, is a certified public accountant licensed in Pennsylvania. He was Senior Vice President of Corporate Support Services (the "Accounting Department") for Allegheny Health Education and Research Foundation ("AHERF") from 1993 to on or about June 2, 1997, reporting directly to AHERF's Chief Financial Officer ("CFO"). Spargo worked as a staff accountant for a large accounting firm for three years and was the director of finance and CFO of two community hospitals prior to joining AHERF. While acting as a staff accountant for the large accounting firm, Spargo participated in one or more audits of the financial statements of public companies, which were included in filings with the Commission.

B. AHERF is a Pennsylvania nonprofit healthcare organization formed in 1983. Until recently, it was the parent holding company and sole member or owner of numerous subsidiaries.[3] On July 21, 1998, AHERF instituted bankruptcy proceedings under Chapter 11 of the United States Bankruptcy Code on behalf of itself and four of these subsidiaries in the U.S. District Court for the Western District of Pennsylvania.

C. By the time of the bankruptcy in July 1998, AHERF's obligated groups were responsible for, at least, thirteen bond issues, with outstanding debt of more than $900 million. The obligation to repay debt within AHERF was placed on groups of one or more of its non-profit subsidiaries known as "obligated groups". By 1997, AHERF had five obligated groups**:** Allegheny General Hospital ("Allegheny General"), Allegheny University Medical Centers, Delaware Valley, Allegheny Hospitals, Centennial ("Centennial"), and Allegheny Hospitals, New Jersey.

D. The AHERF obligated groups, through AHERF as their agent, provided to nationally recognized repositories annual Secondary Market Disclosure Reports ("Disclosure Reports") which contained, among other things, a section explaining the financial health of the reporting entity(ies), debt coverage ratios, and attaching audited financial statements. These Disclosure Reports were made available to the public through these repositories and were the most easily accessible source of information for investors and potential investors in AHERF bonds.

E. In particular, Delaware Valley was obligated to repay approximately $356 million (original principal amount) of tax-exempt Health Services Revenue Bonds issued in June 1996 (the "Delaware Valley Refinancing"). The refinancing documents required AHERF to provide annually to all nationally recognized repositories:

1. Delaware Valley's audited financial statements prepared in accordance with Generally Accepted Accounting Principles ("GAAP"); and

2. Delaware Valley's Secondary Market Disclosure Report that included, among other things, financial information, debt service coverage ratios and utilization statistics.

These documents were made available to the public, including investors in Delaware Valley and other AHERF bond issues, through these repositories.

F. AHERF's financial reporting function, including the initial preparation of financial statements, was primarily handled by Spargo's staff in the Accounting Department, although significant aspects of the financial reporting function also were the responsibility of other departments or entities within AHERF.

G. As a member of AHERF senior management, Spargo participated in all significant decisions affecting, among others, Delaware Valley's financial statements. He oversaw AHERF's accounting department and was responsible for the accuracy of the numbers in the financial statements. He further received and reviewed drafts of Delaware Valley's 1996 Disclosure Report.

H. Between December 12, 1996 and January 7, 1997, AHERF sent Delaware Valley's 1996 Disclosure Report and audited financial statements to the nationally recognized repositories and numerous other third parties.

I. Delaware Valley's audited financial statements for the year ended June 30, 1996 were materially false and misleading and failed to comply with GAAP in that they materially overstated Delaware Valley's 1996 net income and misrepresented the condition of Delaware Valley accounts receivable.

J. Delaware Valley's 1996 Disclosure Report was materially false and misleading in that it mirrored the numerical misstatements in the 1996 financial statements and it materially misrepresented the condition of Delaware Valley accounts receivable.

K. From, at least, December 1996 through June 2, 1997, Spargo willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder in that he, directly or indirectly, in connection with the purchase or sale of securities, namely, AHERF bonds, by use of any means or instrumentality of interstate commerce, or the mails: (1) employed devices, schemes or artifices to defraud; (2) made untrue statements of material fact and omitted to state material facts necessary to make the statements made, in light of the circumstances under which they were made, not misleading; and (3) engaged in acts, practices and courses of business which operated as a fraud and deceit upon persons, including the purchasers and prospective purchasers of such securities. Such violations include his deliberate and/or reckless misrepresentation or failure to disclose, directly or indirectly, to investors:

1. the overstatement of Delaware Valley's net income at June 30, 1996 by the failure to adjust Delaware Valley's bad debt reserves to account for uncollectible accounts receivable; and

2. the misrepresentation of the condition of Delaware Valley accounts receivable in Delaware Valley's 1996 Disclosure Report, including the misrepresentation of the reason for the increase in net accounts receivable.

IV.

On the basis of this Order and the Offer submitted by Spargo, the Commission finds that Spargo willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

V.

In view of the foregoing, the Commission deems it appropriate to accept the Offer submitted by Spargo. In determining to accept the Offer, the Commission considered cooperation afforded the Commission staff.

Accordingly, IT HEREBY IS ORDERED pursuant to Section 21C of the Exchange Act, that Spargo cease and desist from committing or causing any violations and any future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; and

IT IS FURTHER ORDERED, effective immediately, that:

A. Spargo is denied the privilege of appearing or practicing before the Commission as an accountant.

B. After three years from the date of this Order, Spargo may request that the Commission consider his reinstatement by submitting an application to the Office of the Chief Accountant to resume appearing or practicing before the Commission as:

1. a preparer or reviewer, or a person responsible for the preparation or review, of any public company's financial statements that are filed with the Commission. Such an application must satisfy the Commission that Spargo's work in his practice before the Commission will be reviewed either by the independent audit committee of the public company for which he works or in some other acceptable manner, as long as he practices before the Commission in this capacity; and/or

2. an independent accountant. Such an application must satisfy the Commission that:

(a) Spargo, or the firm with which he is associated, is a member of the SEC Practice Section of the American Institute of Certified Public Accountants Division for CPA Firms ("SEC Practice Section");

(b) Spargo, or the firm, has received an unqualified report relating to his, or the firm's, most recent peer review conducted in accordance with the guidelines adopted by the SEC Practice Section; and

(c) As long as Spargo appears or practices before the Commission as an independent accountant he will remain either a member of the SEC Practice Section or associated with a member firm of the SEC Practice Section, and will comply with all applicable SEC Practice Section requirements, including all requirements for periodic peer reviews, concurring partner reviews, and continuing professional education.

C. The Commission's review of an application by Spargo to resume appearing or practicing before the Commission may include consideration of, in addition to the matters referenced above, any other matters relating to Spargo's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.

Jonathan G. Katz
Secretary

Footnotes

[1] Paragraph 1 of Rule 102(e) provides in relevant part that:
The Commission may ... deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice and opportunity for hearing in the matter... (iii) [t]o have willfully violated ... any provision of the Federal securities laws or the rules and regulations thereunder.
[2] The findings herein are made pursuant to Spargo's Offer and are not binding on any other person or entity in this or any other proceeding.

[3] AHERF's underlying entities are referred to as "subsidiaries," although technically AHERF was their sole "member", not a shareholder.

CONSULTANTS

SETTLED INJUNCTIVE PROCEEDINGS

SEC v. Patrick H. McCarthy, Civ. Action No. 1-99-CV-2003 (U.S. District Court for the Middle District of Pennsylvania)(YK), Litigation Release No. 16356 (November 17, 1999).

The Securities and Exchange Commission today filed a complaint for securities fraud against Patrick H. McCarthy, a Philadelphia attorney and former fund raiser and senior adviser to the past Treasurer of the Commonwealth of Pennsylvania. The complaint charges McCarthy with arranging for his law firm to receive undisclosed compensation, in violation of his fiduciary duty, for influencing the selection of a securities dealer in two Pennsylvania refunding bond offerings in 1994.

In a refunding bond offering, an issuer gets the benefit of lower current interest rates on its debt by issuing "refunding bonds" and immediately investing the proceeds in a portfolio of U.S. Treasury or agency securities structured to pay the principal and interest on old, higher interest rate bonds. The Commission's complaint alleges that, although not a Commonwealth employee, McCarthy was viewed by senior staff as the most powerful person in the Pennsylvania Treasurer's office, after the Treasurer and the Executive Deputy Treasurer, at the time of the 1994 refunding bond offerings. Dennis E. Thiemann, then a longtime consultant to Arthurs Lestrange & Company, a Pittsburgh-based broker-dealer which served as the Commonwealth's financial adviser for the offerings, obtained Arthurs Lestrange's agreement that the firm would pay Thiemann one-third of its deal revenues if Thiemann could find a larger broker-dealer which would agree to sell the Treasury securities to the Commonwealth, split its fees with Arthurs Lestrange, and pay 60 percent of the total to Arthurs Lestrange. Thiemann then approached his friend, John M. Seidman, who ran a private consulting firm called JMS Associates, and whom Thiemann believed had contacts within the Treasurer's office. Seidman and Thiemann discussed several firms, including Alex. Brown and Sons Incorporated, which Seidman knew was the financial adviser to the Treasurer's office. Seidman also was a friend of McCarthy, and knew that McCarthy had a long-standing relationship with Alex. Brown's municipal securities business. McCarthy was then approached for his assistance in arranging for Alex. Brown to be appointed to sell the Treasury securities.

The complaint alleges that McCarthy then contacted Alex. Brown and offered that Alex. Brown could be appointed to sell the Treasury securities if it would split fees with Arthurs Lestrange, and pay Arthurs Lestrange 60 percent of the total. McCarthy then used his influence to have Alex. Brown appointed over the objections of the Treasurer's senior staff. After the first refunding closed in March 1994, Arthurs Lestrange paid one-third of its revenues, or $520,891 to Thiemann's firm, HDI, Inc. HDI, in turn, paid $175,250 to JMS Associates and $172,000 to McCarthy's law firm, and retained $173,641. The Commission's actions do not allege that Alex. Brown or Arthurs Lestrange

knew about HDI's payments to JMS Associates or to McCarthy's firm. When senior staff in the Treasurer's office became aware and protested that Alex. Brown had overcharged the Commonwealth for the Treasury securities, McCarthy supported Alex. Brown. Alex. Brown later entered into an agreement to retain McCarthy's firm for $20,000 per month, commencing in June 1994, and McCarthy again used his influence to have Alex. Brown selected to sell the Treasury securities for a second Pennsylvania refunding in June 1994 over the objections of the Treasurer's staff. The Commission's complaint alleges that, while promoting Alex. Brown's interests in the Treasurer's office in connection with both the March and June 1994 refundings, McCarthy knowingly or recklessly failed to disclose to the Treasurer's office or to the Commonwealth that he had a conflict of interest arising from his payment arrangements with Thiemann and Alex. Brown.

Simultaneously with the filing of the complaint, and without admitting or denying the Commission's allegations, McCarthy consented to the entry of a final judgment against him. The final judgment enjoins McCarthy from violating Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder. The final judgment also requires McCarthy to pay a civil penalty of $100,000. McCarthy's law firm voluntarily returned to Pennsylvania the $172,000 obtained from HDI and all of the retainer fees received from Alex. Brown after June 1994, plus interest, and is not the subject of a Commission action.

Also simultaneously with the filing of the complaint, the Commission instituted several administrative proceedings charging securities law violations by other individuals and entitites involved with the Pennsylvania refundings. BT Alex. Brown Incorporated, Alex. Brown's corporate successor, consented to a Commission order which finds that Alex. Brown willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5. Alex. Brown misrepresented the size of the markup charged on the portfolio of Treasury securities sold to Pennsylvania for the March 1994 refunding as 4.5 basis points in price, when it was actually 45 basis points, and failed to disclose fully the fee-splitting arrangement with Arthurs Lestrange. The order also finds that Alex. Brown willfully violated Sections 17(a)(2) and (3) of the Securities Act by charging excessive, undisclosed markups. Without admitting or denying the Commission's findings, BT Alex. Brown agreed to be censured, to cease and desist from future violations, to pay $603,996 in disgorgement related to the March 1994 Pennsylvania refunding, and to comply with undertakings to pay an additional $14,701,250 to settle claims with the Commission, the Internal Revenue Service, and the United States Attorney for the Southern District of New York relating to other refunding bond offerings in which Alex. Brown sold U.S. Treasury securities to bond issuers. Of that amount, $127,674 will be paid directly to certain issuers of refunding bonds.

In a separate administrative proceeding, the Commission's Division of Enforcement has charged Kevin G. Quinn, the head of Alex. Brown's Public Finance Department at the time of the March 1994 Pennsylvania bond refunding, and the lead Alex. Brown banker responsible for that refunding, with willfully violating Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5. In the proceeding against Quinn, the Division alleges that he misrepresented the size of the markup on the Treasury securities which Alex. Brown sold in the Pennsylvania refunding, and that he failed to disclose the

nature, purpose, and extent of Alex. Brown's fee-splitting arrangement with Arthurs Lestrange. The case will be heard by an administrative law judge.

Thiemann, HDI, Seidman, and JMS Associates consented to Commission orders finding that they were causes of McCarthy's violations under Section 8A of the Securities Act and Section 21C of the Exchange Act. Without admitting or denying the Commission's findings, they each consented to orders that they cease and desist from committing or causing violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5. The orders also require HDI and JMS Associates to disgorge the sums they obtained from the March 1994 refunding revenues ($173,641 and $175,250 respectively) plus prejudgment interest.

Arthurs Lestrange and Michael P. Bova, head of municipal finance for Arthurs Lestrange at the time of the 1994 Pennsylvania refundings, consented to a Commission order which finds that they willfully violated Sections 17(a)(2) and (3) of the Securities Act. Although Bova informed Commonwealth officials by letter that Arthurs Lestrange and Alex. Brown were pooling fees, Arthurs Lestrange and Bova failed to disclose that Arthurs Lestrange would receive the largest portion of the pooled revenues, notwithstanding that its own contribution would be much smaller than that of Alex. Brown. Bova's letter also failed to disclose that Arthurs Lestrange had agreed to pay one-third of its revenues to Thiemann's company for bringing to Arthurs Lestrange a share of the deal revenues generated by Alex. Brown. Without admitting or denying the Commission's findings, Arthurs Lestrange and Bova consented to censures and to orders that they cease and desist from future violations. In addition, Arthurs Lestrange will pay a $100,000 penalty, and Bova will pay a $35,000 penalty.

Douglas E. Carter, Quinn's successor as head of the Alex. Brown Public Finance Department, and lead banker for the June 1994 Pennsylvania refunding, consented to a Commission order which finds that he willfully violated Sections 17(a)(2) and (3) of the Securities Act. The order finds that Carter knew or should have known that Alex. Brown had overcharged the Commonwealth 45 basis points instead of the agreed 4.5 basis points on the Treasury portfolio for the March 1994 refunding, and that he did not disclose this fact to the Treasurer's office. Without admitting or denying the Commission's findings, Carter consented to be censured, to cease and desist from future violations, and to pay a penalty of $35,000.

The Commission thanks the United States Attorney for the Southern District of New York, the Department of Justice, the Department of the Treasury, the Internal Revenue Service, and the Commonwealth of Pennsylvania for their cooperation in this matter.

COMMISSION ORDERS – SETTLED ADMINISTRATIVE PROCEEDINGS

In the Matter of HDI, Inc. and Dennis Thiemann, Securities Act Release No. 7777, Exchange Act Release No. 42150, A.P. File No. 3-10102 (November 17, 1999).

I.

The Securities and Exchange Commission (the "Commission") deems it appropriate that public administrative proceedings be, and they hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against HDI, Inc. ("HDI") and Dennis E. Thiemann ("Thiemann").

II.

In anticipation of the institution of these proceedings, HDI and Thiemann have each submitted an offer of settlement, which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceeding brought by or on behalf of the Commission or in which the Commission is a party, and prior to a hearing pursuant to the Commission's Rules of Practice, 17 C.F.R. §201.100 et seq., HDI and Thiemann, without admitting or denying the findings contained herein, except that each admits to the jurisdiction of the Commission over them and over the subject matter of these proceedings, consent to the entry of the findings, the institution of the cease-and-desist order and the order requiring disgorgement set forth below.

III.

Based on the foregoing, the Commission finds as follows:[1]

A. Respondents

1. Dennis E. "Harvey" Thiemann, age 55, is a resident of Shermans Dale, Pennsylvania. Thiemann is the founder of a privately held consulting firm called HDI, Inc.

2. HDI, Inc. is a Pennsylvania corporation. Thiemann and his wife are HDI's only shareholders and employees.

B. Other Relevant Persons

1. John M. Seidman ("Seidman"), is the founder of a privately held Pittsburgh-based business and political consulting firm called JMS Associates, Inc. Seidman served as a senior advisor to the former Treasurer of the Commonwealth of Pennsylvania (hereafter the "Treasurer") during her first campaign for Treasurer in 1988.[2] Seidman was a friend of Thiemann.

2. Patrick H. McCarthy, III ("McCarthy"), a Philadelphia-based attorney and close friend of Seidman, was also actively involved in Pennsylvania state Democratic politics. McCarthy served as transition chief for the Treasurer following her 1988 election. After the Treasurer assumed office in January 1989, McCarthy remained a close confidante of the Treasurer and her Executive Deputy Treasurer.[3] Although McCarthy held no official title and was not employed by the Treasurer's Office, he stayed actively involved in the day-to-day operations, decisions and policies of the Treasurer's Office. McCarthy was *de facto* the most powerful person in the office after the Treasurer and the Executive Deputy

Treasurer. McCarthy had the authority to give orders to staff members and had input and decision making authority, with the Executive Deputy Treasurer, on a wide range of substantive issues, including programs and personnel matters. McCarthy was also extensively involved in selecting vendors, including investment banking firms, that did business with the Treasurer's Office.

C. The March 1994 Pennsylvania Refunding

In late 1993, the Commonwealth of Pennsylvania was considering bond refundings totaling over $ 1 billion.[4] The Governor's Budget Office, which was responsible for all Pennsylvania debt issues, appointed Arthurs Lestrange & Company ("Arthurs Lestrange"), a Pittsburgh-based broker dealer, to serve as the Commonwealth's financial adviser for the refundings. (Arthurs Lestrange had proposed the refundings to the Commonwealth.) The Treasurer's Office, which was generally responsible for the investment of Commonwealth funds, was charged with obtaining investments for the escrows for the refundings. Ultimately, two refundings resulted: (1) the Commonwealth of Pennsylvania $494,145,000 General Obligation First Series, which closed in March 1994 (the "March Refunding") and (2) the Commonwealth of Pennsylvania $469,616,337.34 General Obligation Bond Second Series 1994, which closed in June 1994 (the "June Refunding").

Thiemann, through HDI, served as a longtime consultant for Arthurs Lestrange. Based on his knowledge of a previous Commonwealth bond refunding, Thiemann understood that the Treasurer's Office had in the past selected securities dealers to sell open market securities to the Commonwealth and he believed the Treasurer's Office would be selecting a securities dealer to sell open market Treasury securities to the Commonwealth for the 1994 General Obligation bond refundings. Thiemann also believed that the assignment could be lucrative for the dealer. In January 1994, Thiemann approached Arthurs Lestrange with the idea of having Arthurs Lestrange share in the revenues on the sale of the escrow securities. Thiemann and Arthurs Lestrange believed, however, that Commonwealth officials would view Arthurs Lestrange as too small a firm to handle the purchase and sale of hundreds of millions of dollars in U.S. Treasury securities. Accordingly, Thiemann proposed to Arthurs Lestrange that he would find a larger broker-dealer that could be selected to provide the escrow securities and would agree to split its revenues on a 60/40 basis, with Arthurs Lestrange receiving the 60 percent share. Thiemann further proposed that, if he were successful, Arthurs Lestrange would pay him one-third of its share of the refunding revenues. Arthurs Lestrange agreed to Thiemann's proposal.

Thiemann then consulted with his friend Seidman, the president of JMS. Thiemann explained to Seidman his need to find a larger broker-dealer that would be credible to the Commonwealth as the provider of the escrow service. Thiemann knew Seidman had been an adviser to the Treasurer and Thiemann believed Seidman had contacts within the Treasurer's Office. Seidman and Thiemann discussed a number of potential major investment banks including Alex. Brown & Sons, Inc. ("Alex. Brown"), which bank Seidman informed Thiemann was then the financial adviser to the Treasurer's Office.

Seidman knew that his friend, McCarthy, had a longstanding relationship with Alex. Brown's municipal securities business. Seidman reintroduced Thiemann to McCarthy. McCarthy was subsequently contacted for assistance in arranging for Alex. Brown to be appointed to provide the escrow securities and for Alex. Brown to split its revenues with Arthurs Lestrange.

In January 1994, McCarthy telephoned a senior banker who was then head of Public Finance at Alex. Brown (the "Senior Banker"), about the refundings. McCarthy explained to the Senior Banker that the Commonwealth was planning to issue refunding bonds, but that Arthurs Lestrange was too small to handle the purchase and sale of the escrow securities. McCarthy then offered the Senior Banker the following proposal; Alex Brown could be named the escrow provider if it would agree (1) to take all of the financial risk associated with the sale of the escrow securities and (2) to pool revenues with Arthurs Lestrange and allocate 60 percent of the total to Arthurs Lestrange. Alex. Brown agreed to McCarthy's proposal, and, at McCarthy's instruction, the Senior Banker thereafter contacted Arthurs Lestrange.

Once Alex. Brown agreed to the fee-split with Arthurs Lestrange, McCarthy used his influence within the Treasurer's Office to have Alex. Brown named as the escrow provider for the March Refunding. This was done over the objections of senior staff members who believed that the Treasurer's Office could itself manage the purchase of the escrow securities, and that it was a conflict of interest for Alex. Brown to simultaneously serve as the escrow provider as well as the financial adviser to the Treasurer's Office. After the March Refunding closed, Alex. Brown and Arthurs Lestrange combined and allocated their pooled fees in accordance with their 60/40 fee-splitting agreement. The total pooled fees from the transaction were $2,604,457.10. Arthurs Lestrange contributed $210,000 to the pool, which was its fee for serving as the Commonwealth's financial adviser. Alex. Brown contributed $2,394,457.10 ($1,782,140.70 from the markup on the escrow securities, $418,316.40 in carry[5], and a forward supply contract brokerage fee of $194,000). In accordance with the split formula, Arthur Lestrange received $1,562,674.26 and Alex. Brown received $1,041,782.84 from the transaction. Pursuant to its agreement with Thiemann, Arthurs Lestrange paid one-third of its share of the pooled revenues, or $520,891.42, to HDI. Thereafter, Thiemann paid $175,250 to Seidman's firm, JMS Associates, and $172,000 to McCarthy's law firm for Seidman's and McCarthy's respective roles in the transaction. Following these payments, Thiemann's company, HDI, retained $173,641.42 of the funds paid by Arthurs Lestrange.[6] McCarthy did not disclose to the Treasurer's Office that his law firm would be compensated if Alex. Brown were selected as the escrow provider.

After the pricing of the March Refunding, and during the period leading up to the June Refunding, a dispute arose between Alex. Brown and senior Treasurer's staff over the size of the markup which Alex. Brown charged on the escrow portfolio for the March Refunding. McCarthy promoted Alex. Brown's position, again without disclosing that his firm had received payments from the March Refunding escrow revenues. Because of the overcharge on the March Refunding escrow, the Treasurer's staff did not want Alex. Brown to be appointed escrow provider for the June Refunding. However, with

McCarthy advocating that there had not been any overcharge, Alex. Brown was again selected to provide the escrow securities.

V.

Section 17(a) of the Securities Act prohibits false or misleading statements, or material omissions when there is a duty to speak, in the offer or sale of any security. Section 17(a)(1) requires a showing of scienter; however Sections 17(a)(2) and 17(a)(3) do not require such a showing. Aaron v. SEC, 446 U.S. 680, 697 (1980). Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit false or misleading statements, or material omissions when there is a duty to speak, made with scienter, in connection with the purchase or sale of any security. Both knowing and reckless conduct satisfy the scienter element. *See, e.g.,* Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-69 (9th Cir. 1990). A duty to speak arises, and material omissions become fraudulent, when a person or entity has information that another is entitled to know because of a fiduciary duty or similar relationship of trust and confidence. *See,* Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-55; Chiarella v. United States, 445 U.S. 222, 228 (1980); In re Arleen Hughes, 27 S.E.C. 629 (1948), *aff'd,* 174 F.2d 969 (D.C. Cir. 1949). McCarthy had a duty of disclosure to the Commonwealth because of his relationship with and functions within the Treasurer's Office. The Treasurer's Office placed special confidence in McCarthy, and had a just foundation for belief that he was acting in the Commonwealth's best interests. *See* Antinoph v. Laverell Securities, 703 F.Supp. 1185 (E.D. Pa. 1989); Lazin v. Pavilion Partners, 1995 U.S. Dist. LEXIS 15255, Civ.A. No. 95-601, 1995 WL 614018 (E.D. Pa. Oct. 11, 1995). Moreover, McCarthy's role as a *de facto* decision maker within Treasury imbued him with a fiduciary duty to the citizens of Pennsylvania. *See* United States v. Margiotta, 688 F.2d 108 (2d Cir. 1982); United States v. Gray, 790 F.2d 1290, 1295 (6th Cir. 1986), rev'd on other grounds, McNally v. United States, 107 S.Ct. 2875, 2879 (1987). McCarthy violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 by failing to disclose to the Treasurer's Office or the Commonwealth, while he was advocating for Alex. Brown, that he had a conflict of interest arising from his arrangement with Thiemann to be paid a portion of the escrow revenues.

Section 8A of the Securities Act and Section 21C of the Exchange Act authorize the Commission to enter a cease-and-desist order against any person found to have violated any provisions of these Acts, and against any other person who was a cause of such violation due to an act or omission the person knew or should have known would contribute to such violation. The acts and omissions of Thiemann on behalf of HDI recounted above were acts or omissions that he knew or should have known would contribute to McCarthy's violations.

VI.

On the basis of the foregoing, the Commission finds that HDI and Thiemann were each a cause of McCarthy's violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

VII.

HDI has submitted an Offer of Settlement in which, without admitting or denying the findings herein, it consents to the Commission's entry of this Order, which: (1) makes findings as set forth above and (2) orders HDI to cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and (3) orders HDI to pay disgorgement of $173,641.42 plus prejudgment interest which shall be computed at the underpayment rate of interest established under Section 6621(a)(2) of the Internal Revenue Code, 26 U.S.C. §6621(a)(2), and which shall be compounded quarterly.

VIII.

Thiemann has submitted an Offer of Settlement in which, without admitting or denying the findings herein, he consents to the Commission's entry of this Order, which: (1) makes findings as set forth above and (2) orders Thiemann to cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

IX.

Accordingly, IT IS ORDERED, pursuant to Section 8A of the Securities Act, and Section 21C of the Exchange Act, that:

1. HDI shall cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

2. Thiemann shall cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

3. HDI shall within thirty (30) days of the date of this Order, pay disgorgement of $173,641.42 plus prejudgment interest which shall be computed at the underpayment rate of interest established under Section 6621(a)(2) of the Internal Revenue Code, 26 U.S.C. §6621(a)(2), and which shall be compounded quarterly. Such payment shall be: (1) made by United States postal money order, certified check, bank cashier's check or bank money order; (2) made payable to the United States Securities and Exchange Commission; (3) hand-delivered or mailed to the Comptroller, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (4) submitted under cover letter that identifies HDI as a Respondent in these proceedings, and states the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Brian A. Ochs, Assistant Director, Division of

Enforcement, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0805.

By the Commission

Jonathan G. Katz
Secretary

Footnotes

[1] The findings herein are made pursuant to the Respondents' Offers of Settlement and are not binding on any other person or entity in this or any other proceeding.
[2] The Treasurer served two terms ending in January 1997.
[3] The Executive Deputy Treasurer died in August 1996.
[4] In a refunding, the municipality issues new "refunding" bonds and immediately invests the proceeds in a portfolio of U.S. Treasury or agency securities structured to pay the principal and interest obligations on older, higher interest rate, bonds until the call date and then to pay off the outstanding principal and any call premium. The portfolio of government securities is normally placed in a defeasance escrow to guarantee repayment of the old bonds. For a further discussion of refunding bond issues and defeasance escrows used in such transactions see In the Matter of Lazard Freres & Co. LLC, Exchange Act Release No. 41318 (April 21, 1999).
[5] Profit on open market escrow securities generally has two components: markup and carry. Markup is the difference between the price that the dealer charges the issuer and the prevailing wholesale market price. In re Lehman Bros. Inc., Exchange Act Release No. 37673 (Sept. 12, 1996), 62 SEC Dkt. 2324, 2330. Carry is the difference between (a) the interest and accretion produced by the escrow securities between the sale date and closing date and (b) the cost of financing those securities during that period. *See* Board of Governors of the Federal Reserve System, Trading Activities Manual, Part 2 at 2-8 (March 1994).
[6] The Senior Banker agreed with the Commonwealth that Alex. Brown would mark up the portfolio of escrow securities by 4.5 basis points in price (a basis point is 1/100th of one percent, and a markup of 4.5 basis points is a markup of .045 percent). Instead, the Senior Banker marked up the portfolio by 45 basis points in price or .45 percent. Accordingly, the largest portion of the revenues which JMS and HDI derived from the March Refunding resulted from the Senior Banker's overcharge which occurred without the involvement of Seidman or Thiemann.

In the Matter of JMS Associates, Inc. and John M. Seidman, Securities Act Release No. 7776, Exchange Act Release No. 42149, A.P. File No. 3-10101 (November 17, 1999).

I.

The Securities and Exchange Commission (the "Commission") deems it appropriate that public administrative proceedings be, and they hereby are, instituted pursuant to Section

8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against JMS Associates, Inc. ("JMS") and John M. Seidman ("Seidman").

II.

In anticipation of the institution of these proceedings, JMS and Seidman have each submitted an offer of settlement, which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceeding brought by or on behalf of the Commission or in which the Commission is a party, and prior to a hearing pursuant to the Commission's Rules of Practice, 17 C.F.R. §201.100 et seq., JMS and Seidman, without admitting or denying the findings contained herein, except that each admits to the jurisdiction of the Commission over them and over the subject matter of these proceedings, consent to the entry of the findings, the institution of the cease-and-desist order and the order requiring disgorgement set forth below.

III.

Based on the foregoing, the Commission finds as follows:[1]

A. Respondents

1. John M. Seidman ("Seidman"), age 54, is a resident of Pittsburgh, Pennsylvania. Seidman is the founder of a privately held Pittsburgh-based business and political consulting firm called JMS Associates, Inc. Seidman served as a senior advisor to the former Treasurer of the Commonwealth of Pennsylvania (hereafter the "Treasurer") during her first campaign for Treasurer in 1988.[2]

2. JMS Associates, Inc. ("JMS") is a Pennsylvania corporation. Seidman is JMS' sole shareholder and employee.

B. Other Relevant Persons

1. Dennis E. "Harvey" Thiemann, is the founder of a privately held consulting firm called HDI, Inc. Thiemann was a friend of Seidman.

2. Patrick H. McCarthy, III ("McCarthy"), a Philadelphia-based attorney and friend of Seidman, was actively involved in Pennsylvania state Democratic politics. McCarthy served as transition chief for the Treasurer following her 1988 election. After the Treasurer assumed office in January 1989, McCarthy remained a close confidante of the Treasurer and her Executive Deputy Treasurer.[3] Although McCarthy held no official title and was not employed by the Treasurer's Office, he stayed actively involved in the day-to-day operations, decisions and policies of the Treasurer's Office. McCarthy was *de facto* the most powerful person in the office after the Treasurer and Executive Deputy Treasurer. McCarthy had the authority to give orders to staff members and had input and decision making authority, with the Executive Deputy Treasurer, on a wide range of substantive issues, including programs and personnel matters. McCarthy was also extensively involved in selecting vendors, including investment banking firms, that did business with the Treasurer's Office.

C. The March 1994 Pennsylvania Refunding

In late 1993, the Commonwealth of Pennsylvania was considering bond refundings totaling over $ 1 billion.[4] The Governor's Budget Office, which was responsible for all Pennsylvania debt issues, appointed Arthurs Lestrange & Company ("Arthurs Lestrange"), a Pittsburgh-based broker dealer, to serve as the Commonwealth's financial adviser for the refundings. (Arthurs Lestrange had proposed the refundings to the Commonwealth.) The Treasurer's Office, which was generally responsible for the investment of Commonwealth funds, was charged with obtaining investments for the escrows for the refundings. Ultimately, two refundings resulted: (1) the Commonwealth of Pennsylvania $494,145,000 General Obligation First Series, which closed in March 1994 (the "March Refunding") and (2) the Commonwealth of Pennsylvania $469,616,337.34 General Obligation Bond Second Series 1994, which closed in June 1994 (the "June Refunding").

Thiemann, through HDI, served as a longtime consultant for Arthurs Lestrange. Based on his knowledge of a previous Commonwealth bond refunding, Thiemann understood that the Treasurer's Office had in the past selected securities dealers to sell open market securities to the Commonwealth and he believed the Treasurer's Office would be selecting a securities dealer to sell open market Treasury securities to the Commonwealth for the 1994 General Obligation bond refundings. Thiemann also believed that the assignment could be lucrative for the dealer. In January 1994, Thiemann approached Arthurs Lestrange with the idea of having Arthurs Lestrange share in the revenues on the sale of the escrow securities. Thiemann and Arthurs Lestrange believed, however, that Commonwealth officials would view Arthurs Lestrange as too small a firm to handle the purchase and sale of hundreds of millions of dollars in U.S. Treasury securities. Accordingly, Thiemann proposed to Arthurs Lestrange that he would find a larger broker-dealer that could be selected to provide the escrow securities and would agree to split its revenues on a 60/40 basis, with Arthurs Lestrange receiving the 60 percent share. Thiemann further proposed that, if he were successful, Arthurs Lestrange would pay him one-third of its share of the refunding revenues. Arthurs Lestrange agreed to Thiemann's proposal.

Thiemann then consulted with his friend Seidman, the president of JMS. Thiemann explained to Seidman his need to find a larger broker-dealer that would be credible to the Commonwealth as the provider of the escrow service. Thiemann knew Seidman had been an adviser to the Treasurer and Thiemann believed Seidman had contacts within the Treasurer's Office. Seidman and Thiemann discussed a number of potential major investment banks including Alex. Brown & Sons, Inc. ("Alex. Brown"), which bank Seidman informed Thiemann was then the financial adviser to the Treasurer's Office. Seidman knew that his friend, McCarthy, had a longstanding relationship with Alex. Brown's municipal securities business. Seidman reintroduced Thiemann to McCarthy. McCarthy was subsequently contacted for assistance in arranging for Alex. Brown to be appointed to provide the escrow securities and for Alex. Brown to split its revenues with Arthurs Lestrange.

In January 1994, McCarthy telephoned a senior banker who was then head of Public Finance at Alex. Brown (the "Senior Banker"), about the refundings. McCarthy explained to the Senior Banker that the Commonwealth was planning to issue refunding bonds, but that Arthurs Lestrange was too small to handle the purchase and sale of the escrow securities. McCarthy then offered the Senior Banker the following proposal; Alex Brown could be named the escrow provider if it would agree (1) to take all of the financial risk associated with the sale of the escrow securities and (2) to pool revenues with Arthurs Lestrange and allocate 60 percent of the total to Arthurs Lestrange. Alex. Brown agreed to McCarthy's proposal, and, at McCarthy's instruction, the Senior Banker thereafter contacted Arthurs Lestrange.

Once Alex. Brown agreed to the fee-split with Arthurs Lestrange, McCarthy used his influence within the Treasurer's Office to have Alex. Brown named as the escrow provider for the March Refunding. This was done over the objections of senior staff members who believed that the Treasurer's Office could itself manage the purchase of the escrow securities, and that it was a conflict of interest for Alex. Brown to simultaneously serve as the escrow provider as well as the financial adviser to the Treasurer's Office. After the March Refunding closed, Alex. Brown and Arthurs Lestrange combined and allocated their pooled fees in accordance with their 60/40 fee-splitting agreement. The total pooled fees from the transaction were $2,604,457.10. Arthurs Lestrange contributed $210,000 to the pool, which was its fee for serving as the Commonwealth's financial adviser. Alex. Brown contributed $2,394,457.10 ($1,782,140.70 from the markup on the escrow securities, $418,316.40 in carry[5], and a forward supply contract brokerage fee of $194,000). In accordance with the split formula, Arthur Lestrange received $1,562,674.26 and Alex. Brown received $1,041,782.84 from the transaction.

Pursuant to its agreement with Thiemann, Arthurs Lestrange paid one-third of its share of the pooled revenues, or $520,891.42, to HDI. Thereafter, Thiemann paid $175,250 to Seidman's firm, JMS Associates, and $172,000 to McCarthy's law firm for Seidman's and McCarthy's respective roles in the transaction. Following these payments, Thiemann's company, HDI, retained $173,641.42 of the funds paid by Arthurs Lestrange.[6] McCarthy did not disclose to the Treasurer's Office that his law firm would be compensated if Alex. Brown were selected as the escrow provider.

After the pricing of the March Refunding, and during the period leading up to the June Refunding, a dispute arose between Alex. Brown and senior Treasurer's staff over the size of the markup which Alex. Brown charged on the escrow portfolio for the March Refunding. McCarthy promoted Alex. Brown's position, again without disclosing that his firm had received payments from the March Refunding escrow revenues. Because of the overcharge on the March Refunding escrow, the Treasurer's staff did not want Alex. Brown to be appointed escrow provider for the June Refunding. However, with McCarthy advocating that there had not been any overcharge, Alex. Brown was again selected to provide the escrow securities.

IV.

Section 17(a) of the Securities Act prohibits false or misleading statements, or material omissions when there is a duty to speak, in the offer or sale of any security. Section 17(a)(1) requires a showing of scienter; however Sections 17(a)(2) and 17(a)(3) do not require such a showing. Aaron v. SEC, 446 U.S. 680, 697 (1980). Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit false or misleading statements, or material omissions when there is a duty to speak, made with scienter, in connection with the purchase or sale of any security. Both knowing and reckless conduct satisfy the scienter element. *See, e.g.,* Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-69 (9th Cir. 1990). A duty to speak arises, and material omissions become fraudulent, when a person or entity has information that another is entitled to know because of a fiduciary duty or similar relationship of trust and confidence. *See,* Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-55; Chiarella v. United States, 445 U.S. 222, 228 (1980); In re Arleen Hughes, 27 S.E.C. 629 (1948), *aff'd,* 174 F.2d 969 (D.C. Cir. 1949). McCarthy had a duty of disclosure to the Commonwealth because of his relationship with and functions within the Treasurer's Office. The Treasurer's Office placed special confidence in McCarthy, and had a just foundation for belief that he was acting in the Commonwealth's best interests. *See* Antinoph v. Laverell Securities, 703 F.Supp. 1185 (E.D. Pa. 1989); Lazin v. Pavilion Partners, 1995 U.S. Dist. LEXIS 15255, Civ.A. No. 95-601, 1995 WL 614018 (E.D. Pa. Oct. 11, 1995). Moreover, McCarthy's role as a *de facto* decision maker within Treasury imbued him with a fiduciary duty to the citizens of Pennsylvania. *See* United States v. Margiotta, 688 F.2d 108 (2d Cir. 1982); United States v. Gray, 790 F.2d 1290, 1295 (6th Cir. 1986), rev'd on other grounds, McNally v. United States, 107 S.Ct. 2875, 2879 (1987). McCarthy violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 by failing to disclose to the Treasurer's Office or the Commonwealth, while he was advocating for Alex. Brown, that he had a conflict of interest arising from his arrangement with Thiemann to be paid a portion of the escrow revenues.

Section 8A of the Securities Act and Section 21C of the Exchange Act authorize the Commission to enter a cease-and-desist order against any person found to have violated any provisions of these Acts, and against any other person who was a cause of such violation due to an act or omission the person knew or should have known would contribute to such violation. The acts and omissions of Seidman on behalf of JMS recounted above were acts or omissions that he knew or should have known would contribute to McCarthy's violations.

V.

On the basis of the foregoing, the Commission finds that JMS and Seidman were each a cause of McCarthy's violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

VI.

JMS has submitted an Offer of Settlement in which, without admitting or denying the findings herein, it consents to the Commission's entry of this Order, which: (1) makes

findings as set forth above and (2) orders JMS to cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and (3) orders JMS to pay disgorgement of $175,250 plus prejudgment interest which shall be computed at the underpayment rate of interest established under Section 6621(a)(2) of the Internal Revenue Code, 26 U.S.C. §6621(a)(2), and which shall be compounded quarterly.

VII.

Seidman has submitted an Offer of Settlement in which, without admitting or denying the findings herein, he consents to the Commission's entry of this Order, which: (1) makes findings as set forth above and (2) orders Seidman to cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

VIII.

Accordingly, IT IS ORDERED, pursuant to Section 8A of the Securities Act, and Section 21C of the Exchange Act, that:

1. JMS shall cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

2. Seidman shall cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

3. JMS shall within thirty (30) days of the date of this Order, pay disgorgement in the amount of $175,250 plus prejudgment interest which shall be computed at the underpayment rate of interest established under Section 6621(a)(2) of the Internal Revenue Code, 26 U.S.C. §6621(a)(2), and which shall be compounded quarterly. Such payment shall be: (1) made by United States postal money order, certified check, bank cashier's check or bank money order; (2) made payable to the United States Securities and Exchange Commission; (3) hand-delivered or mailed to the Comptroller, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (4) submitted under cover letter that identifies JMS as a Respondent in these proceedings, and states the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Brian A. Ochs, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0805.

By the Commission

Jonathan G. Katz
Secretary

Footnotes

[1] The findings herein are made pursuant to the Respondents' Offers of Settlement and are not binding on any other person or entity in this or any other proceeding.
[2] The Treasurer served two terms ending in January 1997.
[3] The Executive Deputy Treasurer died in August 1996.

[4] In a refunding, the municipality issues new "refunding" bonds and immediately invests the proceeds in a portfolio of U.S. Treasury or agency securities structured to pay the principal and interest obligations on older, higher interest rate, bonds until the call date and then to pay off the outstanding principal and any call premium. The portfolio of government securities is normally placed in a defeasance escrow to guarantee repayment of the old bonds. For a further discussion of refunding bond issues and defeasance escrows used in such transactions see In the Matter of Lazard Freres & Co. LLC, Exchange Act Release No. 41318 (April 21, 1999).
[5] Profit on open market escrow securities generally has two components: markup and carry. Markup is the difference between the price that the dealer charges the issuer and the prevailing wholesale market price. In re Lehman Bros. Inc., Exchange Act Release No. 37673 (Sept. 12, 1996), 62 SEC Dkt. 2324, 2330. Carry is the difference between (a) the interest and accretion produced by the escrow securities between the sale date and closing date and (b) the cost of financing those securities during that period. *See* Board of Governors of the Federal Reserve System, Trading Activities Manual, Part 2 at 2-8 (March 1994).
[6] The Senior Banker agreed with the Commonwealth that Alex. Brown would mark up the portfolio of escrow securities by 4.5 basis points in price (a basis point is 1/100th of one percent, and a markup of 4.5 basis points is a markup of .045 percent). Instead, the Senior Banker marked up the portfolio by 45 basis points in price or .45 percent. Accordingly, the largest portion of the revenues which JMS and HDI derived from the March Refunding resulted from the Senior Banker's overcharge which occurred without the involvement of Seidman or Thiemann.

SALES PRACTICES

SETTLED INJUNCTIVE PROCEEDING

SEC v. Regald B. Smith, Civ. Action No. 7:00 cv 358 (E.D. Ky.) (Hood, J.), Litigation Release No. 16698, (September 12, 2000).

The Securities and Exchange Commission ("Commission") announced that on September 7, 2000, Judge Joseph M. Hood of the United States District Court for the Eastern District of Kentucky entered an order of permanent injunction against Regald B. Smith ("Smith") of Pikeville, Kentucky, pursuant to Smith's consent, without admitting or denying the Commission's charges, enjoining Smith from violating the antifraud provisions of the federal securities laws, freezing Smith's assets, ordering him to account for and disgorge his ill-gotten gains and pay civil penalties in amounts to be determined, provide the Commission with expedited discovery and prohibiting the destruction of documents.

The Commission filed suit against Smith a day earlier seeking emergency relief in the form of a Temporary Restraining Order and asset freeze, among other things. In its complaint, the Commission accused Smith, a registered representative in Stifel Nicolaus's ("Stifel") Pikeville, Kentucky office, of perpetrating an 18-month scheme to defraud in which he misappropriated more than $ 5 million from at least 6 investors who were his

brokerage clients. On August 28, 2000, Smith confessed to senior Stifel officials that he had conducted the scheme by conning clients into purchasing fictitious bonds, then diverting to his personal use the funds they gave him to invest.

The Commission alleged that Smith, age 55, was, employed by Stifel as the Investment Executive in charge of the Firm's Pikeville, Kentucky office. Smith stole his clients' funds by luring them into believing he had a "special situation" he could offer them. He told them that other Stifel Nicolaus clients' were interested, for one reason or another, in selling short-term bonds from their portfolio. The bonds were particularly attractive not only because they were short term, but also because they were tax-free and promised high yields. After his victims gave him money to purchase the bonds, Smith simply diverted their funds to his own personal use, including the renovation of the Hotel Anthony in Pikeville. To conceal his deceit, Smith told at least one of his victims at or about the time the first bond he sold to them was about to mature, that he could reinvest the client's original investment, plus accrued interest, into another tax-free bond. Smith's repeated this ploy until the victim had written and given Smith checks totaling $ 3.8 million, all of which Smith misappropriated. Smith also admitted that he tried to cover-up his scheme by, among other things, attempting to convince a bank officer to issue him copies of legitimate bond certificates which he could pass off as the fictitious bonds he was selling.

The Commission's complaint charged that Smith's scheme violated the antifraud provisions of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. The Commission sought a temporary restraining order, preliminary injunction and permanent injunction against future antifraud violations, disgorgement with prejudgment interest, civil penalties, and an order freezing assets, expediting discovery, and prohibiting the destruction of documents.

ADMINISTRATIVE PROCEEDINGS – COMMISSION DECISIONS

In the Matter of MGSI Securities, Inc., Bradford A. Orosey, Larry J. Bagwell, Connie L. Bally, Joseph O. Fallin and James W. Ogg, Securities Act Release No. 7578, Exchange Act Release No. 40429, A.P. File No. 3-9702 (September 10, 1998).

On September 10, 1998, the Commission instituted public administrative and cease-and-desist proceedings against Bradford A. Orosey ("Orosey"), Larry J. Bagwell ("Bagwell"), Connie L. Bally ("Bally") and Joseph O. Fallin ("Fallin") and instituted administrative proceedings against James W. Ogg ("Ogg") and MGSI Securities, Inc. ("MGSI") a Houston-based registered broker-dealer. The Order Instituting Administrative And Cease-And-Desist Proceedings Pursuant To Section 8A of the Securities Act of 1933 ("Securities Act") and Sections 15(b), 19(h) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), ("Order") alleges that from various times during 1992 through 1994, Orosey, Bagwell, Bally and Fallin willfully violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, in connection with the offer, sale and/or purchase of securities in the form of collateralized mortgage obligations ("CMOs"). The Order alleges that while at MGSI, Orosey, Bagwell, Bally

and Fallin made misstatements and omissions of material fact and used offering materials containing false and misleading information concerning the risks, volatility, yield projections and lack of liquidity associated with the CMO investments they sold to their municipal clients.

The Order also alleges that MGSI's compliance procedures were inadequate to detect the false information disseminated to investors. Furthermore, the Order alleges that MGSI and Ogg, its president, CEO and compliance officer, failed reasonably to supervise Orosey, Bagwell, Bally and Fallin within the meaning of Exchange Act Section 15(b) in their solicitation of their municipal clients.

A hearing will be scheduled to determine whether the allegations against Orosey, Bagwell, Bally, Fallin, Ogg and MGSI are true, and if so, what sanctions, if any, are appropriate in the public interest against them.

I.

The Securities and Exchange Commission (the "Commission') deems it appropriate and in the public interest to institute a public administrative proceeding pursuant to Section 8A of the Securities Act of 1933 and Sections 15(b), 19(h) and 21C of the Securities Exchange Act of 1934 against MGSI Securities, Inc., Bradford A. Orosey, Larry J. Bagwell, Connie L. Bally, Joseph O. Fallin, and James W. Ogg. Accordingly, it is ordered that a public administrative proceeding be, and hereby is, instituted.

II.

The Commission's public files show that MGSI Securities, Inc. ("MGSI") is registered with the Commission as a broker-dealer with its principal place of business in Houston, Texas

III.

As a result of an investigation, the Division of Enforcement alleges that:

A. From various times during 1992 through 1994, MGSI sold securities in the form of collateralized mortgage obligations ("CMOs") to various municipalities in the United States.

B. CMOs are a type of mortgage-backed derivative security. CMOs are created by pooling individual mortgages and dividing the cash flows of principal and interest into various classes or tranches which pay principal and interest cash flows from the mortgage pool to investors. The timing and amount of payments of principal and interest for various tranches have varying degrees of sensitivity to fluctuations in interest rates. Due to their sensitivity to changes in interest rates, certain risks are generally associated with an investment in CMOs, including market, extension, prepayment and liquidity risks, among others.

C. The CMOs sold by MGSI were Support Class Inverse Floaters ("Inverse Floaters") n1 and Principal Onlys (POs) n2, the value of which plummeted when interest rates rose throughout 1994. Inverse Floaters and POs are some of the riskiest and most volatile tranches of CMOs, and investments in these tranches involve a great deal of market, extension, and liquidity risks.

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n1 Inverse Floaters are CMOs that receive a monthly coupon payment comprised of interest and principal. The size of the coupon is inversely related to changes in a market index, typically the London Interbank Offering Rate ("LIBOR"). The market index usually moves in conjunction with short-term interest rates. The maturity of an Inverse Floater will increase or decrease as the prepayment rate of the underlying mortgages changes, which is the result of changes in long term interest rates. Inverse Floaters can be volatile because they usually adjust interest payments at multiples of changes in the index. Multiples of four or five are common and can be much higher. Thus, interest rate increases can have severe adverse effects on Inverse Floater prices. Support class Inverse Floaters are even more volatile because they also receive residual principal payments. While Inverse Floaters have a high degree of market and liquidity risks, support class Inverse Floaters also have a high degree of extension risk because of residual principal payments associated with them.

n2 POs are CMOs that receive only principal payments of an underlying pool of mortgages. The value of POs are thus sensitive to interest rate fluctuations because an increase in interest rates often results in slower prepayment of principal (extension risk), while a decrease in interest rates often results in faster prepayment (prepayment risk). Support Class POs are even more sensitive to interest rate fluctuations because they receive residual principal payments after other "higher" priority tranches have received their portion of principal payments.

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Respondents

D. Bradford A. Orosey ("Orosey") was, at all relevant times, a registered representative associated with MGSI who serviced an account for Escambia County, Florida. Orosey is not currently employed in the securities industry.

E. Larry J. Bagwell ("Bagwell") was, at all relevant times, a registered representative associated with MGSI who serviced an account for the City of Joplin, Missouri. Bagwell is not currently employed in the securities industry.

F. Connie L. Bally ("Bally") was, at all relevant times, a registered representative associated with MGSI who serviced an account for Lewis and Clark County, Montana.

Bally is currently employed as a registered representative associated with a registered broker-dealer.

G. Joseph O. Fallin ("Fallin") was, at all relevant times, a registered representative associated with MGSI who serviced an account for the City of Williamsburg, Virginia and a registered representative associated with another registered broker-dealer. Fallin is currently employed as a registered representative associated with a registered broker-dealer.

H. James W. Ogg ("Ogg") is the president, chief executive officer and compliance officer of MGSI.

Overview

I. From 1992 to 1994, while at MGSI, Bagwell, Fallin. Orosey and Bally ("the registered representatives"), through material misrepresentations and omissions, sold high-risk CMOs to their respective clients, four different municipalities located throughout the country ("the Municipalities"). The misrepresentations and omissions were made in oral communications and written documents provided to the Municipalities and typically concerned critical information necessary to fully evaluate the significant risks associated with an investment in these highly volatile securities.

J. As a result of the registered representatives' aggressive sales tactics, misstatements and omissions, the Municipalities were induced to purchase securities with significant risks that resulted in aggregate losses of over $27,450,000

K. The failure of MGSI and one of its principals, Ogg, reasonably to supervise the registered representatives allowed the fraud to unfold.

L. As a result of the fraudulent sales to the Municipalities, MGSI earned profits of $ 3,863,406. Commissions to Bagwell, Fallin, Orosey and Bally based upon such sales totaled at least $ 1,732,876.

Orosey's Fraudulent Conduct

M. From February 1993 through April 1994, Orosey, in connection with the purchase and sale of certain securities to Escambia County, namely CMOs, omitted to state material facts necessary to make the positive statements he made regarding projected performance not misleading. Orosey described the investments he was selling to Escambia County as a "Fannie Mae" or "Freddie Mac." This description was misleading in light of his failure to disclose the type of securities (i.e., Inverse Floaters and Pos).

Orosey's description of the investments was also misleading in light of his failure to disclose that the investments were subject to dramatic fluctuations in duration, yield and market value as interest rates changed. In his solicitations, Orosey provided misleading information about the expected performance of the CMOs by using figures based on

unrealistic assumptions that portrayed the securities in a favorable light. Orosey also used misleading yield tables and "PSA" speeds n3 and failed to fluctuate the coupon rate to present an accurate and realistic picture of the future potential yields of the CMOs he sold. In certain instances, Orosey furnished documentation to Escambia County which misrepresented that the yields on the securities could not drop below a certain level, when, in fact, the yields could have, and actually did, go much lower. On other occasions,

Orosey provided information which failed to indicate any possibility of significantly lower yields and failed to disclose important information that would have revealed how the securities he offered would perform. In addition, in subsequent communications, Orosey also misrepresented the current yield and performance of the securities he had already sold to Escambia County. As a result of Orosey's fraudulent misrepresentations and omissions, Escambia County was fraudulently induced to stock its investment portfolio with numerous high risk CMOs which incurred a significant decline in value.

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n3 PSA speed refers to the rate of prepayments on a pool of mortgages.

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Bagwell's Fraudulent Conduct

N. From June 1992 through February 1994, Bagwell, in connection with the purchase and sale of certain securities to the City of Joplin, namely CMOs, omitted to state material facts necessary to make the positive statements he made regarding projected performance not misleading. Bagwell knowingly misrepresented the risks associated with the securities by omitting to fully disclose the volatility, extension, market value and liquidity associated with such investments. Bagwell also failed to provide his client with the basic disclosure materials, such as yield tables, necessary to fully evaluate the risks associated with these securities. In his solicitations, Bagwell knowingly misled his client by providing only projections of high yields and principal payments based on favorable PSA speeds, while failing to disclose that the yield and principal payments would precipitously decline at other potential PSA speeds Bagwell's representations regarding how the CMOs would perform were misleading in light of the CMO's failure of the stress test and in light of how the CMOs would perform under other more likely scenarios. In addition, Bagwell also misrepresented the market value and performance of the CMOs that the City of Joplin had already purchased from MGSI and furnished reports containing false information hiding this decline in market value and performance. As a result of Bagwell's fraudulent misrepresentations and omissions, the City of Joplin was fraudulently induced to stock its investment portfolio with numerous high risk CMOs which incurred a significant decline in value.

Bally's Fraudulent Conduct

O. From August 1993 through July 1994, Bally, in connection with the purchase and sale of certain securities to Lewis & Clark County, namely, CMOs, omitted to state material facts necessary to make the positive statements she made regarding projected performance not misleading. Bally knowingly misrepresented the risks associated with the CMOs by omitting to fully disclose the volatility, extension, market value and liquidity associated with such investments. Bally's representations regarding the risks were misleading, in light of her failure to disclose that monthly principal payments could cease on POs, that the monthly coupon could decline to zero for an Inverse Floater, that cash-flows, after diminishing significantly, could restart only after a significant time, and that the market value could drop significantly. In her solicitations, Bally provided misleading information about the projected performance of the CMOs based on a single set of assumptions and never disclosed how the security would react under other various likely assumptions that would cast the security in a negative light. Bally used misleading yield tables in her solicitations and, in some instances, highlighted (by circling) a single particular yield that unrealistically presented the securities in a favorable light. Bally's representations regarding the yields were misleading inasmuch as she failed to disclose the significantly lower yield that the security was projected to incur at the median PSA speed. Furthermore, Bally's representations of the future potential yields of the Inverse Floaters were misleading in light of her failure to fluctuate the coupon rate; therefore, she only presented a positive, stable picture of the future potential yields of the Inverse Floaters. Bally also misrepresented the significance of the CMO's failed Federal Financial Institutions Examination Council's test and falsely portrayed a low priced bond as a "fire sale" when, in fact, the market value had dropped substantially due to an increase in interest rates. As a result of Bally's fraudulent misrepresentations and omissions, Lewis & Clark County was fraudulently induced to stock its investment portfolio with numerous high risk CMOs which incurred a significant decline in value.

Fallin's Fraudulent Conduct

P. From September 1992 through April 1994. Fallin, in connection with the purchase and sale of securities to the City of Williamsburg, namely, CMOs, omitted to state material facts necessary to make the positive statements he made regarding projected performance not misleading. Fallin knowingly misrepresented and failed to fully disclose the nature and characteristics of the CMOs and the risks concerning volatility, extension, market value and liquidity associated with such investments. In his solicitations, Fallin misrepresented maturity dates for these securities by omitting to disclose that they were subject to dramatic fluctuations in duration, yield and market value; instead, in his solicitations Fallin used a single yield, coupon interest rate and cash-flow and never disclosed other potential yields that a particular security could incur at other likely interest rate scenarios. In addition, Fallin utilized yield tables in his solicitations that failed to fluctuate the coupon rate thereby misrepresenting the projected performance of the securities. Fallin's statements concerning the CMOs were misleading inasmuch as he failed to provide his clients with the basic disclosure materials, such as yield tables, necessary to fully evaluate the risks associated with an investment in these securities.

Fallin also knowingly misrepresented his background and experience in the securities industry. In his solicitations, Fallin failed to disclose the average life and duration of certain CMOs. In 1994, Fallin refused to provide timely information concerning the value of Williamsburg's CMOs and his fraudulent omission of this information prevented Williamsburg from taking timely corrective action. As a result of Fallin's fraudulent misrepresentations and omissions, the City of Williamsburg was fraudulently induced to stock its investment portfolio with numerous high risk CMOs which incurred a significant decline in value.

Ogg’s Failure To Supervise

Q. During the relevant time period alleged herein Ogg was responsible for supervising MGSI's day-to-day sales practices and conducting the annual compliance reviews for MGSI. Ogg was also responsible for updating and revising MGSI's supervisory procedures and ensuring that they were enforced. Ogg failed reasonably to supervise MGSI's sales practice activity. Ogg failed to ensure that MGSI's registered representatives complied with MGSI's procedures regarding outgoing correspondence and failed to conduct proper supervisory reviews of customer account files Ogg also failed to make and maintain any records evidencing that he conducted any supervisory reviews.

MGSI'S Failure To Supervise

R. During the relevant time period, MGSI failed to adopt, implement and follow adequate supervisory and compliance procedures to prevent and detect the fraudulent disclosures regarding the recommendation and sale of CMOs. Its policies and procedures for reviewing the accuracy and adequacy of the registered representatives' communications with customers who bought the CMOs did not take into account the special features and risks of those securities. For example, MGSI had no policy specifying what type of information need by provided to the customer in connection with the sale of CMOs and had no procedures to ensure that MGSI customers received such information.

Violations

S. As a result of the conduct described above, Orosey, Bagwell, Bally and Fallin committed or caused violations of, and willfully violated, Sections 17(a)(1), 17(a)(2) and 17(a)(3) of the Securities Act of 1933 ("Securities Act") and Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5, thereunder, by making false and misleading statements of material fact and omissions of material fact in connection with the offer, sale and/or purchase of CMOs.

T. As a result of the conduct described above, MGSI and Ogg failed reasonably to supervise Orosey. Bagwell, Bally and Fallin with a view to preventing the above-referenced violations.

IV.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate in the public interest and for the protection of investors that public proceedings be instituted to determine

A. Whether the allegations set forth in Section III, hereof are true and, in connection therewith, to afford Orosey, Bagwell, Bally, Fallin, Ogg and MGSI an opportunity to establish any defense to such allegations;

B. Whether, pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, Orosey, Bagwell, Bally and Fallin should be ordered to cease and desist from committing or causing a violation or any future violation of any or all of the Sections or Rules specified in Section III. above;

C. What, if any, remedial sanctions are appropriate in the public interest against Orosey, Bagwell, Bally, Fallin, Ogg and MGSI;

D. Whether, Orosey, Bagwell, Bally, Fallin and MGSI should be required make an accounting and pay disgorgement plus prejudgment interest pursuant to Section 8A of the Securities Act and Sections 21B and 21C of the Exchange Act; and

E. Whether civil money penalties should be imposed against Orosey, Bagwell, Bally, Fallin, Ogg and MGSI, pursuant to Section 21B of the Exchange Act.

V.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section IV hereof shall be convened not earlier than 30 days and not later than 60 days from service of this Order at a time and place to be fixed and before an Administrative Law Judge to be designated by further order as provided by Rule 200 of the Commission's Rules of Practice. 17 C.F.R. @201.200.

IT IS FURTHER ORDERED that Orosey, Bagwell, Bally, Fallin, Ogg and MGSI file an answer to the allegations contained in this Order Instituting Administrative and Cease-And-Desist Proceedings Pursuant To Section 8A of the Securities Act and Sections 15(b), 19(h) and 21C of the Exchange Act ("Order") within twenty (20) days after service upon them of this Order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. @ 201.220.

If respondents fail to file an answer, or fail to appear at a hearing after being duly notified, they may be deemed in default and the proceedings may be determined against them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 310 and 220 of the Commission's Rules of Practice, 17 C.F.R. @ 201 310 and @ 201.220.

This Order shall be served upon the respondents personally or by certified mail, forthwith.

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceedings will be permitted to participate or advise in the decision upon this matter, except as witnesses or counsel in proceedings held pursuant to notice.

Because this proceeding is not "rule-making" within the meaning of Section 4(c) of the Administrative Procedure Act, it is not deemed subject to the provisions of that Section delaying the effective date of any final Commission action.

By the Commission

In the Matter of MGSI Securities, Inc., Bradford A. Orosey, Larry J. Bagwell and Connie L. Bally, Initial Decision Release No. 156, A.P. File No. 3-9702 (January 12, 2000).

Appearances: Mitchell E. Herr and Terry Tennant, for the Division of Enforcement, Securities and Exchange Commission
Jacks C. Nickens and Paul D. Flack, for Respondents Connie L. Bally and Larry J. Bagwell
Daniel R. Kirschbaum for Respondent James W. Ogg

Before: William J. Cowan, Administrative Law Judge

I. Introduction

The Securities and Exchange Commission ("Commission") initiated this proceeding on September 10, 1998, pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Sections 15(b), 19(h) and 21C of the Securities Exchange Act ("Exchange Act") against MGSI Securities, Inc.("MGSI"), Bradford A. Orosey, Larry J. Bagwell ("Bagwell" or "Mr. Bagwell"), Connie L. Bally ("Bally" or "Ms. Bally"), Joseph O. Fallin, and James W. Ogg.

I held a hearing in Houston, Texas from May 10 through May 18, 1999, at which allegations against Respondents Bally and Bagwell, described below, were tried. Respondent Joseph O. Fallin submitted an Offer of Settlement, which the Commission accepted in its Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order as to Joseph O. Fallin, dated May 5, 1999. The hearing as to Respondent Bradford A. Orosey was continued by my Order issued April 20, 1999, because Mr. Orosey had submitted an Offer of Settlement. The Commission accepted Mr. Orosey's Offer of Settlement in its Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order as to Bradford A. Orosey, issued May 25, 1999.

Respondent James W. Ogg has reached an agreement in principle with the Division of Enforcement ("Division") to settle matters as to him. I continued the hearing as to Mr. Ogg, pending completion of the settlement and its submission to the Commission. (Tr. 85.) [1] On December 16, 1999, I issued an Order directing that a report be filed as to the

status of the matter. In a Joint Status Report filed pursuant my December 16, 1999 Order, the Division and counsel for Mr. Ogg reported that a settlement continues to be worked on and that a Commission decision on such a settlement can be expected within ninety days of its filing. Accordingly, this matter remains pending as of the date of this initial decision.

By motion filed August 18, 1999, the Division moved for entry of an order making findings, imposing a cease-and-desist order and revoking the broker-dealer registration of MGSI by default for failure to appear at the hearing and answer the charges made against it in this proceeding. The Division later moved, on December 14, 1999, to set disgorgement and penalties with respect to MGSI. On December 30, 1999, counsel for Bally and Bagwell filed a response in opposition to the Division's motion for disgorgement and penalties. On January 6, 2000, the Division filed a reply in support of their motion to set disgorgement and penalties with respect to MGSI. On or about January 7, 2000, counsel for Bally and Bagwell filed a response to the Division's reply. These motions are discussed *infra*. The hearing proceeded to consider only the allegations against Bally and Bagwell (hereinafter "the Respondents"). This decision covers charges against MGSI, Bally, and Bagwell.

I received a Pre-Trial Brief from the Division and a Pre-Hearing Brief from Bally and Bagwell. In addition, on May 6, 1999, Respondents submitted an unauthorized "Response to Enforcement Division's Prehearing Brief." The Division waived objection to receipt of that filing. (Tr. 229.)

The following post-hearing briefs have been received:

- Division's Post-Trial Brief, filed August 19, 1999
- Respondents' Post-Trial Brief, filed August 19, 1999
- Division's Post-Trial Reply Brief, filed October 1, 1999
- Respondents' Post-Trial Reply Brief, filed October 1, 1999
- Joint Status Report by Division and Respondent Ogg, filed December 29, 1999

The record consists of 1,924 pages of hearing transcript and 222 exhibits. [2]
The Division alleges that from 1992 to 1994, Respondents, while registered representatives licensed by the National Association of Securities Dealers ("NASD") and associated with MGSI, violated the anti-fraud provisions of the federal securities statutes. Ms. Bally and Mr. Bagwell are charged with committing or causing violations of, and willfully violating, Sections 17(a)(1), 17(a)(2), and 17(a)(3) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, by making false and misleading statements of material fact and omissions of material fact in connection with offer and sale and/or purchase of high-risk Collateralized Mortgage Obligations ("CMOs") to certain municipalities.

Regarding Respondent Bally, the Division alleges that, in connection with the purchase and sale of CMOs to Lewis & Clark County, Montana, from August 1993 to July 1994, Ms. Bally:

- Omitted to state material facts necessary to make the positive statements she made regarding projected performance not misleading;

- Knowingly misrepresented the risks associated with the CMOs by omitting to fully disclose the volatility, extension, market value and liquidity associated with such securities;

- Provided misleading information about the projected performance of CMOs based upon a single set of assumptions and never disclosed how the security would react under other various likely assumptions that would cast the security in a negative light and failed to disclose that monthly principal payments could cease on Principal Only CMOs, that the monthly coupon could decline to zero for Inverse Floater CMOs and that cash-flows, after diminishing significantly, could restart only after a significant time, and that market value could drop significantly;

- Used misleading yield tables in her solicitations, highlighting in some cases a single particular yield that unrealistically presented the security in a favorable light;

- Provided misleading representations of yield by failing to disclose the significantly lower yield that the security was projected to incur at the median PSA speed,[3] and;

- Provided misleading representations of future potential yields of Inverse Floaters[4] by failing to fluctuate the coupon rate;

- Misrepresented the significance of the fact that the CMOs failed Federal Financial Institutions Examination Council's ("FFIEC") test; and

- Falsely portrayed a low priced bond as a "fire sale" when, in fact, the market value had dropped substantially due to an increase in interest rates.

The Division claims that, as a result of the above alleged fraudulent misrepresentations and omissions of Respondent Bally, Lewis & Clark County was fraudulently induced to stock its investment portfolio with numerous high risk CMOs which incurred a significant decline in value.

Regarding Respondent Bagwell, the Division alleges that, in connection with the sale of CMOs to the City of Joplin, Missouri from June 1992 to February 1994, Mr. Bagwell:

- Omitted to state material facts necessary to make the positive statements he made regarding prospective performance not misleading;

- Knowingly misrepresented the risks associated with the securities by omitting to fully disclose the volatility, extension, market value and liquidity associated with such securities;

- Failed to provide his client with the basic disclosure materials, such as yield tables, necessary to fully evaluate the risks associated with these securities;

- Knowingly misled his client in his solicitations by providing only projections of high yields and principal payments based on favorable PSA speeds while failing to disclose that the yield and principal payments would precipitously decline at other potential PSA speeds;

- Misrepresented the market value and performance of CMOs already purchased and furnished reports containing false information, hiding a decline in market value and performance

The Division claims that, as a result of the above alleged fraudulent misrepresentations and omissions of Respondent Bagwell, the City of Joplin was fraudulently induced to stock its investment portfolio with numerous high risk CMOs which incurred significant declines in value.

II. Findings of Fact and Conclusions of Law

a. The CMO Securities

The CMOs sold by Ms. Bally and Mr. Bagwell are types of mortgage-backed securities whose cash flows are derived from the mortgage payments of individual borrowers.[5] The primary risk of mortgage-backed securities derives from the unpredictability of the timing of their cash flows, which is attributable to changes in the pattern of prepayments on underlying mortgages. Prepayments increase as interest rates decline, while prepayments decrease as interest rates rise. (Div. Ex. 241 at 3.) Another characteristic of mortgage-backed securities is that principal is repaid each month, due to regular scheduled amortization and payments. Accordingly, even though the maturity of underlying mortgages might be thirty years, most of the principal in mortgage-backed securities will be paid back earlier, causing reference in such instruments to "average life," which is the weighted-average time until principal is returned to the investor, instead of maturity. (*Id.*)

There are numerous categories of CMOs. Speaking generally, some of the CMO categories, such as the so-called PAC bonds, and TAC (Targeted Amortization Class) bonds, have been designed to limit the effect of changing prepayments on the cash flow of the bond, thus making cash flows of these investments more stable. (*Id.* at 4.) In order to create categories of these investments with more stable cash flows, other classes as noted above must be structured with correspondingly greater sensitivity to changing prepayments. These securities are called "support class" bonds. (*Id.*) Thus, the stability of the CMO categories like PACs and TACs come at the expense of the support class bonds which have been created specifically to absorb the instability removed from the stabilized classes. (Div. Ex. 243 at 5-6.)

CMOs also vary in terms of their interest payments. The types include: Fixed Coupon, under which bonds earn a fixed rate of interest on the principal outstanding; Principal Only ("PO"), which do not receive any interest payment; Interest Only ("IO"), which receive only interest or pay a small amount of principal; Floating Rate, which pay an

amount of interest equal to an index plus a margin; and Inverse Floaters ("IF"), where the coupon varies inversely with changes in a specified interest rate index. The value of POs and IOs are extremely dependent upon prepayment expectations, and IFs are very sensitive to interest rate changes, as well as prepayment expectations. Indeed, IFs provide the counter balance to the more stable Floating Rate class, absorbing the effect of interest rate change risk that was removed to create the Floating Rate class. (Div. Ex. 241 at 4.)

POs and IFs are examples of security types in a CMO deal that tend to exhibit greater risk and uncertainty. These support class bonds appeal to investors who generally take more risk in exchange for the higher potential yields that such investments may provide, such as hedge funds and large money managers. On the other hand, buyers of the PAC and Floating Rate bonds tend to be investors like banks and insurance companies looking for more predictable cash flows. (*Id.* at 5.) These types of support class bonds were sold by Ms. Bally to Lewis & Clark County and by Mr. Bagwell to the City of Joplin, Missouri. For all classes of CMOs relevant here, return of principal is guaranteed, if held to maturity. Market values, however, fluctuated with prepayment experience and interest rate movements. Changes in prepayments experience and interest rates caused the market value of the CMO securities at issue here to decline, and average lives to extend. The consequences of these developments are the subject of this proceeding.

b. The Disclosure Requirements

i. NASD Requirements - Positions of Parties

The Division contends that the National Association of Securities Dealers ("NASD") requires detailed disclosures by brokers of risks associated with CMOs in sales of these securities. The need for such disclosure is, the Division maintains, derived from the principle of fundamental fairness enunciated in NASD's Manual, under Rules of Fair Practice (Div. Ex. 405A). In the section entitled "Fair Dealing With Customers," the NASD Board states that, when new products are introduced, members should "[M]ake every effort to make customers aware of the pertinent information regarding the products." (*Id.* at 2047.) In its Manual, NASD also adopted conduct rules governing communications with the public about CMOs via advertising media, such as print, radio and television. (Div. Ex. 1029.) These conduct rules for advertising, originally adopted in early 1993, included requirements for communications about CMOs such as educational materials which fully explained the nature of CMOs and their features, including the effect on value and prepayment rates of interest rate changes. (*Id.* at 4179.) The rules are detailed and specific as to the required content of CMO advertising.

NASD Notice to Members 93-18, issued in March 1993, also dealing with advertising, further advised that a CMO advertisement might be misleading if it advertised a CMO yield alone, without extensive disclosure, such as illustrations depicting yield variations under different prepayment assumptions, average lives and maturities. (Div. Ex. 238.) Also in this publication, the NASD instructed that yield and average life predictions in print advertising be based upon consensus prepayment assumptions from a nationally recognized service, such as Bloomberg. (*Id.* at 100.) NASD Notice to Members 93-73, issued in October 1993, which deals with Members' obligations to customers when selling CMOs, stated that brokers must ensure that their customers understand the

characteristics and risks of CMOs, including that average life and yield estimates depended upon the accuracy of prepayment assumptions, and must provide information about the sensitivity of POs and IFs to interest rate changes. (Div. Ex. 239.)

Respondents contend that these NASD publications do not constitute statutes, rules or regulations. As to NASD Notice to Members 93-73, Respondents argue that, even if it is considered authoritative, it merely requires that members ensure that customers understand the characteristics and risks associated with CMOs. Absent is any reference to Bloomberg medians or varying LIBOR, they say. Respondents further contend that any obligations arising from these publications are imposed on "members," which would not include registered representatives like Ms. Bally or Mr. Bagwell, but to MGSI, the member firm.

Further, Respondents assert that NASD Notice to Members 93-18 provides guidelines, not rules, and is related to advertising, not other forms of communications. Further, this publication does not require disclosure of the Bloomberg median, varied LIBOR, or prepayment projections at any particular speed. Moreover, Respondents contend that they had not even seen these Notices, which went to the member firm. (*see* Tr. 413-14.)

ii. Industry Marketing Standards and Practices - Positions of the Parties

The Division presented testimony of expert witnesses that certain minimal disclosures had become standard in marketing CMOs by the time that the sales of securities in issue here were made. (Div. Ex. 241 at 14; *See also* Tr. 682.) These disclosures, it is alleged, came to be standard in cases where the customer did not have independent access to the analytics needed to evaluate the security. (Tr. 90, 188, 681-82; Div. Ex. 243 at 12.) Among the disclosures said to have become a universal standard for CMO sales in such circumstances is an unbiased prepayment forecast for the CMO in question. The Bloomberg median, a consensus of Wall Street prepayment forecasts for the underlying collateral, is available at all points in time and is commonly used as a point of departure for assessing a particular CMO, the Division contends. (Div. Ex. 243 at 10; Tr.130, 179.)

Also included in the standard disclosures, according to the Division, are yield tables centered on the Bloomberg median. (Div. Ex. 243 at 12.) For floating rate CMOs (here, IFs), the Division contends that it is standard to disclose yield tables that vary the interest rate index, such as by providing a two-dimensional, so-called "7 x 7" yield table. (Div. Exs. 243 at 13, 244 at 50, 72, 80, 86.) In addition, the standard disclosures must be specific to each CMO and must be communicated in writing, according to the Division. (Tr. 51, 175, 160-61, 189-90.)

The Respondents argue that there is no universal disclosure standard that the brokers charged here were required to follow. They contend that there is no published standard that compels disclosure of the Bloomberg median, yield tables centered around that median, or "7 x 7" yield tables that vary the interest rate for floating rate securities like IFs. They point to the inability of the Division's expert witness Mr. Davidson to cite to a publication of such a standard, to identify when it was adopted, or to have recalled including it in his book on CMOs published in 1994. (Tr. 91-98.) Division expert witnesses Williams and Weiner were similarly unaware of any publication of such a

standard (Tr. 1850-51, 694-95.) Nor is there an industry marketing standard that would have required these specific disclosures, Respondents maintain. (Tr. 1662.)

iii. Findings and Conclusion re: Disclosure Standards

At the outset, I find that there is no statute, rule or regulation that would have required Ms. Bally or Mr. Bagwell to make the specific disclosures suggested by the Division and its expert witnesses for the securities at issue here, *i.e.*, the Bloomberg prepayment forecast consensus, yield tables centered on that Bloomberg median, or the so-called two-dimensional "7 x 7" yield table that varied LIBOR for IFs. Nor is there any evidence of a published standard at the time these sales were made which contained specific disclosure requirements that prudent brokers would be expected to follow when selling CMOs. The most that can be said from the evidence adduced here is that some investment professionals adopted a practice under which information about Bloomberg consensus prepayment forecasts, yield tables centered on such forecasts and a yield table that varied LIBOR for IFs was provided to customers who lacked the capability to perform their own analytics. Others saw the disclosure requirement differently, that it was enough to provide more general disclosure of market, extension and liquidity risks of the offered securities. (Resp. Ex. 902A at 8-12.)

The NASD publications cited by the Division do not clearly provide disclosure requirements for registered representatives when offering CMOs to their customers. The closest any of these publications come to imposing specific disclosure requirements is NASD Notice to Members 93-18. This is the Notice which conveys CMO Advertising Guidelines to NASD members. These are self-styled guidelines that "[p]rovided a framework for members to assess the accuracy and appropriateness of Collateralized Mortgage Obligations (CMO) advertising." (Div. Ex. 238.) This publication's primary purpose is exactly that - to provide guidelines for CMO advertising by NASD members. The print advertising guidelines in this publication, including a Standardized CMO Advertisement, require that statements of yield and average life be based on consensus prepayment assumptions from a nationally recognized service, like Bloomberg, or the member must be able to justify the assumption used. However, it is not directly applicable to the transactions here because its primary purpose was to provide members with advertising guidance, not to provide brokers with specific disclosure requirements.

Even as to advertising, Notice to Members 93-18 offered "guidelines" which, while obviously of considerable importance, fell at least one step short of a binding rule. In addition, while the Bloomberg-based consensus prepayment forecast is specifically mentioned, the guidelines permitted departure from that specific disclosure if the assumption used could be justified. There is a sentence in this publication which states that, in addition to providing advertising guidance, it is intended also to augment the business conduct framework for all communications and sales practices relating to CMOs. However, there is no persuasive evidence that this publication was intended by NASD, or seen by its members, as imposing new specific disclosure requirements for CMO sales, such as yields centered around the Bloomberg consensus prepayment forecast, and no suggestion that the brokers here were so informed.[6]
The NASD Notice to Members that is more directly relevant here is 93-73. (Div. Ex. 239.) This is the Notice to Members that spells out Members' obligations to customers

when selling CMOs, as distinguished from Notice to Members 93-18, which principally concerned advertising CMO products. Notice 93-73 contains, *inter alia*, the following advice: (1) Members and their associated persons must ensure that customers understand the characteristics and risks of CMOs; (2) investors need to understand what prepayment assumptions are and that they are factored into the offering price, yield and market value of an offered CMO; (3) market values of POs are extremely sensitive to prepayment rates, which, in turn, vary with interest rate changes;[7] and (4) investors in IFs should be made aware of the risks and characteristics of the IF being purchased in light of their high price volatility as interest rates move. (*Id.*) Nothing in this notice requires the kind of specific disclosures which the Division contends are required for CMO sales to investors unable to perform their own analytics. But this Notice does provide a pretty good summary of what disclosures the brokers charged here were reasonably required to make in order to render their sales presentations not misleading and in violation of the Securities laws.[8] Moreover, if the expert testimony in this proceeding was culled to ascertain the level of disclosure virtually all could agree was the least that was required, a similar list would be developed.

c. Respondent Connie Bally

Respondent Connie L. Bally is a registered representative who has worked in the securities industry since 1984. (Tr. 320.) From 1984 through 1999, Ms. Bally worked for numerous securities dealers, including: Charles Schwab; Eppler, Guerin & Turner; Austin Investment Source/Source Securities; Landmark Investments, Inc.; Dover Group, Inc.; Schaefer Securities, Inc.; UMIC Inc.-Union Planters Investment Bankers Group; Howard, Weil, Labouisse, Friedrichs, Inc.; Marcus, Stowell & Beye ("MS&B"); MGSI Securities, Inc.("MGSI"); and TDI. (Div. Ex. 85, Tr. 320-1, 329-332, 339, 342-3, 352.) Ms. Bally has been involved in the sale of mortgage-backed securities since at least 1987, and received training in the sale of mortgage-backed securities and CMOs at these firms. (Tr. 327, 353-354.)

The allegations that Ms. Bally made fraudulent misrepresentations and omissions in the sale of securities to Lewis & Clark County, Montana involve transactions from August 1993 through July 1994, when she was employed as a registered representative with MGSI. (Tr. 343.) Before the instant action, Ms. Bally had received only one customer complaint, which occurred when she was employed at Landmark Investments. That complaint was investigated by the NASD, which, according to Ms. Bally, found that she did not do anything deliberately wrong. (Tr. 343-45.)

Ms. Bally was familiar with a so-called NASD "know your customer" rule from her course of study and examination for the Series 7 SEC license required to sell securities. (Tr. 387-8.) She believed that the rule required her to know the investment sophistication level of her customers, to be sensitive to the level of sophistication of her customers, to provide securities that are appropriate for her customers, to make sure that her customers had a reasonable basis for an investment decision, and that her customers understood a security well enough to make an intelligent investment decision. (Tr. 389.) More specifically as to the type of securities involved in this matter, Ms. Bally understood that the NASD required that its members ensure that their customers understood the characteristics and risks associated with CMOs. (Tr. 391-2, Div. Ex. 239.)

d. Ms. Bally's customer, Randall Redpath

Randall R. Redpath was the Finance Officer for Lewis & Clark County, Montana, during the time relevant to the securities sales at issue here. As such, he was charged with the responsibility to make investments of the County's public funds during this time period. The investment funds managed by Mr. Redpath consisted of a pool of cash balances in approximately 300 public funds earmarked for, *inter alia*, schools, fire departments and irrigation districts. They comprised Lewis & Clark County's operating cash, cash reserve and bond proceeds, funds that were used for the day to day cash flow of the county. (Tr. 263-4.)

Mr. Redpath was subpoenaed to testify in this proceeding but did not respond to the subpoena. Much of the information in this record concerning Mr. Redpath is contained in Div. Ex. 234, which is the transcript of Mr. Redpath's sworn interview conducted by SEC investigative staff on January 11, 1996. This exhibit was received in evidence as a prior sworn statement, under the provisions of Rule 235, 17 C.F.R. § 201.235(a)(4), over the objection of Ms. Bally's counsel. (Tr. 231-51.) The Division, which argued for admission of the prior sworn statement of Mr. Redpath at the hearing, has on brief requested that I not rely on that testimony in reaching my decision, "[t]o avoid creating an appellate issue." Div. Br. at 16, fn16. In the Respondents' Initial Brief, counsel for Respondent Bally renews the objection to the admission of this statement, for the reasons stated at the hearing.

I reject the arguments of both the Division and Respondents. The prior sworn statement is admissible for the reasons indicated at the hearing. It is desirable, in the interests of justice, to receive this sworn statement into evidence, notwithstanding the rule against hearsay testimony or the lack of opportunity to cross-examine. *Gotham Securities Corp., et al.*, Admin. Proc. 3-4352 (April 10, 1974); *SEC v. Glass Marine Industries, Inc.*, 194 F. Supp. 879 (D. Del. 1961). Findings supported by this exhibit are only those that are cited to Div. Ex. 234. As to those findings, due consideration has been given to the fact that the witness was not available for cross-examination, *i.e.*, it has been accorded less weight than it would have received had it been subject to cross-examination. Nevertheless, the exhibit presents sworn testimony and provides useful information regarding Mr. Redpath, his background, and his transactions with Ms. Bally. The interests of justice will be better served by its admission.

Mr. Redpath was a graduate of the University of Montana, with a Bachelor's degree in Business Administration (concentration in Accounting), and took graduate courses in Public Administration at that same institution. (Div. Ex. 234 at 7.) While taking no courses on investments at the University of Montana, he did attend a four week night course at Carroll College presented by the brokerage firm of D.A. Davidson on stocks and bonds, and attended a one day investment seminar at another broker-dealer, Government Securities Corporation ("GSC"), in Houston in September 1992. Only the latter covered CMOs and derivative securities. (*Id.* at 8-9.) The GSC seminar explained the characteristics of inverse floaters and POs, among other securities. (*Id.* at 10.) Mr. Redpath also had a three-hour conversation with a representative from the brokerage firm Dain Bosworth explaining what CMOs were and how they worked. (*Id.* at 15-16.)

His employment history included several auditing positions, followed by service in the Treasurer's office in Gallatin County, Montana, where he was responsible for accounting and financial reporting, but not investment decisions. (*Id.* at 12-14.) Mr. Redpath became the Finance Officer with the Lewis & Clark County Treasurer's office in November 1991, where he was initially responsible for accounting and financial reporting, but soon was given the additional responsibility of making investment decisions for the county. (*Id.* at 16-17.) He was a member of the Government Finance Officers Association ("GFOA") and received its publications. (Tr. 283-84.) He was considered by his immediate superior, the County's Treasurer, Clerk and Recorder, to be a very honest person with integrity. (Tr. 314.)

Mr. Redpath had no personal investment experience, *i.e.*, he did not have a brokerage account, and never bought a stock, bond or other security for himself. (Div. Ex. 234 at 59.) He had no computer software program that could determine yields for CMOs at specific PSA speeds or otherwise analyze CMOs. (*Id.* at 250.) He believed that if something was a Fannie Mae, or Freddie Mac, it was fully insured by the U.S. government and not risky. (*Id.* at 144.) Because of what he considered an inadequate background in the area, he relied upon Ms. Bally a lot and felt that, while not managing the County's portfolio, she was managing the securities that she had sold him. (*Id.* at 148.)

Notwithstanding his professed inadequate securities background, Mr. Redpath did have some idea that the CMO securities offered to him by Ms. Bally entailed greater risk than the fixed rate instruments he had in the County's portfolio because they offered greater yield. (*Id.* at 150.) He understood that a certain hierarchy of riskiness existed with different CMO securities, running from fixed rate securities at the low risk end of the spectrum to IFs at the high risk end, with POs somewhere in between, because of his demonstrated ability to move in and out of POs. (*Id.* at 150-52.)

The investment funds managed by Mr. Redpath consisted of an approximate $20 million pool of cash balances that were earmarked for such things as schools, fire departments and irrigation districts. They comprised the County's operating cash, reserve cash, and bond proceeds. (Tr. 263.) At the time that Mr. Redpath joined Lewis & Clark County, most of these funds had been invested in STIP, the State Short Term Pool (Div. Ex. 234 at 21.), which offered the liquidity required for daily cash flows, but which was providing very low interest. (*Id.* at 24, 40.) Before Mr. Redpath began doing business with Ms. Bally, the County had invested two to three million dollars of its long term available funds in CMOs, and had good experience, getting principal back very rapidly. (*Id.* at 25-26.) These CMOs were fixed rate PAC instruments. (*Id.* at 18-19.)

Mr. Redpath performed an analysis to determine how much of the County's funds could be invested in longer-term products that had the potential for greater returns, like CMOs. From this analysis, Mr. Redpath concluded that the County had ten million dollars - a level which it was never required to dip below - to invest long term. (Div. Ex. 234 at 23-24.) By long term, Mr. Redpath meant longer than STIP, one to two years, which was

similar to his experience with the PAC CMOs in the County's portfolio that had returned principal quickly. (*Id.* at 28, 30.) Mr. Redpath, however, agreed that he may have told Ms. Bally that he could hold something for twenty or thirty years, given that the moneys invested long term would come from the portion of the County's investment pool which would never be touched by the County. (*Id.* at 40.)
Mr. Redpath received a "massive amount of calls" and several visits from brokers seeking the County's business. (Div. Ex. 234 at 83-84; Tr. 281) He purchased CMOs from Dain Bosworth after engaging in a three-hour call during which the broker explained CMOs and how they operated. (Div. Ex. 234 at 16.) He also purchased IFs from the GSC brokerage firm before purchasing any from Ms. Bally. (*Id.* at 92.)

Mr. Redpath professes to have been unaware of the increased risks associated with the Support Class derivative CMOs as compared with the Fixed Rates CMOs in the County's portfolio (*Id.* at 144.), but was aware that the Support Class derivative securities were less conservative than the Fixed Class. (*Id.* at 150.) He understood, as well, that IFs needed to be balanced with floating rate securities to offset risk in the overall portfolio and purchased more stable floating rate securities for this purpose from GSC's broker, Scott Stafford. (*Id.* at 256.)

He was willing to make the move from more conservative investments to less conservative to get higher yield. (*Id.* At 150.)[9] He stated that he had been "pushed" to get higher yields by the budget office. (Div. Ex 234 at 299.) From all of Mr. Redpath's experience, education, dealings with brokers, and available literature, he understood that the primary risk of the CMO securities at issue in this case was that interest rates would increase and the value of the securities would decline, and that these investments offered the potential of increased yield for the assumption of the associated risks.[10]

e. Ms. Bally's dealings with Mr. Redpath

Connie Bally located Mr. Redpath as a potential securities customer through a "cold call" from a lead list furnished to her at MS&B. (Tr. 379, 528.) She ascertained in her initial contacts with Mr. Redpath that he had 30-year CMOs in the County's portfolio, and that he was interested in preservation of principal and increased yields over STIP rates or local CDs. (Tr. 530.) She further understood that the County's investments were restricted to obligations of the U.S. Treasury and direct and indirect obligations of agencies of the government. (*Id.*)

She believed that Mr. Redpath understood the characteristics and risks of CMOs. (Tr. 555.) Mr. Redpath received a prospectus and a Federal Financial Institution Examination Council ("FFIEC") stress test with the confirmation for each CMO purchase from Ms. Bally when she was with MS&B. (Resp. Ex. 506; Tr. 533.) He looked through the first few prospectuses for the securities Ms. Bally sold him, but did not read them. (Div. Ex. 234 at 286-87.) Ms. Bally further furnished a Bloomberg yield table for each security she was presenting to Mr. Redpath both while at MS&B and at MGSI. She knew that Mr. Redpath did not have a Bloomberg terminal and was basing his decisions whether or not to purchase a security from information she supplied. (Tr. 385-87.) In fact, her business practice was to provide to Mr. Redpath for each security offered for sale a Bloomberg spread sheet, furnished to her by her trading desk, that contained, *inter alia*, information

about the historical PSAs for the security, yield and average life at various PSA speeds, including speeds slower than the historical speeds. (Tr. 368-69, 493, 539-40, 561, 567, 569-70.)

Ms. Bally found the historical information on PSA speeds that is contained on the Bloomberg screens she used to be valuable and would provide it to her customers whether or not it had been specifically requested. (*Id.*) While the Bloomberg median prepayment consensus forecast was encompassed within the prepayment speeds shown on the screens provided by Ms. Bally to her customer in almost every instance (Tr. 667.), she did not focus her client's attention on the Bloomberg median, but preferred to work off of historical prepayment speed information. (Tr. 408.) While Ms. Bally professed not to know what a Bloomberg median actually was at the time of the sales to Mr. Redpath, (Tr. 479; *see also* Tr. 408, 481.), this testimony is not credible in light of her prior sworn statement (Div. Ex. 228 at 271.) and her understanding and working knowledge of all other elements of Bloomberg sheets described in her testimony at the hearing.

The Bloomberg screens provided to Mr. Redpath by Ms. Bally for IF securities did not vary the LIBOR because Mr. Redpath did not ask her for such a presentation. (Tr. 497-98.) Ms. Bally understood that it would have been important when buying an IF to see the various yields with changes in LIBOR, as well as changes in long-term interest rates. (Div. Ex. 228 at 164.)

Ms. Bally's practice was to go over the relevant information on the Bloomberg sheet with Mr. Redpath when she called to offer him a particular CMO. (Tr. 540.) She believed that he was well versed at reading Bloomberg pages from the many conversations she had with him over the two and a half years that she dealt with him. (*Id.*) She frequently circled certain information on the sheet for discussion purposes in telephone calls with Mr. Redpath. This highlighting was intended as a point of departure for discussion of elements of the particular offering. (Tr. 431.)

(i) Representative Transactions

FNMA 1993-205H (PO)

Ms. Bally sold the first block of this security to Mr. Redpath on September 24, 1993. (Div. Ex. 65.) This was a Support Class PO backed by 30-year FNMA 7 percent collateral. This new issue bond had a Pricing Speed of 400 PSA, at which its yield would be 2.97 percent with an average life of 6.8 years. At the time that it was offered for sale, the Bloomberg median prepayment consensus speed for this security was 302 PSA, at which speed it was expected to yield 1.81 percent and have an average life of 10.71. (Div. Ex. 243 at Exs. 21, 22.) The Bloomberg screen furnished to Mr. Redpath by Ms. Bally for this security showed PSA speeds ranging from 200 to 1,000. Although this range encompassed the value of the Bloomberg median prepayment consensus, it was not specifically identified. At 200 PSA, the yield was projected to be 1.337 percent and the average life 15.83 years. At 1,000 PSA, the yield was projected to be 25.61 percent and

the average life 0.89 years. (Resp. Ex. 430.) As this was then a new security, there was no historical PSA information available. (*Id.*) The sale price was 82 3/4. (Div. Ex. 65.)

The second purchase of this security by Mr. Redpath from Ms. Bally at MGSI occurred on January 19, 1994. By this time the price had dropped and the purchase was made at 68.5. The Bloomberg median prepayment consensus speed at this date declined to 274 PSA, which carried a projected yield of 4.15 percent and an average life of 11.86 years. (Div. Ex. 243, Ex. 23.)

Finally, Ms. Bally sold the third block of FNMA 1993-205H to Mr. Redpath on March 7, 1994, at a price of 39.75, less than half the price of the first purchase. (Tr. 466.) The Bloomberg median prepayment consensus speed on this date for this security was 231 PSA. (Div. Ex. 243, Ex. 26.) Ms. Bally provided yield tables to Mr. Redpath that showed PSA speeds ranging from 200 to 800. Although this range encompassed the value of the Bloomberg median prepayment consensus, it was not specifically identified. At 200 PSA, the yield projected was 5.9 percent and the average life 15.57 years. At 800 PSA, the yield projected was 120.4 percent and the average life 1.07 years.[11] The yield table also disclosed the following historical PSA speeds for this security: (Div. Ex. 69.)

Feb 94	Jan 94	Dec 93	Nov 93	Oct 93
269	518	705	719	407

Ms. Bally circled the column of yields at 500 PSA (yield 35.29 percent at the offered price, with an average life of 3.69 years.) She also circled the January 1994 historical PSA speed of 518. (*Id.*)

At the time of the sale of the third block of this security, Ms. Bally was aware that interest rates had changed drastically beginning in early 1994, that the Federal Reserve Bank kept raising interest rates and that there was turmoil in these markets. (Tr. 457, 600.) She offered the third block of this security to Mr. Redpath as a "cheap insurance policy" and an opportunity to "dollar cost average." (Tr. 458; Div. Ex. 69.) Three weeks after this purchase, on March 30, 1994, Ms. Bally advised Mr. Redpath that she could sell this security for 40.25, enabling him to realize a gain of $4,000.

FNMA 1994-19S (IF)

Ms. Bally sold FNMA 1994-19S, a TAC Class Inverse Floater backed by 30-year FNMA 7.5 percent collateral to Mr. Redpath in two transactions on March 31, 1994, and on April 15, 1994. For the second transaction, Ms. Bally furnished a Bloomberg screen presenting yield tables ranging from PSA speeds of 150 to 750. The Bloomberg median prepayment consensus speed (not specifically identified as such on the tables presented by Ms. Bally) was 226 PSA, down from the Bloomberg median for the first transaction of 276 PSA. (Div. Ex. 243 at 25-26.) At the Bloomberg median, the yield would have ranged between 8.6 and 11.6 percent. (Div. Ex. 74 at 4.) For a price of 73 20/32, at 150 PSA, the yield projected was 7.56 percent and the average life 12.31 years. At 500-750 PSA, the

projected yield was 30.29 percent, and the average life 1.35 years. (*Id.*) The historical PSA speeds shown on this screen were as follows:

APR 94	MAR 94	FEB 94
512	556	600

Ms. Bally circled yields and average lives at 500 PSA, which projected a yield of 30.29 percent and an average life of 1.35 years and the historical PSA speed for April 1994 of 512. (*Id.*)

None of the Bloomberg screens furnished by Ms. Bally to Mr. Redpath for this sale disclosed the impact that changes in LIBOR would have on this security's yield. (*Id.*) Ms. Bally further provided handwritten notes on the screens she provided with commentary that included: "Deep discount," "great yield," and "short average life." (*Id.*)

(ii) Consequences of the transactions

Mr. Redpath followed a course of increasing investments in POs and IFs that were offered to him for sale by Ms. Bally. His original purpose was to invest only the portion of the County's funds that were available for long term investment in such securities because of the opportunities for increased yields and the remote likelihood that such funds would be required for immediate needs.[12] However, these investments at times came to constitute 85 to 89 percent of the County's total investment portfolio. (Tr. 313.) This investment approach was successful in 1992-1993 (Tr. 291.), which coincided with a period of declining interest rates. However, with rising interest rates and tumult in the markets in 1994, the wisdom of this investment strategy became doubtful as average lives extended, yields declined, and prices fell. (Tr. 267, 313.) The market values of the CMOs held by Lewis & Clark County by December 1994 - January 1995 were approximately $7.5 million below their cost. (Tr. 310.)

As a consequence of these developments, the County and School District No. 1, whose funds were included in the pooled amount managed by Mr. Redpath, jointly asked the state auditor's office to look into the MGSI and GSC brokerage firms. The state auditor barred these firms from further business in Montana, pending the outcome of the investigations. (Tr. 268.) These investigations concluded in settlements, whereby GSC refunded to the State approximately $415,000, and MGSI $25,000, to settle the claims. (Tr. 268, 279.) Lewis & Clark County also retained an investment professional to review the portfolio and reinstituted an investment committee to set County investment policy. (Tr. 267, 269.) In addition, the State of Montana has adopted regulations that bar local governments from investing in CMOs. (Tr. 269.)[13]

Lewis & Clark County is still holding some CMOs purchased from MGSI until such time as it can sell them and realize a return of at least 2-4 percent over the life of the investment. (Tr. 307-310.)

f. Conclusions re: Ms. Bally

Ms. Bally is charged with violating antifraud statutes by, among other things, omitting to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. Rule 10b-5, 17 C.F.R. § 240.10b-5. Section 17(a) of the Securities Act is a comprehensive anti-fraud statute dealing with perpetration of fraud in the offer of sale of securities. Section 17(a)(1) makes it unlawful "to employ any device, scheme, or artifice to defraud." Section 17(a)(2) prohibits the use of false statements or omissions of material fact to obtain money or property. Section 17(a)(3) forbids any person from engaging "in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon" a purchaser of securities. Section 10(b)5 of the Exchange Act and Rule 10b-5 thereunder make it unlawful for any person, directly or indirectly, in connection with the purchase or sale of a security, to make an untrue statement of material fact; omit to state a material fact; use any device, scheme or artifice to defraud; or engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person.

The antifraud statutes are intended to reach a broad category of behavior. *General Bond & Share Co. v. SEC*, 39 F.3d 1451 (10th Cir. 1994). They contain broad prohibitions against manipulative, deceptive or fraudulent practices; *C.E. Carlson, Inc. v. SEC*, 859 F.2d 1429 (10th Cir. 1988), (citing *Richardson v. MacArthur,* 451 F.2d 35, 40 (10th Cir. 1971); and do not attempt to specify each particular form of proscribed misconduct. *In re Silicon Graphics*, 183 F.3d 970 (9th Cir. July 2, 1999). These broad prohibitions notwithstanding, the specific acts or omissions alleged to be fraudulent must be measured against standards of disclosure that would ensure that these statutes were not violated. The appropriate standard for disclosure in these circumstances is that brokers selling CMOs were required to ensure that their customers understood: (1) the characteristics and risks of CMOs; (2) what prepayment assumptions are and that they are factored into the offering price, yield, and market value of an offered CMO; (3) market values of POs are extremely sensitive to prepayment rates, which, in turn, vary with interest rate changes; and (4) the risks and characteristics of IFs being purchased in light of their high price volatility as interest rates move. I find that the record evidence as a whole supports this disclosure standard; *i.e.*, that even if NASD Notice to Members 93-78 can be construed as inapplicable to these brokers, the disclosure requirements discussed in that Notice are fully supported by and are fully consistent with the testimony of the Division's and the Respondent's expert witnesses.[14]

Applying these standards to Ms. Bally's conduct, it is first clear that Ms. Bally believed that her customer, Mr. Redpath understood the characteristics and risks of CMO securities because she was aware that: (1) he had purchased CMOs previously, albeit the less risky PAC class of CMOs; (2) she had furnished to him prospectuses and a FFIEC stress test for each CMO he bought from her while she was at a predecessor firm, MS&B, (3) she provided yield tables by fax and discussed them with him for each sale; and (4) he seemed knowledgeable about these securities, given what she knew about his background and experience. From all appearances to Ms. Bally, (and to Mr. Redpath's supervisor, see Tr. 283), he seemed to know what he was doing.

It is necessary to discuss whether, in fact, Mr. Redpath understood the characteristics and risks of CMO securities, and to assess Ms. Bally's culpability if we conclude that he did not. We are hobbled a bit in this inquiry because Mr. Redpath did not appear at the hearing and was not subject to cross-examination. From the record evidence, one may conclude, in hindsight, that Mr. Redpath was not fully aware of the characteristics and risks of CMOs. However, Ms. Bally provided enough information to enable Mr. Redpath to ascertain the nature of these financial instruments and to enable him to assess whether he wanted to deal with them. She did not withhold materials that would have shown these securities in a less favorable light. It appears that Mr. Redpath did not do all that he should have done to study the characteristics and risks of the bonds that Ms. Bally was offering for sale. He was content to sit back and realize the high interest and gains he was obtaining from purchases and trades in CMOs offered by Ms. Bally and others, without questioning his seeming good fortune or doing serious analysis of the risks associated with the interest-rate sensitive securities he was purchasing and selling.

Ms. Bally provided the information that she was required to provide. It cannot be said that she omitted material facts necessary to make her statements not misleading. The information that she routinely provided contained all of the data required for a person of reasonable competence in this field to assess the risks associated with the proffered investment opportunities. There is no doubt that Mr. Redpath was a person of reasonable competence in these matters as the facts laid out above plainly reveal. While the standard being applied speaks of ensuring that the customer understood the characteristics and risks of the securities, that standard can be met by something short of getting inside the customer's head to see if he really did fully appreciate the complexity and the risks of the instruments she offered for sale. That is something that cannot be definitively known except in hindsight. All of the outward signs Ms. Bally observed were consistent with her view that Mr. Redpath knew the characteristics and risks of the CMO securities.

Ms. Bally satisfies the second test dealing with prepayment assumptions as well. Her business practice was to furnish to Mr. Redpath for each security she was presenting to him for sale a Bloomberg yield table that disclosed information about the historical PSAs for the security, and yield and average life at various PSA speeds. While not specifically identifying the Bloomberg median consensus prepayment speed projection for each security, the range of prepayment speeds in the Bloomberg yield tables customarily furnished by Ms. Bally to Mr. Redpath was sufficiently broad that it included that Bloomberg median value.[15] These yield tables that she conveyed to him disclosed which prepayment assumptions were built into the offering price, yield and market values, and depicted what would happen to these values at several different prepayment speeds. More was not required.

Ms. Bally repeatedly testified that she worked from historical PSAs, a practice that the Division treated with derision, suggesting a certainty that the past would not be prologue to the future. It felt that it was misleading on her part to focus on historical information about prepayments when forecasts of the future were available. However, it was not an unreasonable practice, and certainly not a misleading one, to present and focus on historical data for something as volatile as interest rate trends. As Ms. Bally wisely

testified, she had no ability to predict interest rate directions. She thought, reasonably in my view, that historical information about prepayment rates would be useful to a customer contemplating an investment in securities with high interest rate sensitivity. She regularly presented yield tables that depicted a range of prepayment scenarios, which included recent historical information, and their implications.[16] There is, moreover, no hard evidence that the Bloomberg medians *actually* predicted the trend of future interest rates better than historical data, the testimony of the Division's experts notwithstanding. (Tr. 1744-45.)[17]

The Division also made much of the fact that Ms. Bally circled certain data on the Bloomberg yield tables that she furnished to Mr. Redpath, which often was based upon an historic PSA. Div. Ex. 69 shows that, in early March 1994, Ms. Bally circled the 500 PSA column on the yield table in a fax to Mr. Redpath, which corresponded with the January 1994 monthly PSA, even though the February figure, 269 PSA, was then available. The Division sees this as misleading, but the lower February PSA is actually stated on the yield table, and that table includes a PSA speed even lower than the most recent historical (February) PSA level. From this table, a person with reasonable competence in this field and fair eyesight could see, for example, that at PSA 200, the yield would be 5.9 percent and average life 15.57 years. Moreover, the historical PSA data reflects a down-up-down pattern, ranging from 407 PSA in October 1993, up to 719 PSA in November, then down to 518 PSA in January, and down further to 269 PSA in February. So, it is only with hindsight that we can confirm the Division's view that, at this juncture, interest rates were trending up and would continue to do so.

The third standard, that the broker must ensure that the customer understands that market values of POs are extremely sensitive to prepayment rates, which, in turn, vary with interest rate changes, also has been satisfied here. This is confirmed by the information that Ms. Bally routinely provided to Mr. Redpath and the fact that Mr. Redpath purchased the same PO (FNMA 1993-205H) at vastly different prices, which reflected an implicit understanding that market values were highly sensitive to prepayment rates, which in turn varied with changes in interest rates. (Tr. 716.) The Division's arguments that Ms. Bally misled Mr. Redpath in his subsequent purchases of FNMA 1993-205H, when she described them as a cheap insurance policy, and a good opportunity to dollar average, are not persuasive. Mr. Redpath was not so unsophisticated that he was unaware of the consequences of these subsequent purchases at lower prices. The more persuasive view is that he was aware that the market value of these securities was very sensitive to prepayment rate swings influenced by changing interest rates.

The fourth disclosure standard relates to IFs. It requires the broker to ensure that the customer understands the risks and characteristics of IFs being purchased in light of their high price volatility as interest rates move. The record evidence supports the view that this standard is best met by the provision of a two-dimensional, so-called "7 x 7 table," for inverse floaters (available on Bloomberg), which shows the effects on coupon and yield of changes in the interest rate index and prepayment speeds. (Div. Ex. 243 at 13-14.) It is clear that Ms. Bally did not provide Mr. Redpath with any table showing the effect upon coupon or yield from changes in the interest rate index (here, LIBOR) for

FHLMC 1602-SA (IF) or other IFs. (Tr. 501-02.) Ms. Bally contended that she did not supply such a table because Mr. Redpath did not request it. (*Id.*) She was aware that there was a formula stated on the IF security from which one could compute the coupon changes resulting from changes in the interest rate index, and believed Mr. Redpath had the ability to do that (Tr. 382, 420.), but accepted that he could not compute yield changes on those securities from LIBOR and prepayment changes without a Bloomberg format. (Tr. 421.)

The information provided by Ms. Bally to Mr. Redpath associated with IF securities fell short of the best information she could have supplied, *i.e.*, the Bloomberg 7 x 7 yield tables that varied coupon and yield with changes in LIBOR and prepayment speeds. There is some uncertainty in the record as to the availability of these types of Bloombergs in the time frame at issue and as to Ms. Bally's awareness of these co-varied tables at the time of these transactions. (*see* Tr. 420.) Nevertheless, a complete picture of the sensitivity of this type of security to interest rate changes was not communicated to Mr. Redpath.

The question remains whether the omission of this information rises to the level of being misleading and a violation of the fraud statutes. I conclude that it does not. First, the business relationship that existed between Ms. Bally and Mr. Redpath includes an impressive information transfer, even though it did not routinely include the co-varied LIBOR yield tables for IFs.[18] The information she provided should have enabled a customer with the background of Mr. Redpath to assess the characteristics and risk of all of the CMOs he was purchasing, including those IFs that were sensitive to movement of the interest rate index. The degree of sophistication of the investor here is also relevant to this issue. Ms. Bally believed that she was dealing with a knowledgeable customer. She was aware that Mr. Redpath was a C.P.A., and that he was quite capable of making calculations based upon formulas in the securities that provided him requisite information on his security purchases, and that, if he needed more, he could ask for it, and she would supply it.[19] I do not believe it was her duty to take steps even beyond those she did take to ascertain if in fact Mr. Redpath was as knowledgeable as his statements and his credentials suggested.[20]

This is not a case where the negligence of the victim can be seen as excusing a fraud by the broker. The victim (Mr. Redpath) may have been negligent in the execution of his fiduciary responsibilities to Lewis & Clark County, but he was not perceived as "credulous and unwary"[21] by the broker charged here. Neither can it be said that Ms. Bally unscrupulously defrauded Mr. Redpath by preying upon his negligence. For all she knew, he was on top of his job, asking the right kind of questions and making the right kinds of calculations and judgments.

Finally, there has not been demonstrated on this record an intent on Ms. Bally's part to deceive. Ms. Bally's motives, while mercenary, lacked scienter, that is, she did not have a mental state embracing an intent to deceive. *Malone v. Microdyne Corp.*, 26 F.3d 471, 478 (4th Cir. 1994), quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193, n. 12 (1976).[22]

The Division has alleged numerous examples of mendacious activity on the part of Ms. Bally. (Div. Br. at 22-33.) Many of these examples reflect, not lies, as the Division contends, but genuine confusion about terminology and its use in questions. For example, the questioning of Ms. Bally regarding use of historical information, the definition of short term, and her knowledge of the Bloomberg system, was by and large inconclusive and cannot be regarded as dispositive on the question of her mendacity.

In addition to the one relatively clear example of mendacity mentioned above concerning her knowledge of Bloomberg median availability, only one other is significant enough to require further comment. That concerns the FFIEC test. Ms. Bally is charged with misrepresenting the significance of the FFIEC test. The record confirms that she was aware that the test was good information. (Div. Ex. 228 at 70-71; but see Tr. 510-11.) She provided the FFIEC test results to Mr. Redpath, but might have downplayed their value to him by observing that the test applied to financial institutions, and not public funds, such as Lewis & Clark County. (Tr. 515.) The test does apply to financial institutions, as Ms. Bally said, but provides all investors with good information on risk. I conclude that her failure to advise Mr. Redpath of the usefulness of these test results was not intended to deceive, but reflected her understanding of the applicability of the test. Her testimony as to her knowledge of Bloomberg medians, which lacked credibility, was of little consequence, given the information she did provide to Mr. Redpath as to the nature of the CMO securities she was offering for sale and the inclusion of the Bloomberg median value in the range of PSA assumptions supplied on yield tables. These are the sole indications in this record of misrepresentation or untruthfulness. Neither rises to the level of decisional consequence on the issue of scienter. The record taken as a whole fails to demonstrate that Ms. Bally intended to defraud or manipulate her client in the manner here suggested by the Division.

For all of the above reasons, I conclude that the Division has not supported the contention that Ms. Bally made fraudulent representations and omissions in the sale of the following CMOs to Lewis & Clark County, Montana in violation of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder:

- FNMA 1993-183 SD (8/31/93)
- FNMA 93-203 SA (9/10/93)
- FHLMC 1602 SA (9/14/93)
- FNMA 93-205 H (9/24/93, 1/19/94, 3/7/94)
- FNMA 92-96 B (11/23/93)
- FHLMC 1611 PD (12/14/93)
- FNMA 93-51 E (1/27/94)
- FNMA 94-19 S (4/15/94)

- FNMA 94-19 K(4/21/94)

Neither has the Division proved that Ms. Bally violated Section 17(a) of the Securities Act of 1933 or Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

Consequently, there is no basis for ordering Ms. Bally to cease and desist such violations, for imposing any remedial sanction, for disgorging any ill-gotten gains or for paying any civil penalty.

g. Respondent Larry Bagwell

Larry J. Bagwell began working as a bond salesman with MS&B in late 1990, and moved on to MGSI in June 1991, where he remained until September 1994. (Tr. 1184-85.) He received some training in CMOs at MS&B, including occasional classes covering such things as floating rate CMOs and Bloomberg yield tables, and better training in CMOs at MGSI. (*Id.*) He became reasonably familiar with CMOs and sold them throughout this period of time. (Tr. 1186.) He knew how to use the Bloomberg system. (Tr. 1224.) Mr. Bagwell holds NASD Series 7 and 63 licenses. (Tr. 1233.)

The allegations that Mr. Bagwell made fraudulent misrepresentations and omissions in the sale of CMO securities to the City of Joplin, Missouri involve transactions from June 1992 through February 1994, when he was employed with MGSI. Mr. Bagwell understood that it was his responsibility as a broker to ensure that his customers understood the characteristics and risks of CMOs and other securities, as well. (Tr. 1235-36.)

h. Mr. Bagwell's customer, Linda Sharp

Linda Sharp received a Bachelor of Science degree in Business Administration, with a major in Accounting, from Missouri Southern State College in 1982. (Tr. 726.) Her education did not include any courses in finance or investments. (Tr. 726-7.) She began her career right after receiving her B.S. degree by accepting a position with Cusack, Mense, Brown and Company, a small Certified Public Accounting firm in Joplin, Missouri. (Tr. 727.) In 1984, she moved to Baird, Kurtz and Dobson, a larger, regional CPA firm in Joplin, with two partners of her original firm. (*Id.*) While with Baird, Kurtz and Dobson, Ms. Sharp passed the CPA examination. (*Id.*)

At these firms, Ms. Sharp performed auditing work for government and not-for-profit entities and tax work during the tax season. She was involved with the City of Joplin's audits for 10 years. During her tenure with the two CPA firms, Ms. Sharp's exposure to investments was limited to obtaining bank confirmations of Certificates of Deposit ("CDs") held by the firms' municipal clients. (Tr. 728-9.) She provided no investment consulting services. (*Id.*) Her personal investment experience was limited to buying five shares of Wal-Mart stock and a mutual fund. (Tr. 734.)

Ms. Sharp became Director of Finance for the City of Joplin on March 2, 1992. (Tr. 729.) Among her duties was investing money, pooled in a Treasurer's fund, that the City obtained from sales and property taxes and other revenue sources. These funds were to be used for Joplin's regular operations. Ms. Sharp believed that her foremost responsibility

was to keep Joplin's funds safe and to earn the best return she could. (Tr. 735.) When Ms. Sharp assumed her position as Director of Finance, the City had about $11 million in Certificates of Deposit in local banks, and $9 million in a money market checking account. (Tr. 736.) When the CDs became due, Ms. Sharp was getting bids of around 3 percent interest from local banks offering to renew the instruments for six months. (Tr. 737.) She concluded that these banks were not interested in these deposits, since the offered interest rate was so low, and she sought new vehicles for investment.

Ms. Sharp prepared a simplified cash flow worksheet to determine how much money could be put into investments, such as mortgage-backed securities like "Ginnie Maes," obligations of the Government National Mortgage Association, and CMOs, to obtain a greater yield. (Tr. 935, 976,) She purchased Ginny Maes from a local bank during her first months on the job. She understood that these obligations were guaranteed to return her investment. (Tr. 739-40,), and she believed them to be "nice, safe" investments. (Tr. 937.) Although Ms. Sharp understood that these securities would return a higher yield than CDs, she did not have a good understanding of the risk/reward relationship when she entered into the purchase of Ginny Mae securities (Tr. 939.) She did, however, understand the common principle that when one invests for a higher yield, one can expect to assume some additional risks. (Tr. 1040.) Ms. Sharp stated that she would not have purchased CMOs if she thought that Joplin could lose money (Tr. 754, 838-39.) and did not think she was gambling or speculating by making investments in CMOs. (Tr. 753-54.)

Ms. Sharp was a member of the Missouri Finance Officers and Treasurers Association and the GFOA. She attended GFOA's annual conference and seminars in 1992 and 1993. (Tr. 811.) At the 1993 conference, Ms. Sharp attended a session dealing with CMO investments and their application in government portfolios. (Resp. Ex. 132; Tr. 1060-61.) The session included presentations on "Understanding the Risks and Benefits of CMOs," "What Needs to be Done Prior to Purchasing a CMO," "Stable or Risky CMO Tranches: Which Do You Own?" (Resp. Ex. 128.) She also visited the offices of MGSI and Westcap Securities and received information on CMOs, as well as on the Bloomberg analytic system. (Resp. Ex. 126; Tr. 1103.) Ms. Sharp had in her possession in 1992 or early 1993 an article entitled "Collateralized Mortgage Obligations: Not Perfect Investments as Claimed." (Tr. 1027-28.)

i. Mr. Bagwell's dealings with Ms. Sharp

Larry Bagwell reached Ms. Sharp by making a cold call phone contact on June 3, 1992. (Tr. 1481.) In this call, he obtained basic information as to the City of Joplin's investments, including the fact that the City had $11 million that was not needed for cash flow, $8 to 9 million of which was returning about 6 percent in investments maturing in the near future. (Tr. 1481.) Mr. Bagwell also sent to Ms. Sharp a PSA Government Securities Manual. (Div. Ex. 173; Tr. 748-49.) In a second call on June 15, 1992, Mr. Bagwell spent 54 minutes explaining CMOs to Ms. Sharp, in the context of describing a range of investment possibilities. (Tr. 1485-96.) On July 31, 1992, Mr. Bagwell faxed Ms. Sharp a yield matrix for a CMO security, on which he numbered various portions. (Resp. Ex. 8.) He proceeded to take Ms. Sharp through each of the items on the matrix for the purpose of explaining them to her. (Tr. 1511.) Mr. Bagwell believed that Ms.

Sharp was engaged in the subject of the 54-minute call from her frequent questions and participation in the call (Tr. 1495.) and that she seemed to understand the elements of the yield table. (Tr. 1511.) [23]

Ms. Sharp did not have access to a Bloomberg terminal or other computer analytics for CMOs. (Tr. 764-65.) She relied upon Mr. Bagwell for analytic information and for assurance that the securities she purchased were priced fairly and made sense for Joplin. (Tr. 766; 1226.)

Mr. Bagwell's practice was to review the specifics of bonds that he was offering for sale to Ms. Sharp orally by phone. It was unusual for him to fax her information about a proposed sale. (Tr. 771.) [24] Mr. Bagwell explained that this practice was customary for him with all of his customers. (Tr. 1538-40.)

Mr. Bagwell claims to have presented complete information to Ms. Sharp by phone for each bond offered for sale. This included, for a new issue, the price of the bond, the starting coupon, the pricing PSA speed, the underlying collateral, information on yield and average life for a range of PSA levels, and, for IFs, the effects of changes in the LIBOR interest rate index. (Tr. 1536-38.) Mr. Bagwell claims further that it was his normal business practice to vary the CMO up and down 300 basis points from the Bloomberg consensus median and disclose this information to his customer orally for every transaction. (Tr. 1173.) He retained the yield tables and his notes from these calls. (Resp. Exs. 2, 8.)

Ms. Sharp's recollection and contemporaneous notes paint a different picture. She testified that she took down on a "sticky note" all of the numbers that Mr. Bagwell communicated to her on a typical sales call. (Tr. 831, 835; Div. Exs. 147, 148.) The data she recorded fell well short of the information that Mr. Bagwell claims to have communicated.

This discrepancy is not easily resolved. It is unlikely that Mr. Bagwell communicated the full range of information he outlined at Tr. 1536-38 for each and every transaction with Ms. Sharp. It is equally unlikely that Ms. Sharp wrote down all of the information he did communicate on the sticky notes she used for this purpose. Her note-keeping habits and general casual demeanor with respect to her investment responsibilities do not give one confidence that she wrote down all of the data Mr. Bagwell revealed to her.

For several reasons, I conclude that Mr. Bagwell's testimony is more credible on this issue than Ms. Sharp's, but there remains uncertainty about the depth of information he actually provided to Ms. Sharp in his various sales calls. He revealed one instance where he made a note of the fact that, because he was calling Ms. Sharp from home instead of his office (dealing with a family illness), he was unable to communicate to Ms. Sharp information on yields or collateral. (Resp. Ex. 2 at MGJ 1111; Tr. 1524-25.) This suggests a likelihood that, ordinarily, he provided a fuller range of information in his other calls to Ms. Sharp. Then there is Ms. Sharp's practice of recording information from Mr. Bagwell on "sticky notes." Such notes have a limited amount of space. It seems highly probable that Ms. Sharp limited her notetaking to only those facts she needed for

her own record-keeping. Consequently, these notes cannot be relied upon to divulge all of the information Mr. Bagwell provided. Finally, there is Ms. Sharp's statement that when Mr. Bagwell called, she was off doing a jillion other things. (Tr. 932.) From this, as well as examples in the record of Ms. Sharp's faulty memory,[25] I conclude that her recollection of the telephone calls from Mr. Bagwell deserves somewhat less credence than his, and that Mr. Bagwell at least disclosed the information contained in his notes and holding pages, whether or not Ms. Sharp's notes are fully in accord.

This is not to suggest that Mr. Bagwell is totally credible either in relative terms or on the more important issue of whether he communicated more than he recorded on his notes and holding pages. It is clearly self-serving of him to now claim that a full range of disclosure was made in all instances save the one when his sales call was made from home. Although MGSI taped broker calls on a rotating basis, no such records of sales calls to Ms. Sharp have been disclosed here. Thus, there is nothing in the record to corroborate Mr. Bagwell's claims. I conclude that he conveyed to Ms. Sharp all of the information contained in his notes and holding pages for the securities at issue here. The record does not support his assertion that his business practice included the full disclosure described in his testimony at Tr. 1536-38, or that this practice was followed in all cases.

Mr. Bagwell provided monthly portfolio reports to the City of Joplin. During March through September 1994, these reports deleted a market value column that had previously been included. Throughout 1993 and into January and February 1994, these reports had displayed *cost* values in the market value column of the report. (Tr. 1444, 1472.) In January and February 1994, this column continued to show cost figures, which were now above market value, due to the implications of increasing interest rates on these values. (Tr. 1445.) In 1993, the reverse was the case, *i.e.*, the market value column showed cost figures which were below market value. (Tr. 1444.) Ms. Sharp was advised that the market value column contained cost figures in late 1992. (Tr. 1902.) In March 1994, MGSI deleted this column and informed Ms. Sharp of the reason why, *i.e.*, that it had contained cost information and did not reflect market value. (Tr. 1908.)[26]

(i) Representative transactions

FHLMC 1602 SA (IF)

Mr. Bagwell sold this support class IF security to the City of Joplin on September 14, 1993. Its collateral was 30-year, 6.5 percent mortgages. (Div. Ex. 244 at 65.) The pricing speed was 200 PSA. The coupon for this security is tied to the one-month LIBOR interest rate index, so that for each 1.0 percent change in LIBOR, the coupon would increase or decrease by 3.25 percent. (*Id.*) The security is an Inverse Floater, so the coupon moves inversely with the change in direction of the LIBOR. (*Id.*) The information conveyed to Ms. Sharp by Mr. Bagwell about this security included the effect on yield and average life at 200, 300, and 400 PSA, but he did not vary LIBOR. (*Id.* at 70; Tr. 1406-07.) The cap and the formula which produces the coupon was disclosed. Ms. Sharp had the ability to use the formula to determine current coupon based upon the one month LIBOR. (Tr. 1407; Div. Ex. 147.) Since this is an IF, a two dimensional matrix, such as a 7 x 7 yield table, would be the preferred mechanism for disclosing risks at various interest rate and prepayment levels. (Div. Ex. 147 at 69-70.) Such information was not provided in writing. All of Mr. Bagwell's disclosures as to this security were made in a telephone call to Ms. Sharp. (Div. Ex. 147.) For the period beginning with the City of Joplin's purchase through March 1999, this security actually yielded a 2.931 percent return. (Div. Ex. 244 at 71.)

FNMA 1993-225 SO (IF)

Mr. Bagwell sold this support class IF security to the City of Joplin on October 28, 1993 and on November 2, 1993. (Div. Exs. 148, 149, 244 at 51.) The underlying collateral consisted of three groups of loans, the largest percentage being 6.5 percent 30-year mortgage loans. (Div. Ex. 244 at 51.) The coupon for this security is tied to the one-month LIBOR interest rate index, so that for each 1.0 percent change in LIBOR, the coupon would increase or decrease by 3.30 percent. (*Id.*) This security is an Inverse Floater where the coupon moves inversely with the change in direction of the LIBOR. The information conveyed to Ms. Sharp about this security by Mr. Bagwell confirmed by contemporaneous notes of both Mr. Bagwell and Ms. Sharp include the yield and average life at the pricing speed of 200 PSA. (Div. Exs. 148, 144 at MGJ 2968.) Ms. Sharp also noted the 3.3 times one-month LIBOR formula. (Div. Ex. 148.) Although Mr. Bagwell testified that he made wider disclosure generally about the securities he offered to Ms. Sharp, there is nothing to corroborate this testimony as it might apply to this security. In addition, this is an IF security, for which a two-dimensional yield representation, such as a 7 x 7 yield table, would be the preferred disclosure. Such information was not provided in writing. All of Mr. Bagwell's disclosures as to this security were made in a telephone call to Ms. Sharp. (*Id.*) For the period from December 1993 through March 1999, this security actually yielded a 4.53 percent return. (Div. Ex. 244 at 57.)

FNMA 1993-184M (PO)

Mr. Bagwell sold this support class security to the City of Joplin on September 8, 1993. (Div. Ex. 244 at 27.) The underlying collateral consisted of new 30-year mortgage loans at an average rate of about 7.5 percent. (*Id.*) This is a Principal Only security, which has a zero coupon. The yield is achieved by purchasing at a discount and receiving principal repayment at par or 100 percent. (*Id.*) Principal repayment is highly sensitive to prepayment speeds. (*Id.*) The pricing speed was 200 PSA for this new security. (*Id.* at 28.) Information conveyed to Ms. Sharp by Mr. Bagwell confirmed by contemporaneous notes of both individuals was a 9.01 percent yield and an average life of 1.6 years, based upon a 600 PSA. (Div. Exs. 144 at MGJ 2970, 150, 151.) As with other securities and his business practice, all the information about this security was conveyed orally to Ms. Sharp by Mr. Bagwell. During the period that the City of Joplin held this security through March 1999, the bond paid down $201,403 of its $4,225,000 principal, with no principal repaid during the last five years. (Div. Ex. 244 at 33.) The security had a negative rate of return over the holding period. (*Id.*)

FNMA 1993-228G (PO)

This support class security was sold by Mr. Bagwell to the City of Joplin on October 14, 1993, and October 23, 1993. The underlying collateral was new 30-year mortgage loans with an average interest rate of about 7.5 percent. (Div. Ex. 244 at 20.) This is a Principal Only security, which has a zero coupon. The yield is achieved by purchasing at a discount and receiving principal repayment at par or 100 percent. (*Id.*) The pricing speed for this security was 350 PSA, at which yield would be 2.5 percent, with an average life of 9.2 years. (*Id.*) For the October 14, 1993 transaction, Mr. Bagwell sold the security while at home. He advised Ms. Sharp that it was a "super PO, and cheap," and "really didn't even explain yields or collateral," because he did not have his dealer sheets with him at home. (Div. Ex. 160; Tr. at 1347.) This was outside of his normal practice. (Tr. 1347.) The next day, after the purchase, Mr. Bagwell went over further details of this security, including a discussion of the security's likely performance at prepayment speeds of 500 to 1,000 PSA, but disclosed nothing at or below the pricing speed of 350 PSA. (Div. Ex. 144 at MGJ 2968.) On October 23, 1999, Mr. Bagwell sold the City of Joplin more of this security. The disclosure focused on a prepayment speed of 572 PSA, which was the one-month historical prepayment rate for this bond. (*Id.*; Div. Ex. 244 at 22.) Since October 1993, this security paid down to $1,909,529 from $2,000,000, and has not repaid principal in the last 5 years. (Div. Ex. 244 at 26.) The security has had a negative return over the holding period. (*Id.*)

FNMA 203 SA (IF)

This support class security was sold by Mr. Bagwell to the City of Joplin on September 9, 1993. The underlying collateral was 30-year mortgage loans at 6.5 percent. This is an Inverse Floater security where the coupon moves inversely with the change in direction of the LIBOR.

(Div. Ex. 244 at 58.) The coupon for this SA class security purchased by Joplin is tied to the one-month LIBOR interest rate index. For each 1.0 percent change in LIBOR, the coupon would increase or decrease by 2.6 percent. (*Id.*) The information provided to Ms. Sharp by Mr. Bagwell related to this purchase, confirmed by their contemporaneous notes, included yields and average lives at 200 and 250 PSA and the coupon formula. (Div. Exs. 144 at MGJ 2970, and 163.) The pricing speed was 200 PSA. (Div. Ex. 244 at 60.) As with other IFs, the preferred disclosure for this security would include information conveyed as a two-dimensional matrix that varies the short term interest rate index (LIBOR here) and prepayment speed. Mr. Bagwell did not disclose such information. (Tr. 1400.) Actual yield for this security over the period from the time of purchase by Joplin through March 1999, was 4.767 percent. (Div. Ex. 244 at 64.)

FHLMC 1653 SB (IF)

This support class security was sold to the City of Joplin by Mr. Bagwell on December 15, 1993. Its collateral consisted of mortgage loans with a weighted-average remaining term of 358 months and a weighted-average coupon of 7.46-7.60 percent. (Div. Ex. 244 at 41.) This is an Inverse Floater security where the coupon moves inversely with the change in direction of the LIBOR. (*Id.*) The coupon for this SB class security purchased by Joplin is tied to the one-month LIBOR interest rate index. For each 1.0 percent change in LIBOR, the coupon would increase or decrease by 7.0 percent. (*Id.*) The prepayment pricing speed for this security was 235 PSA. Mr. Bagwell disclosed yield and average life predicated on 300 and 700 PSA, as well as the coupon formula and collateral information. (Div. Exs. 144 at 2967, 168.) He also advised that the coupon would drop to 18.20 percent if LIBOR went to 3.5 percent, but did not disclose a two dimensional matrix showing the effects on yield and average life of changes in LIBOR and prepayment speeds. (Div. Ex. 168.) For the holding period from date of purchase through March 1999, this security yielded 1.753 percent and returned no principal for over five years. (Div. Ex. 244 at 50.) Joplin sold this security on May 5, 1995, for a loss of $619,041. (*Id.*)

FNMA 1993 205H (PO)

This support class security was sold to the City of Joplin by Mr. Bagwell on January 14, 1994. The collateral for this security consisted of new 30-year mortgage loans at a weighted-average rate of 7.56 percent. (Div. Ex 244 at 34-35.) This is a Principal Only security, which has a zero coupon. The yield is achieved by purchasing at a discount and receiving principal repayment at par or 100 percent. (*Id.*) The pricing speed for this issue when new in September 1993 was 400 PSA; however, by the time of this sale in January 1994, interest rates had risen and projected prepayment estimates had declined to about 195 PSA. (*Id.* at 35; Div. Ex. 157; Tr. 1361.) Mr. Bagwell disclosed to Ms. Sharp yields and average lives at prepayment speeds of 518 PSA and 850 PSA. (Div. Ex. 144 at MGJ 2966; Tr. at 1371-72.) The 518 PSA was the January 1994 historical prepayment speed for this security at January 24, 1994. (Div. Ex. 157.) This security had not repaid any principal for over five years and had a negative rate of return for the holding period ending at March 1999. (Div. Ex. 244 at 40.)

FNMA 1993 206SE (IF)

This support class security was sold to the City of Joplin by Mr. Bagwell on September 27, 1993. (Div. Ex. 244 at 153.) Its underlying collateral consisted of 30-year, 6.5 percent mortgage loans. (Div. Ex. 244 at 81.)

This is an Inverse Floater security where the coupon moves inversely with the change in direction of the LIBOR. (*Id.*) The coupon for this SE class security purchased by Joplin is tied to the one-month LIBOR interest rate index. For each 1.0 percent change in LIBOR, the coupon would increase or decrease by 3.2 percent. (*Id.*) The pricing speed for this issue was 200 PSA. In addition to collateral information and the coupon formula, Mr. Bagwell disclosed to Ms. Sharp information about average lives and yields at 200, 250 and 300 PSA. (Div. Exs. 144 at MGJ 2969, 155 at MGJ 1124.) He did not vary LIBOR in his telephone conversations with Ms. Sharp related to this IF security, nor did he furnish two dimensional matrix depictions of changes in yield and average lives at various LIBOR index rates and different prepayment speeds. (Div. Ex. 244 at 85.) The actual yield for this security over the holding period through March 1999 was 2.364 percent, and no principal had been repaid over this span. (*Id.*)

FHLMC 1584 SB (IF)

This support class security was sold to the City of Joplin by Mr. Bagwell on August 17, 1993.[27] The underlying collateral was mortgage loans having a weighted-average remaining term of 358 months, and a weighted-average coupon of 7.10 percent. (Div. Ex. 244 at 73.)

This is an Inverse Floater security where the coupon moves inversely with the change in direction of the LIBOR. (*Id.*) The coupon for this SB class security purchased by Joplin is tied to the one-month LIBOR interest rate index. For each 1.0 percent change in LIBOR, the coupon would increase or decrease by 4.18 percent. (*Id.*) The pricing speed for this security was 185 PSA. Mr. Bagwell disclosed yields and average lives at 185 and 250 PSA, as well as collateral information and the coupon formula. (Div. Exs. 144 at 2971, 170.) He further varied LIBOR to the extent of disclosing the "corners" of the two-dimensional yield table (Div. Ex. 169), where LIBOR increased or decreased by 3 percentage points. (Tr. 1385-86.) This security has actually yielded a total rate of return of 3.289 percent for the period from the date of purchase by Joplin through March 1999. No principal had been repaid in that time span. (Div. Ex. 244 at 80.)

(ii) Consequences of the transactions

Ms. Sharp followed a course of purchasing CMO securities offered to her by Mr. Bagwell and selling them at times to realize profits. Her intent was to achieve a better yield for moneys that the City of Joplin would not require to meet cash flow needs. (Tr. at 986.) She had identified about $11 million that was "extra" and not required to meet ongoing requirements that could be invested in securities with some additional extension risk in

order to get better yields. (Resp. Ex. 2 at 1.) Ms. Sharp bought similar CMO securities from Mr.Crow, with Westcap Corporation. (Resp. Ex. 126.) During the period from November 1992 through October 1993, she invested an average of $15.6 million, producing $2.7 million of interest and trading gains, for a total return in the City's fiscal year 1993 of 12.96 percent. (Resp. Ex. 66.) As a result of these and subsequent purchases, Joplin increased its interest income substantially and profited from sales of these securities as long term interest rates declined.

As interest rates began to rise in 1994, the performance of the City's interest rate-sensitive CMO portfolio changed. Moreover, publicity about the negative experience of other municipalities and governmental units with CMOs led to increased attention on Joplin's portfolio. A new City Manager became concerned about market value declines and asserted approval authority over Ms. Sharp's investment decisions. (Tr. 885.) She was sent to discuss the City's investments with a Kansas City law firm under false pretense (Tr. 884-85.) and was shortly thereafter dismissed as Joplin's Finance Director. (Tr. at 980.) That law firm then pursued legal claims on the City's behalf against MGSI and Westcap.

j. Conclusions re: Mr. Bagwell

Mr. Bagwell is charged with violating the above-cited antifraud statutes by, among other things, omitting to state material facts necessary in order to make the statements he made not misleading. It is alleged that Mr. Bagwell violated these statutes by painting materially misleading pictures of the CMOs he sold by emphasizing only the upside potential yields using favorable prepayment assumptions, while failing to disclose that the CMOs would be far less attractive investments under other prepayment assumptions. He is further charged with fraudulent misrepresentation in monthly portfolio reports he provided to the City of Joplin from September 1993 through September 1994.

Turning first to the allegations that Mr. Bagwell knowingly provided false market values in the January and February monthly reports to Joplin, and later surreptitiously removed the market value column to hide losses in the account due to interest rate increases during 1994, the credible testimony of a principal of MGSI, Mr. Iverson, cited above, presents a plausible explanation for the problem with the market value column. The fact that the column actually *understated* market value during 1993 provides support for the position of the respondent here, that the column, when displayed, always showed cost figures and was actually deleted to *avoid* misrepresentation of market values when those values declined. Ms. Sharp was informed at the outset of her relationship with MGSI that the market value column on the monthly report contained cost figures, and was again reminded in early 1994 of that fact and the reason for its deletion from reports subsequent to February 1994. Moreover, that the column reflected the cost of the securities, as opposed to market value, should have been apparent to the recipient from her own records. I conclude that there was no misrepresentation here. (Tr. 1902, 1908.)

As to the disclosure issues, I will again employ the standard used to assess Ms. Bally's conduct, since similar securities were sold by Mr. Bagwell to the City of Joplin. Under that standard, it is first required that the broker ensures that his customer understand the characteristics and risks of CMOs. Mr. Bagwell had a 54-minute telephone conversation

with Ms. Sharp, which he used to acquaint her with the CMOs he would be offering for sale. He followed this up with a telephone call to explain the elements of a Bloomberg yield table. Although Ms. Sharp did not recall these calls, the record contains Mr. Bagwell's notes (Resp. Ex. 2.) and a copy of the marked yield table (Resp. Ex. 8.) which provide support for his testimony on this subject. (Tr. 1485-95.) He also sent her a PSA Government Securities Manual (Div. Ex. 173; Tr. 748-49.) to further inform her about government securities, although this document in fact provides relatively skimpy information about CMOs. Mr. Bagwell visited Ms. Sharp after some early CMO purchases, but before the ones at issue in this case, and provided Bloomberg yield tables for those securities she had purchased and other information. (Resp. Ex. 32.) These tables depicted the risks associated with changing prepayment rates on yield and average lives. In addition, Ms. Sharp had received prospectuses and yield tables from her purchases of CMOs from Westcap in early 1993, which depicted the yields and average lives under numerous prepayment scenarios. (Resp. Ex. 126.) Mr. Bagwell reasonably concluded that Ms. Sharp was familiar with CMOs, including their peculiar characteristics and risks, either from information he provided, or that he knew her to have received from other sources.[28] I conclude that he satisfied the standard of ensuring that his client understood the characteristics and risks of CMOs.

In fact, Ms. Sharp was exposed to other information from which she learned or should have learned even more about these securities. She attended a GFOA conference from May 2-5, 1993, at which CMOs were extensively discussed. (Resp. Ex. 132.) She received publications dealing with this subject (Resp. Ex. 72; Tr. 1027-28.), and she had discussions with bankers and auditors about the risks of these instruments in the relevant time frame. (Tr. 781-82, 1024.) Her own reports, written after the interest rate rise, reflected a full understanding of the nature of CMOs and their attendant risks. (Resp. Exs. 63, 66.) Even discounting the value of the second report because it was written in an environment where her job was in jeopardy, one cannot escape the conclusion that Ms. Sharp fully appreciated the nature of the investments she made with Mr. Bagwell. Her protestations to the contrary are not persuasive and are contradicted by other facts in evidence.

The second standard requires disclosure of prepayment assumptions and their effect on yield, average lives, and price. For each security questioned by the Division, Mr. Bagwell's holding pages and notes, and, in most instances, Ms. Sharp's notes, confirm that Mr. Bagwell conveyed information about prepayment assumptions and their effect on the subject variables. However, the information was conveyed orally, and was not uniform or consistent with respect to the range of prepayment scenarios across all securities sold. For example, for FHLMC 1602 SA (IF), Mr. Bagwell quoted effects across three different PSA speeds, including the pricing speed, but for FNMA 1993 184M (PO), he focused only on one, PSA 600, when the pricing speed was 200 PSA. I do not believe that the latter example constituted adequate disclosure regarding prepayment assumptions. Similarly, disclosure was inadequate for FNMA 1993-225 SO (IF) because only one PSA speed was discussed; and for FNMA 1993 205H (PO), because Mr. Bagwell focused on one PSA speed, 518, and a higher speed, 800 PSA, when the bond's actual PSA had declined to 195.[29]

There is also the question whether oral disclosure was sufficient, even in the cases where a broader range of prepayment assumptions was conveyed. I conclude that there is a clear reason to prefer written disclosure, because the effects of varying prepayment assumptions on yield, price and average lives is much more apparent in a visual context. Nevertheless, I conclude that oral disclosure would suffice, provided the information was complete enough to paint a true picture of the risks of the security offered for sale at various prepayment speeds. As noted, the information disclosed by Mr. Bagwell about the effect of prepayments on price, yield and average lives for the sales of FNMA 1993-184M (PO), FNMA 1993-225 SO (IF) and FNMA 1993 205H (PO) was not fully adequate to satisfy the standard.[30]

The third prong of the disclosure standard is that the broker must ensure that the customer understands that market values of POs are extremely sensitive to prepayment rates, which, in turn, vary with interest rate changes. I conclude that here, as with the general risk standard first considered, there is enough information in the record to conclude that Ms. Sharp appreciated this fact. Particularly, Ms. Sharp's reports, and the information provided by Mr. Bagwell and Mr. Crow of Westcap would be sufficient to meet this test. The fourth disclosure standard relates to IFs. It requires that the broker ensure that the customer understands the risks and characteristics of IFs being purchased in light of their high price volatility as interest rates move. The record confirms that this standard would best be met by the provision of a two-dimensional matrix that shows the impact on yield of changes in prepayment speeds and the interest rate index. (Div. Ex. 244.) Such information was not provided by Mr. Bagwell at the time of the sales of the securities in question here. In one case, FHLMC 1584 SB (IF), it appears that Mr. Bagwell varied LIBOR by discussing with Ms. Sharp the "corners" of a two-dimensional yield table that varied LIBOR. (Div. Ex. 169.) However, the record will not support a conclusion that this was Mr. Bagwell's normal business practice. He did communicate the coupon formula to Ms. Sharp regularly, but this was not fully adequate to achieve satisfactory disclosure of the effect of interest rates on yields and market value of IFs. (*See, e.g.*, Div. Ex. 244 at 45.)

In sum, Mr. Bagwell did not fully satisfy reasonable disclosure standards relating to the provision of prepayment speed assumptions and interest rate index changes for several of the securities he sold to the City of Joplin. We turn next to assess whether there was an intent to deceive Ms. Sharp by these omissions.

Scienter is a state of mind embracing an intent to deceive, manipulate or defraud. *Aaron v. SEC*, 446 U.S. 680 (1980); *Hochfelder*, 425 U.S. 185 at 193. Scienter is established by showing that the respondent acted intentionally or with severe recklessness. *Hackbart v. Holmes*, 675 F.2d 1114, 1117 (10th Cir. 1982). Recklessness, in turn, is defined as "an extreme departure from the standards of ordinary care...which presents the danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."

Meyer Blinder, 50 S.E.C. 1215, 1229-30 (1992) (quoting *Sundstran Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977). For purposes of Sections 17(a)(1) and 10(b)5 and Rule 10b-5, proof of scienter need not be direct, but may be "a matter of inference from circumstantial evidence." *Herman & MacLean v. Huddleston,* 459 U.S. 375, 390 n.30 (1983); *Pagel, Inc. v. SEC*, 803 F.2d 942, 946 (8th Cir. 1986).

I find insufficient evidence, either direct or circumstantial, of an intent to deceive on the part of Mr. Bagwell when he provided less than full disclosure of certain information to Ms. Sharp for the securities identified above. It seems clear that Mr. Bagwell went about his responsibilities in an organized and business-like fashion. He was clearly motivated to make sales, but he also respected the rules of the game, as he understood them. Thus, he developed the City of Joplin as a potential customer by engaging in a lengthy telephone call explaining the CMO securities he would be offering for sale, and following up with a more detailed explanation of the variables on a Bloomberg yield table. He supplied explanatory materials and post-sale yield tables. While his customary procedure of conveying information about specific securities by phone left something to be desired, I cannot find any evidence that this *modus operandi* was intended to deceive his customers. It appears more that he was a broker most comfortable with telephonic communications.

There is also no indication that he deliberately withheld critical evaluative information that his customers needed, nor any suggestion that he refused or delayed responding to requests for additional information from his customer. He did not knowingly disregard any rule or disclosure requirement. Nor can it be said that he unduly pressured Ms. Sharp to make the CMO purchases. Describing a bond as "cheap," (Resp. Ex. 168 at MGJ 1684.) or that he "really liked" a particular security (Resp. Ex. 9.), alleged by the Division as examples of undue sales pressure, is more in the nature of sales puffery than pressure. In short, Mr. Bagwell is at fault for providing less than complete disclosure as to certain securities, and for providing an inconsistent level of detail about the various bonds he offered for sale. The fact that he satisfied disclosure requirements for some of the securities he sold to Joplin belies an intent to manipulate or deceive with respect to others, given that the bonds he offered for sale were similar in terms of risks. Further, the fact that he purchased some of the same securities that he sold to Joplin for himself and sold some to his mother and his son, as well, further suggests an absence of deception as to their worthiness. (Tr. 1569-73; Resp. Ex. 213.)

I also find that the City of Joplin was not so unsophisticated a purchaser that it would have been misled by the disclosure lapses identified on this record. Ms. Sharp could and should have paid more attention to the risks of the securities she was purchasing, but she was not the victim of a deceitful, manipulative broker here. She had enough information from Mr. Bagwell and others accumulated over the relevant time period, the right educational and experiential background, and sufficient knowledge at her disposal to enable her to form her own judgments about the wisdom of these purchases.[31] *Banca Cremi v. Alex. Brown*, 955 F. Supp. 499 (D. Md. 1997), *aff'd*, 132 F. 3d 1017 (4th Cir. 1997).

For all of the above reasons, I conclude that the Division has not supported the contention that Mr. Bagwell made fraudulent misrepresentations and omissions in the sale of the following CMOs to the City of Joplin, Missouri, in violation of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder:

- FNMA 1602 SA (9/14/93)
- FNMA 1993-225 SO (10/29/93)
- FNMA 1993-184M (9/8/93)
- FNMA 1993-228G (10/14/93, 10/21/93)
- FNMA 203 SA (9/9/93)
- FHLMC 1653 SB (12/15/93)
- FNMA 1993-205 H (1/14/94)
- FNMA 1993 206E (9/27/93)
- FHLMC 1584 SB (8/17/93)

Neither has the Division proved that Mr. Bagwell violated Section 17(a) of the Securities Act of 1933 or Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

Consequently, there is no basis for ordering Mr. Bagwell to cease and desist such violations, for imposing any remedial sanction, for disgorging any ill-gotten gains or paying any civil penalty.

III. Pending Motions

As noted above, the Division has moved for entry of an order making findings, imposing a cease-and-desist order and revoking MGSI's registration as a broker-dealer by default. The Division has further moved on December 13, 1999, in a "Motion to Set Disgorgement and Penalties with Respect to MGSI Securities, Inc.," that MGSI be ordered to disgorge $290,959, plus pre-judgment interest, and that a First Tier Penalty of up to $50,000 be imposed upon MGSI. MGSI has not responded to these motions, but counsel for Bally and Bagwell oppose the Division's latter motion.

MGSI is found in violation of the Securities laws, as charged in the Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Sections 15(b), 19(h) and 21C of the Securities Exchange Act of 1934, by its failure to appear and answer these charges.

IV. Public Interest

MGSI will not be ordered to disgorge $290,959, the Division's calculation of MGSI's ill-gotten gains from the trades of Ms. Bally and Mr. Bagwell. Disgorgement should be ordered only when it is clear that ill-gotten gains have been realized, and that such gains are attributable to proven violations of the securities laws. *See Canady*, Securities

Exchange Act of 1934 Rel. No. 41250 (April 5, 1999) (where the S.E.C. excluded from a disgorgement order commissions paid by non-testifying customers.) The findings and conclusions herein with respect to these transactions do not support the notion of ill-gotten gains on MGSI's part for failure to supervise Bally and Bagwell. Nor is it in the public interest to assess a civil penalty in these circumstances. The orders below will be sufficient to render justice in this instance.

Record Certification

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b) (1997), I certify that the record includes the items set forth in the record index issued by the Secretary of the Commission on July 7, 1999, and corrected by my order issued July 28, 1999.

Order

It is ordered that MGSI cease and desist from violations of the Securities laws, as charged in the order instituting these proceedings.

It is ordered that the registration of MGSI Securities, Inc. as a broker-dealer be revoked.

It is ordered that the allegations against Connie L. Bally and Larry J. Bagwell be dismissed.

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 (1997). 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 any party, the initial decision shall not become final as to that party.

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William J. Cowan
Administrative Law Judge

Footnotes

1 References to pages in the Stenographic Transcript of the hearing held beginning May 10, 1999, and ending May 18, 1999, shall be shown as "(Tr.___.)."
2 The Division's Exhibits have been identified in the hearing transcript and marked as "DX-___." Respondents' Exhibits were identified in the hearing transcript and marked as "Defendants Exhibit ___." For purposes of clarity and to avoid confusion around the use of the letter "D" in both sets of exhibits, each Division Exhibit will be referred to herein by number as "(Div. Ex.___.)"; and each Respondent Exhibit will be referred to herein by number as "(Resp. Ex.___.)".

3 "PSA speed" is a measure of the rate of prepayments in the pool of mortgages that form the collateral for CMOs. "PSA" refers to the Public Securities Association prepayment model. (See Div. Ex. 241, at fn. 3.)
4 An Inverse Floater is a bond whose monthly coupon varies inversely to the value of a particular interest rate index, usually a short-term interest rate, such as the 1-month London Interbank Offer Rate ("LIBOR"). Inverse Floaters are a type of so-called "support class" security derived from the division of CMO collateral into securities structured to have stable cash flows, such as so-called "Planned Amortization Class ("PAC") bonds, and less stable "support class" securities. (Div. Exs. 243 at p.6; 241 at p. 4.)
5 A substantial portion of the mortgage-backed securities market consists of securities issued by Government National Mortgage Association ("GNMA"), Federal National Mortgage Association ("FNMA") and Federal Home Loan Mortgage Corporation ("FHLMC").
6 These NASD Notice to Members were communicated directly only to members, not to the registered representatives charged here. However, Members were charged with the responsibility to keep their brokers advised about such NASD Notices, and the evidence suggests that they did so. (Tr. at 413-14.)
7 While this Notice is not artfully crafted, in that it does not affirmatively impose a disclosure sentence in the section on POs, whereas it does for other securities it covers, I believe that it reasonably can be assumed from the Notice as a whole that investors in POs should be made aware of the sensitivity to prepayment rate changes and the relationship between prepayment rate changes and the general level of interest rates.
8 This Notice is dated October 1993, which is after some of the sales at issue here. However, the standards set forth in this document present reasonable expectations as to the information required to be provided by brokers selling CMOs in the time frame of 1993-1994, as the record here so demonstrates.
9 I have evaluated Mr. Redpath's statements to the contrary at page 151 of Div. Ex. 234 in response to leading questions from the Division's interrogators, and find them less credible than his original assertions at Page 150.
10 For example, Mr. Redpath was aware, in early 1994, that the price of the CMOs he had purchased earlier had declined, and that that decline affected yields and average lives. He continued to purchase these securities (*e.g.*, the third purchase of FNMA 1993-205H in early March 1994 at less than half the price of the original purchase). (Div. Ex. 69.)
11 These tables centered on a price of 41 24/32, but the purchase was made at 39 24/32. (Tr. 597.)
12 See Div. Ex. 234 at 23-24.
13 Statewide, there had been about $100 million invested in CMOs. $30-38 million of this was from Lewis & Clark County's investments. (Tr. 277.)
14 While the Division's experts argued that more specific disclosure was required by industry practice, I have concluded that there was no generally accepted universal disclosure standard at the time of these sales that would encompass the kind of specific disclosures discussed in their testimony. It is fair to conclude, however, that the Division's experts would not disagree that at least the kind of disclosure required by

NASD Notice to Members 93-78 should have been made, even though they thought much more was required.
15 It is not universally accepted that the Bloomberg median was the appropriate projection for these securities. The Bloomberg median is a projection of the long-term average of the speed at which the underlying mortgages will prepay. While widely used, it is more appropriate for long term tranches than the short-term tranches involved here. (Resp. Ex. 902A at 20, 23; see also Tr. 1732.)
16 Respondents state that it is undisputed that Ms. Bally provided Mr. Redpath Bloombergs for every transaction at issue in this case. Resp. Reply at 22. The Division seemingly disputes this, noting that the record contains Bloombergs furnished by Ms. Bally for only three transactions. Div. Reply at 18-19. However, Ms. Bally testified that her business practice was to send Bloombergs to Mr. Redpath. (Tr. 399, 539-40.) She stated in a prior sworn statement that there were instances where she did not fax him anything before a sale, (Div. Ex. 228 at 48.) but the record better supports the view that her regular business practice was to fax him the Bloombergs.
17 The Division's expert Weiner testified that *conceptually*, historical experience is a worse predictor of future performance than the Bloomberg median because it uses a rear-view mirror to forecast what is going forward. (Tr. 710, emphasis added.) Division witness Davidson testified that it would be inappropriate to use historic speeds for this purpose because they are not a projection of future performance (Tr. 150.), and that historic PSAs were interesting, but not relevant in a time of changing interest rates. (Tr. 690-91.) However, Division witness Weiner agreed that projection models employed historical data (Tr. 691.), and that such data was useful information, although what is really important is to look forward. (Tr. 712.) Given that historical information is useful and employed in models to develop future forecasts, it cannot be said to be unreasonable or misleading to provide and focus upon such information in sales contacts.
18 Mr. Redpath estimated that he and Ms. Bally had 300 to 400 telephone conversations over the year and a half period of their business relationship. (Div. Ex. 234 at 268.)
19 One time, he asked where would LIBOR have to go for the coupon to go to zero, and she undertook to provide that information. (Div. Ex. 228 at 160.)
20 There is also evidence that Mr. Redpath was reserved in his communications with Ms. Bally, suggesting an unwillingness on his part to explore the subject of these transactions in any more detail than he needed (Tr. 553.) This is confirmed by his declination of an opportunity to attend a seminar that MGSI sponsored on August 19, 1993 (Tr. 554.)
21 Div. Reply at 29.
22 The Division concedes that scienter is required to prove violations of Section 17(a)(1) and Section 10(b). (Div. Brief at 71.) While the Division also stated that scienter need not be shown to establish violations under Section 17(a)(2) or (3), it did not distinguish between which allegations of misconduct it was pursuing under which Section of the statute.
23 Ms. Sharp did not recall much about the 54-minute call or the exercise that Mr. Bagwell described of going through the yield matrix with numbered items (Tr. 753; 1068.), but I conclude that Mr. Bagwell did have such conversations with Ms. Sharp, from his credible testimony and contemporaneous records. (Resp. Exs. 2 and 8.)

24 Mr. Bagwell provided Ms. Sharp with Bloomberg yield table for securities she had previously purchased in a visit he made to her office in June 1993. (Resp. Ex. 32; Tr. 1546-51.)
25 It is also worth noting at this juncture that I found Ms. Sharp often offered unreliable testimony and had a poor memory. Some of this is undoubtedly excused by the passage of time, there having passed about six to seven years since these transactions occurred. (Tr. 752, 853, 901, 1000.) The record contains several other instances where I had to advise Ms. Sharp to respond directly to the questions instead of offering responses indicating doubt or possibility. (*see, e.g.* Tr. 752, 852, 938.) In general, I found her testimony insufficiently reliable to counter conflicting testimony of Mr. Bagwell.
26 Ms. Sharp could not recall such conversations (Tr. at 866.), but I found the testimony of Mr. Iverson more credible on this point.
27 The Division notes that this sale falls outside the statute of limitations, so it does not seek a civil money penalty related to the sale. It does, however, seek disgorgement of the commission earned by Mr. Bagwell for this sale because the statute of limitations does not apply to disgorgement, citing *Barbato*, Securities Exchange Act of 1934 Rel. No. 41034 (Feb. 10, 1999).
28 I have concluded that Ms. Sharp's testimony here that she did not understand the relationship between assumptions about prepayments and their effect on CMOs lacks credibility because it is inconsistent with prior sworn testimony given closer in time to these events and the discrepancy is inadequately explained. (She claimed to have had a bad cold the day of the prior sworn testimony, or probably didn't understand the question) (Tr. 940-42.) Moreover, her own reports reflect a rather clear understanding of these relationships. (Resp. Exs. 63, 66.)
29 I note that this security also arose in the context of Ms. Bally's sales to Lewis & Clark County, but she provided yield tables that depicted a greater range of prepayment speeds and their impacts.
30 For FNMA 1993-228G (PO), where Mr. Bagwell did not communicate any information on yields or collateral, he did call the next morning, presenting an array of prepayment assumptions, albeit all above the pricing speed. I conclude that this constituted a good faith attempt to satisfy the disclosure standard.
31 "Competent adults who do not need to be led around on a leash do, occasionally, buy a piece of blue sky." *State of West Virginia v. Morgan Stanley & Co., et al.*, 459 S.E.2d 906, 914 n.17 (W.Va. 1995).

In the Matter of MGSI Securities, Inc., Exchange Act Release No. 42717, A.P. File No. 3-9702 (April 25, 2000).

ORDER MODIFYING SANCTIONS AND NOTICE THAT INITIAL DECISION, AS MODIFIED, IS FINAL

On January 12, 2000, the administrative law judge issued an initial decision in this proceeding.[1] Among other things, the law judge found that MGSI Securities, Inc. was in default. The law judge revoked MGSI's registration as a broker and dealer and ordered MGSI to cease and desist from the conduct charged in the Order Instituting Proceedings.[2] The Order Instituting Proceedings charged MGSI with failure reasonably to supervise, with a view to preventing violations of the securities laws.

The time for filing a petition for review of the initial decision has expired. No such petition has been filed. The Commission has determined to review the decision on its own initiative for the limited purpose described below.

Rule of Practice 155 grants the hearing officer the authority "to determine the proceeding against" a party that defaults "upon consideration of the record, including the order instituting proceedings."[3] While the Order Instituting Proceedings in this matter was brought under both Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934,[4] the order did not seek a cease and desist order against MGSI pursuant to those sections. Rather, the order requested only an accounting and disgorgement, as well as revocation of MGSI's registration as a broker and dealer. The law judge therefore did not have the authority to impose a cease-and-desist order on MGSI.

Accordingly, IT IS ORDERED that the sanction imposed by the administrative law judge on MGSI Securities, Inc. requiring MGSI to cease and desist from violations of the securities laws be, and it hereby is, set aside.

Notice is hereby given, pursuant to Rule 360(e) of the Commission's Rules of Practice[5] that, as modified above, the initial decision of the administrative law judge has become the final decision of the Commission.

Accordingly, IT IS HEREBY ORDERED that the registration of MGSI Securities, Inc. as a broker and dealer be, and hereby is, revoked.

By the Commission.

Jonathan G. Katz
Secretary

Footnotes

1 MGSI Securities, Inc., Initial Decision Rel. No. 156 (Jan. 12, 2000) __ SEC Docket __.
2 The law judge also denied the Division's motion to require MGSI to pay disgorgement. In the same decision, the law judge dismissed the proceeding as to other respondents.
3 17 C.F.R. § 201.155.
4 15 U.S.C.§§ 77h-1, 78u-3.
5 17 C.F.R. § 201.360(e).

<u>In the Matter of Larry J. Bagwell and Connie L. Bally,</u> Exchange Act Release No. 42425, A.P. File No. 3-9702 (February 11, 2000).

NOTICE THAT INITIAL DECISION HAS BECOME FINAL

The time for filing a petition for review of the initial decision in this proceeding has expired. No such petition has been filed, and the Commission has not chosen to review the decision on its own initiative.

Accordingly, notice is hereby given, pursuant to Rule 360(e) of the Commission's Rules of Practice, that the initial decision of the administrative law judge 1 has become the final

decision of the Commission with respect to Larry J. Bagwell and Connie L. Bally. The order contained in that decision dismissing the proceeding as to Larry J. Bagwell and Connie L. Bally is hereby declared effective.

For the Commission by the Office of the General Counsel, pursuant to delegated authority.

Jonathan G. Katz
Secretary

Footnotes

1 MGSI Securities, Inc., Initial Decision Rel. No. 156 (Jan. 12, 2000), __ SEC Docket __.

COMMISSION ORDERS - SETTLED ADMINISTRATIVE PROCEEDINGS

In the Matter of Marion Bass Securities Corp. and Gerald Chandik, [Release-No in Original], A.P. File No. 3-9471, 1997 SEC LEXIS 2056 (September 30, 1997).

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Sections 15(b), 19(h) and 21C of the Exchange Act of 1934 ("Exchange Act") against Marion Bass Securities Corp. and that public administrative proceedings pursuant to Sections 15(b) and 19(h) of the Exchange Act be instituted against Gerald Chandik.

II.

The Commission's public official files disclose that:

Marion Bass Securities Corp. ("MBSC") has been registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") since 1979.

III.

As a result of an investigation, the Division of Enforcement alleges that:

A. At all times relevant to this proceeding, MBSC was headquartered in Charlotte, North Carolina, was a member of the National Association of Securities Dealers, Inc. ("NASD"), and was engaged in a general securities business.

B. Gerald Chandik ("Chandik") has served as MBSC's compliance officer since he joined the firm in or about May 1991 and is registered with the NASD as a general securities principal, municipal securities principal, and financial and operations principal.

The Respondents Charged MBSC Customers Undisclosed, Excessive Markups And Markdowns

C. Between March 1991 and March 1994, MBSC sold to its customers certain municipal securities, specifically: Brevard County, Florida revenue bonds; Chattanooga, Tennessee Health Educational and Housing Facility Board Nursing Home revenue bonds; College Park, Georgia Business & Industrial Development Authority Industrial Development revenue bonds; Illinois Industrial Pollution Control Financing Authority revenue bonds; Jacksonville, Florida Health Facilities Authority Hospital revenue bonds; Luzerne County, Pennsylvania Industrial Development Authority Industrial Development revenue bonds; Montgomery County, Ohio Hospital revenue bonds; New York, New York general obligation bonds; Pensacola Care Inc. First Mortgage revenue bonds; Quantum Community Development District, Florida special assessment bonds; Sarasota County, Florida Health Facilities Authority Hospital revenue bonds; Spring City, Tennessee Health Educational and Spring City Health Care Center Association revenue bonds; Sumner County, Tennessee Health Educational and Housing Facilities Board revenue bonds; and Wilson County, Tennessee Health and Educational Facilities Board revenue bonds.

D. Between March 1991 and March 1994, in connection with the sale of these municipal securities, MBSC charged its customers undisclosed, excessive markups in approximately 121 trades.

E. The undisclosed, excessive markups MBSC, through its traders, charged its customers in connection with the sale of these municipal securities ranged from approximately 4.17% to 16.07% and generated excess profits to MBSC totaling approximately $ 29,416.

F. Between April 1993 and February 1994, MBSC, through its traders, sold to, and purchased from, its customers certain government securities, specifically, Federal National Mortgage Association securities ("FNMAs") and Resolution Trust Funding Corporation bonds ("RTFCs").

G. Between April 1993 and February 1994, in connection with the purchase and sale of FNMAs and RTFCs, MBSC charged its customers undisclosed, excessive markups and markdowns in approximately 66 trades.

H. The undisclosed, excessive markups and markdowns MBSC charged its customers in connection with the purchase and sale of FNMAs and RTFCs ranged from approximately 3.26% to 4.44% and generated excess profits to MBSC totaling approximately $ 418,094.

I. MBSC generated illegal profits totaling approximately $ 447,510 through the excessive markups and markdowns described in Paragraphs C through H above.

J. During the period from May 1991 through March 1994, Chandik, as chief compliance officer of MBSC, was responsible for, among other things, organizing the compliance department, maintaining the firm's policies and procedures manual and its supervisory procedures manual, and ensuring that the firm's compliance rules and procedures were communicated to the supervisors, traders and registered representatives.

K. During the period from May 1991 through March 1994, Chandik was responsible for drafting the firm's markup and markdown policy found in MBSC's supervisory procedures manual to ensure that the firm did not charge its customers excessive markups or markdowns.

L. During the period from May 1991 through March 1994, Chandik was responsible for monitoring the firm's trading activity each day to ensure compliance with MBSC's markup and markdown policy, as well as all applicable government rules and regulations. He was responsible for reviewing the firm's blotter and approving both the municipal and government securities transactions. In addition, he was responsible for supervising the traders who charged excessive markups and markdowns on behalf of MBSC. Chandik had the authority to cancel trades that he believed were excessively marked up and to cause them to be reissued at a lower price and to cancel trades that he believed were excessively marked down and to cause them to be reissued at a higher price.

M. During the period from March 1991 through March 1994, MBSC willfully violated Section 17(a)(1) of the Securities Act of 1933 ("Securities Act") by, directly and indirectly, using the means and instruments of transportation or communication in interstate commerce and by use of the mails in the offer and sale of securities to employ

devices, schemes, and artifices to defraud purchasers of securities, as more particularly described in Paragraphs C through H above, with respect to the markups.

N. During the period from March 1991 through March 1994, MBSC willfully violated Sections 17(a)(2) and 17(a)(3) of the Securities Act by, directly and indirectly, using the means and instruments of transportation or communication in interstate commerce and by using the mails in the offer and sale of securities: (1) to obtain money and property by means of untrue statements of material fact and omissions to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, and, (2) to engage in transactions, practices, and a course of business which operated as a fraud or deceit upon purchasers of securities sold by MBSC, as more particularly described in Paragraphs C through H above.

O. During the period from March 1991 through March 1994, MBSC willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder by, directly and indirectly, using the means and instrumentalities of interstate commerce and of the mails in connection with the purchase and sale of securities: (1) to employ devices, schemes, and artifices to defraud, (2) to make untrue statements of material facts and to omit to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, and (3) to engage in acts, practices, and a course of business which operated as a fraud or deceit upon MBSC's customers, as more particularly described in Paragraphs C through H above.

P. During the period from March 1991 through March 1994, MBSC willfully violated Section 15(c)(1) of the Exchange Act and Rule 15c1-2 thereunder, by making use of the mails and the means and instrumentalities of interstate commerce to effect transactions in, and to induce and to attempt to induce the purchase and sale of securities otherwise than on a national securities exchange of which MBSC was a member, by (1) engaging in acts, practices, and a course of business which operated as a fraud or deceit upon MBSC's customers, and (2) making untrue statements of material fact and omitting to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, which statements or omissions were made with knowledge or reasonable grounds to believe that the statements or omissions were untrue or misleading, as more particularly described in Paragraphs C through H above.

Q. During the period from March 1991 through March 1994, MBSC willfully violated Section 15B(c)(1) of the Exchange Act by making use of the mails and the means and instrumentalities of interstate commerce to effect transactions in, and to induce and to attempt to induce the purchase and sale of, municipal securities in contravention of Rule G-17 of the Municipal Securities Rulemaking Board ("MSRB"), as more particularly described in Paragraphs C through E above.

R. During the period from March 1991 through March 1994, MBSC willfully violated Section 15B(c)(1) of the Exchange Act by making use of the mails and the means and instrumentalities of interstate commerce to effect transactions in, and to induce and to

attempt to induce the purchase and sale of, municipal securities in contravention of Rule G-30 of the MSRB, as more particularly described in Paragraphs C through E above.

S. During the period from March 1991 through March 1994, MBSC willfully violated Rule G-17 of the MSRB by failing to deal fairly with other persons and engaging in deceptive, dishonest and unfair practices, as more particularly described in Paragraphs C through E above.

T. During the period from March 1991 through March 1994, MBSC willfully violated Rule G-30 of the MSRB by selling municipal securities for the account of MBSC to customers at aggregate prices that were not fair and reasonable, taking into consideration all relevant factors, as more particularly described in Paragraphs C through E above.

U. During the period from May 1991 through March 1994, Chandik failed reasonably to supervise MBSC's traders who were subject to his supervision, within the meaning of Section 15(b)(4)(E) of the Exchange Act, with a view to preventing violations of Section 17(a) of the Securities Act, Sections 10(b), 15(c)(1) and 15B(c)(1) of the Exchange Act and Rules 10b-5 and 15c1-2 thereunder, and Rules G-17 and G-30 of the MSRB, as more particularly described in Paragraphs J through T above.

V. During the period form May 1991 through March 1994, Chandik failed reasonably to discharge the supervisory duties and obligations that devolved upon him as compliance officer at MBSC, including the following:

1. Chandik was responsible for adopting and maintaining the firm's policies and procedures manual and its supervisory procedures manual, which included the firm's markup and markdown policy. Chandik failed to establish adequate policies and procedures which would prohibit the traders from charging excessive markups and markdowns to MBSC's customers; and

2. Chandik failed to detect and prevent the undisclosed excessive markups and markdowns charged by the MBSC's traders. Chandik reviewed the firm's daily trading activity. He had the authority to cancel trades that were excessively marked up and to cause them to be reissued at a lower price and to cancel trades that were excessively marked down and to cause them to be reissued at a higher price, yet he failed to cancel the subject transactions which were excessively marked up or marked down.

IV.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate in the public interest and for the protection of investors that public proceedings be instituted to determine:

A. Whether the allegations set forth in Section III. above are true and in connection therewith to afford MBSC and Chandik the opportunity to establish any defense to such allegations;

B. What, if any, remedial action is appropriate in the public interest against MBSC and Chandik pursuant to Sections 15(b) and 19(h) of the Exchange Act;

C. Whether, pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, MBSC should be ordered to cease and desist from committing or causing a violation and any future violation of any or all of the Sections or Rules specified in Section II above;
D. Whether, pursuant to Section 8A of the Securities Act and Sections 21B and 21C of the Exchange Act, an order against MBSC should require it to pay disgorgement, including prejudgement interest; and

E. Whether, pursuant to Section 21B of the Exchange Act, civil penalties should be imposed on MBSC and Chandik.

V.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section IV. hereof be convened not earlier than thirty (30) days and not later than sixty (60) days from service of this Order Instituting Proceedings and Notice of Hearing Pursuant to Section 8A of the Securities Act and Sections 15(b), 19(h) and 21C of the Exchange Act ("Order") at a time and place to be fixed, and before an Administrative Law Judge to be designated by further Order as provided by Rule 200 of the Commission's Rules of Practice, 17 C.F.R. 201.200.
IT IS FURTHER ORDERED that each Respondent shall file an answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided in Rule 220 of the Commission's Rules of Practice, 17 C.F.R. 201.220. If any Respondent fails to file the directed answer, or fails to appear at a hearing for which proper notice has been given, such Respondent may be deemed in default and the proceeding may be determined against such Respondent upon consideration of this Order, the allegations of which may be deemed to be true, as provided by Rules 220 and 310 of the Commission's Rules of practice, 17 C.F.R. 201.220 and 201.310.
This Order shall be served upon Respondents by certified mail forthwith.

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice.

In the Matter of Marion Bass Securities Corp. and Gerald Chandik, A.P. File No. 3-9471, Securities Act Release No. 7929, Exchange Act Release No. 43754 (December 20, 2000).

I.

The Securities and Exchange Commission ("Commission") has instituted public administrative and cease-and-desist proceedings pursuant to Sections 8A of the Securities

Act of 1933 ("Securities Act") and Sections 15(b), 19(h) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Marion Bass Securities Corp. ("MBSC") and public administrative proceedings pursuant to Sections 15(b) and 19(h) of the Exchange Act against Gerald Chandik ("Chandik").

n1 MBSC and Chandik have each submitted an Offer Of Settlement which the Commission has determined to accept.

- - - - - - - - - - - - - - - - -FOOTNOTES- - - - - - - - - - - - - - - - -

n1 These administrative proceedings were instituted on September 30, 1997.

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II.

Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, prior to a hearing pursuant to the Commission's Rules of Practice, 17 CFR 201.100 et seq., and without admitting or denying the findings herein, except that MBSC and Chandik admit the jurisdiction of the Commission over them and the subject matter of these administrative proceedings and admit only the findings contained in Section III.A. and III.B. below, MBSC and Chandik, by their Offers of Settlement, consent to the entry of this Order Making Findings, Imposing Remedial Sanctions, And Issuing Cease-And-Desist Order Pursuant to Section 8A of the Securities Act of 1933 and Sections 15(b), 19(h), and 21C of the Securities Exchange Act of 1934 (the "Order").

III.

On the basis of this Order and the Offers Of Settlement submitted by MBSC and Chandik, the Commission finds that:

A. MBSC has been registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Exchange Act since 1979. MBSC is headquartered in Charlotte, North Carolina, is a member of the National Association of Securities Dealers, Inc. ("NASD"), and is engaged in a general securities business.

B. Chandik has served as MBSC's compliance officer since June 1991. Chandik is registered with the NASD as a general securities principal, municipal securities principal, and financial and operations principal.

C. From March 1991 through March 1994, MBSC sold municipal securities to its customers. Among those municipal securities that MBSC sold were eighteen different municipal securities issues which included: revenue bonds which funded or refunded retirement facilities, nursing homes or hospitals; industrial development revenue bonds; a general obligation bond; and a special assessment bond.

D. From March 1991 through March 1994, MBSC, in connection with the sale of these eighteen municipal securities issues to customers in 110 transactions, charged undisclosed, excessive markups which ranged between 4.07% to 7.9%.

E. From April 1993 through February 1994, MBSC sold U.S. government agency and government agency-like securities to certain of its institutional customers. Among those securities that MBSC sold were Resolution Funding Corporation ("RFCO") zero coupon securities and Federal National Mortgage Association ("FNMA") zero coupon securities.

F. From April 1993 through February 1994, MBSC, in connection with the sale of RFCO and FNMA zero coupon securities to institutional customers in 63 transactions, charged undisclosed, excessive markups which ranged between 3.45% to 4.41%.

G. In October 1993, MBSC purchased RFCO zero coupon securities from an institutional customer in 3 transactions. In connection with the purchase of these securities, MBSC charged the institutional customer an undisclosed, excessive markdown of 3.26%.

H. MBSC did not disclose to its customers that it charged the markups and markdowns in connection with the transactions described in Paragraphs III.C through G above.

I. During the period from May 1991 through March 1994, Chandik was responsible for drafting the firm's markup and markdown policy found in MBSC's supervisory procedures manual, which was to prevent excessive markups or markdowns from being charged.

J. Chandik also had the responsibility, ability and authority, from at least July 1993, to affect the conduct of MBSC employees who set the prices and the markups and markdowns charged to customers in the transactions set forth in paragraphs III.C through III.G above. Chandik monitored MBSC's trading activity to detect and prevent excessive markups and markdowns from being charged. Chandik reviewed MBSC's blotter and order tickets. He had the authority to cancel trades that had excessive markups or markdowns and to have the trades re-executed at different prices, which he did on certain occasions. He had the authority to, and did, discipline MBSC employees for, among other things, charging excessive markups.

IV.

MBSC's Undisclosed, Excessive Markups

The markups that MBSC charged on the municipal securities (ranging from 4.07% to 7.9%) and the markups and markdowns it charged on FNMA and RFCO zero coupon securities (ranging from 3.26% to 4.41%) were excessive and bore no reasonable relationship to the prevailing market price for these securities. Accordingly, MBSC,

through negligent conduct, violated Sections 17(a)(2) and (3) by charging undisclosed excessive markups.

Chandik Failed Reasonably To Supervise

Sections 15(b)(4)(E) and 15(b)(6)(A) of the Exchange Act provide for the imposition of sanctions upon a person who "has failed reasonably to supervise, with a view to preventing violations of the provisions of [the federal securities laws], another person who commits such a violation, if such other person is subject to his supervision."

Employees of brokerage firms who have legal or compliance responsibilities do not become "supervisors" for purposes of Sections 15(b)(4)(E) and 15(b)(6) solely because they occupy those positions. Rather, determining if a particular person is a "supervisor" depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue. (footnote omitted)

John H. Gutfreund, 51 S.E.C. 93, 113 (1992).

As set forth in Paragraph III.J, Chandik had the responsibility, ability and authority to affect the conduct of MBSC employees who set the prices and the markups and markdowns charged to customers on certain of the securities transactions at issue here. Accordingly, Chandik was a "supervisor" for purposes of Sections 15(b)(4)(E) and 15(b)(6)(A). See First Albany Corporation, 50 S.E.C. 890, 896 (1992); Craig Leibold, 68 SEC Docket 0304, 0306 (1998).

V.

On the basis of this Order and the Offers Of Settlement submitted by MBSC and Chandik, the Commission finds that:

A. MBSC willfully n2 violated Sections 17(a)(2) and (3) of the Securities Act by charging undisclosed, excessive markups in the sale of municipal securities and FNMA and RFCO zero coupon securities and by charging undisclosed, excessive markdowns in the purchase of RFCO zero coupon securities, as more particularly described above.

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n2 In applying the term "willful" in Commission administrative proceedings instituted pursuant to Sections 15(b), 15B, 15C, 17A, and 19(h) of the Exchange Act, Section 9 of the Investment Company Act, and Section 203 of the Investment Advisers Act, the Commission evaluates on a case-by-case basis whether the respondent knew or reasonably should have known under the particular facts and circumstances that his conduct was improper. In this case, as in all Commission administrative proceedings charging a willful violation under these statutory provisions, the Commission applies this standard to persons - specifically, securities industry professionals -- who are directly subject to Commission jurisdiction and who have a responsibility to understand their

duties to the investing public and to comply with the applicable rules and regulations which govern their behavior.

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B. Chandik failed reasonably to supervise MBSC employees pursuant to Section 15(b)(6) of the Exchange Act and within the meaning of Section 15(b)(4)(E) of the Exchange Act, with a view to preventing their violations of Section 17(a)(2) and (3) of the Securities Act, as more particularly described above.

VI.

In view of the foregoing, it is appropriate, in the public interest, and for the protection of investors to impose the sanctions specified in MBSC's and Chandik's Offers Of Settlement.

ACCORDINGLY, IT IS ORDERED that:

A. As to MBSC:

1. MBSC be and hereby is censured pursuant to Section 15(b)(4) of the Exchange Act;

2. MBSC cease and desist from committing or causing any violations and any future violations of Section 17(a)(2) and (3) of the Securities Act, pursuant to Section 8A of the Securities Act;
3. MBSC shall, within 10 days of the entry of this Order, pay disgorgement and prejudgment interest in the total amount of $ 100,000.00 to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Comptroller, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies MBSC as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Richard P. Wessel, District Administrator, Securities and Exchange Commission, Atlanta District Office, 3475 Lenox Road, N.E., Suite 1000, Atlanta, GA 30326; and

4. MBSC shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of $ 50,000.00 to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Comptroller, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies MBSC as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Richard P. Wessel, District Administrator, Securities and Exchange

Commission, Atlanta District Office, 3475 Lenox Road, N.E., Suite 1000, Atlanta, GA 30326.

B. As to Chandik:

1. Chandik be and hereby is censured pursuant to Section 15(b)(6) of the Exchange Act.

By the Commission.

In the Matter of Oliver Williams, Exchange Act Release No. 40347, A.P. File No. 3-9681 (August 20, 1998).

On August 20, 1998, the Commission instituted administrative and cease-and-desist proceedings pursuant to Section 8A of the Securities Act (Securities Act) and Sections 15(b), 15B(c)(4), 19(h) and 21C of the Securities Exchange Act of 1934 (Exchange Act), against Oliver Williams (Williams) of Miami, Florida. The Order Instituting Proceedings (Order) alleges that Williams operated as a non-registered principal of a municipal securities broker-dealer and that Williams was the president and sole owner of that broker-dealer. The Order further alleges that from February through April 1996, while unregistered, the broker-dealer, through Williams, executed underwriting agreements which contained misrepresentations regarding the broker-dealer's registration and capitalization status.

The Order alleges that Williams willfully committed violations of Sections 17(a) of the Securities Act, Section 10(b) of the Exchange Act and, and Rule 10b-5, thereunder, and Rules G-2 and G-17 of the Municipal Securities Rulemaking Board (MSRB). The Order further alleges that Williams caused and aided and abetted violations of Sections 15B(a)(1), 15(c)(1) and 15B(c)(1) of the Exchange Act.

A hearing will be scheduled to determine whether the allegations against Williams are true, and if so, what sanctions, if any, are appropriate in the public interest against Williams.

In the Matter of Oliver Williams, Securities Act Release No. 7791, Exchange Act Release No. 42333, A.P. File No. 3-9681 (January 12, 2000).

I.

The Securities and Exchange Commission ("Commission") instituted public administrative and cease-and-desist proceedings pursuant to Section BA of the Securities Act of 1933 ("Securities Act") and Sections 15(b), 15B(c)(4), 19(h) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Respondent Oliver Williams ("Williams") on August 20, 1998.

II.

Respondent Williams has submitted an Offer of Settlement ("Offer") to the Commission, which the Commission has determined to accept. Solely for the purpose of this proceeding and any other proceeding brought by or on behalf of the Commission, or in which the Commission is a party, and without admitting or denying the findings contained herein, except as to the jurisdiction of the Commission over the Respondent and over the subject matter of this proceeding and as to Sections III. A. and B. below, which are admitted, Respondent Williams by his Offer consents to the entry of findings, remedial sanctions and cease-and-desist order set forth below.

III.

On the basis of this Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order") and the Offer submitted by Respondent Williams, the Commission finds that:

A. Oliver Williams ("Williams" or "Respondent"), at all relevant times, operated as a non-registered principal of a broker-dealer and was the broker-dealer's founder, president and sole shareholder. Until January 1996, Williams was registered with the National Association of Securities Dealers, Inc. ("NASD") as a municipal securities principal of the broker-dealer.

B. At all relevant times, the broker-dealer operated as a municipal securities broker-dealer within the meaning of Sections 3(a)(30) and 3(a)(31) of the Exchange Act. The broker-dealer was headquartered in Miami, Florida.

C. Since its inception, the broker-dealer's primary source of business was underwriting state and local municipal debt.

D. The broker-dealer withdrew its registration from the NASD effectively on December 20, 1995 and from the Commission on January 12, 1996.

E. In 1995, Williams and the broker-dealer were financially distressed due to Williams' bankruptcy and increased capital requirements pursuant to Exchange Act Rule 15c3-1. In approximately November 1995, Williams decided to close the firm. Williams filed the broker-dealer's withdrawal of registration as a municipal securities broker-dealer on November 14, 1995. The broker-dealer's withdrawal became effective with the NASD and the Commission on December 20, 1995 and January 12, 1996, respectively. As a result of this action, Williams also surrendered his Municipal Securities Principal registration.

F. Although Williams withdrew the broker-dealer's registration as a municipal securities broker-dealer in December 1995, he did not inform any municipalities with which the broker-dealer was registered in underwriting pools that it could no longer do business as a

municipal securities broker-dealer. As a result, the broker-dealer continued to be selected as an underwriter for municipal underwritings, and Williams and the broker-dealer engaged in municipal securities business while Williams was not registered as a principal and had not requalified, as required by Municipal Securities Rulemaking Board (“MSRB") Rule G-3.

G. From February 1996 through April 1996, while unregistered, Williams, through the broker-dealer, executed underwriting agreements which committed his firm to purchase up to $ 21,877,750 in par value of municipal bonds in at least two underwritings - - a $ 142,555,000 school bond refunding and a $295,000,000 aviation revenue bond underwriting. Through Williams' efforts, the broker-dealer submitted orders for over $ 12,550,000 in municipal bonds and earned $ 2,319 in net proceeds as a result of its unlawful participation in these underwritings.

H. After being advised of the broker-dealer's selection to these underwritings, Williams executed underwriting agreements with the senior managing underwriters. These agreements contained material misrepresentations regarding the broker-dealer's registration and capitalization.

I. In addition, Williams also misrepresented in the underwriting agreements that the broker-dealer was sufficiently capitalized to market the bonds to be allocated to it under "all existing federal, state, and local laws" and in accordance with Section 15(c)(3) of the Exchange Act.

J. For example, the agreement Williams executed on March 7, 1996, which was similar to the other agreement the broker-dealer entered into, contained the following clause:

"Each Underwriter severally represents (a) that it is registered under the Exchange Act; (b) that it is either a bank or a member in good standing of the National Association of Securities Dealers, Inc.; (c) that it is not in violation of, and that it may enter into the commitments (including contingent commitments) contained herein and in the Purchase Contract without violating (i) Section 15(c)(3) of the Exchange Act, (ii) any rule relating to financial responsibility imposed by any national securities exchange of which such Underwriter is a member, or (iii) any restriction imposed by any such exchange or by any governmental authority; (d) that it has complied with the dealer registration requirements, if any, of the various jurisdiction in which it offers Securities for sale. . ."

K. Williams signed the underwriting agreements after the effective date of the broker-dealer's registration withdrawal on January 12, 1996 and after Williams was fined $ 40,000 and barred by the NASD as a principal on January 25, 1996.

L. Even though Williams was unable to pay the NASD fine at the time of the underwritings, he committed the broker-dealer to an underwriting liability of $ 7,127,750 and $ 14,750,000, respectively, for each underwriting.

M. Williams was aware of his role in the broker-dealer's scheme to conduct unregistered underwriting business and rendered substantial assistance to that scheme by executing underwriting agreements, executing orders and by submitting solicitations for underwritings.

N. Williams has submitted a sworn financial statement and other evidence and has asserted his financial inability to pay disgorgement plus prejudgment interest and a civil penalty. The Commission has reviewed the sworn financial statement and other evidence provided by Williams and has determined that Williams does not have the financial ability to pay disgorgement of $ 2,319 plus prejudgment interest and a civil penalty.

Violations

O. As a result of the conduct described above, Williams willfully committed violations of Sections 17(a)(1), 17(a)(2) and 17(a)(3) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and MSRB Rule G-17 by misrepresenting the registration status and qualifications of the broker-dealer. Williams, acting through the broker-dealer, also willfully committed violations of MSRB Rule G-2 by engaging in municipal securities business while not registered as a principal and by failing to requalify in accordance with MSRB Rule G-3.

P. As a result of the conduct described above, Williams caused and willfully aided and abetted violations of Sections 15B(a)(1), 15(c)(1), and 15B(c)(1) of the Exchange Act, and Rule 15c1-2 thereunder, by effecting the purchase and sale of municipal securities while the broker-dealer was not registered with the Commission as a broker-dealer or municipal securities dealer, and by misrepresenting the registration status and qualifications of the broker-dealer.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to accept the Offer submitted by Williams and impose the remedial sanctions and cease-and-desist order specified therein.

Accordingly, IT IS ORDERED that:

A. Pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, Williams is ordered to cease and desist from committing or causing any violation or any future violation of Sections 17(a)(1), 17(a)(2) and 17(a)(3) of the Securities Act, Sections 10(b), 15(c)(1), 15B(a)(1) and 15(B)(c)(1) of the Exchange Act and Rules 10b-5 and 15c1-2 thereunder, and MSRB Rules G-2 and G-17.

B. Williams be, and hereby is, suspended from association with any broker, dealer or municipal securities dealer for a period of twelve months, effective on the second Monday following the entry of this order.

C. Williams shall be liable for, and pay disgorgement of $ 2,319 plus prejudgment interest, but that the payment of such amount shall be waived and a civil money penalty will not be imposed based upon Williams' demonstrated financial inability to pay.

D. The Division of Enforcement ("Division") may, at any time following the entry of this Order, petition the Commission to: (1) reopen this matter to consider whether Respondent Williams provided accurate and incomplete financial information at the time such representations were made; (2) order disgorgement of $ 2,319 plus prejudgement interest; (3) determine the amount of civil penalty to be imposed; and (4) seek any additional remedies that the Commission would be authorized to impose in this proceeding if Respondent's offer of settlement had not been accepted. No other issues shall be considered in connection with this petition other than whether the financial information provided by the Respondent was fraudulent, misleading, inaccurate or incomplete in any material respect, the amount of civil penalty to be imposed and whether any additional remedies should be imposed. Respondent may not, by way of defense to any such petition, contest the findings in this Order or the Commission's authority to impose any additional remedies that were available in the original proceeding.

By the Commission.

In the Matter of Bradford A. Orosey, Securities Act Release No. 7686, Exchange Act Release No. 41444, A.P. File No. 3-9702 (May 25, 1999).

I.

The Securities and Exchange Commission ("Commission") instituted public administrative and cease-and-desist proceedings pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Sections 15(b), 19(h) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Respondent Bradford A. Orosey ("Orosey") on September 10, 1998.

II.

Respondent Orosey has submitted an Offer of Settlement ("Offer") to the Commission, which the Commission has determined to accept. Solely for the purpose of this proceeding and any other proceeding brought by or on behalf of the Commission, or in which the Commission is a party, and without admitting or denying the findings herein, except as to the jurisdiction of the Commission over Respondent and over the subject matter of this proceeding and as to Section IV.A., which is admitted, Respondent Orosey by his Offer consents to the entry of findings and remedial sanctions set forth below.

III.

On the basis of this Order Making Findings and Imposing Remedial Sanctions ("Order") and the Offer submitted by Respondent Orosey the Commission finds [The findings herein are not binding on anyone other than Orosey.] that:

IV.

A. At all relevant times, Bradford A. Orosey ("Orosey") was a registered representative associated with MGSI Securities, Inc. ("MGSI"), a registered broker-dealer and, prior to that, with another registered broker-dealer. Orosey is not currently employed in the securities industry.

B. At all relevant times, Orosey serviced an account for Escambia County, Florida ("Escambia"), to which he sold CMOs.

C. CMOs are a type of mortgage-backed derivative security. CMOs are created by pooling individual mortgages and dividing the cash flows of principal and interest into various classes or tranches which pay principal and interest cash flows from the mortgage pool to investors. The timing and amount of payments of principal and interest for various tranches have varying degrees of sensitivity to fluctuations in interest rates. Due to their sensitivity to changes in interest rates, certain risks are generally associated with an investment in CMOs, including market, extension, prepayment and liquidity risks, among others.

D. The CMOs sold by Orosey to Escambia were Support Class Inverse Floaters ("Inverse Floaters") and Principal Onlys ("POs"), the value of which plummeted when interest rates rose throughout 1994. Inverse Floaters and POs are some of the riskiest and most volatile tranches of CMOs, and investments in these tranches involve a great deal of market, extension, and liquidity risks.

E. From February 1993 to April 1994, Orosey, in connection with the purchase and sale of securities to Escambia, namely CMOs, omitted to state material facts necessary to make the positive statements he made regarding projected performance not misleading. Orosey described the investments he was selling to Escambia as a "Fannie Mae" or "Freddie Mac." This description was misleading in light of his failure to disclose the type of securities (i.e., Inverse Floaters and POs). Orosey's description of the investments was also misleading in light of his failure to disclose that the investments were subject to dramatic fluctuations in duration, yield and market value as interest rates changed. In his solicitations, Orosey provided misleading information about the expected performance of the CMOs by using figures based on unrealistic assumptions that portrayed the securities in a favorable light. Orosey also used misleading yield tables and "PSA" speeds (which refers to the rate of prepayments on a pool of mortgages) and failed to fluctuate the coupon rate to present an accurate and realistic picture of the future potential yields of the CMOs he sold. In certain instances, Orosey furnished documentation to Escambia which misrepresented that the yields on the securities could not drop below a certain level, when, in fact, the yields could have, and actually did, go much lower. On other occasions, Orosey provided information which failed to indicate any possibility of significantly

lower yields and failed to disclose important information that would have revealed how the securities he offered would perform. In addition, in subsequent communications, Orosey also misrepresented the current yield and performance of the securities he had already sold to Escambia. As a result of Orosey's fraudulent misrepresentations and omissions, Escambia was fraudulently induced to stock its investment portfolio with numerous high risk CMOs which incurred a significant decline in value.

F. As a result of the conduct described above, Orosey committed or caused violations of, and willfully violated, Sections 17(a)(1), 17(a)(2) and 17(a)(3) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

G. Respondent Orosey has submitted a sworn financial statement and other evidence and has asserted his financial inability to pay disgorgement plus prejudgment interest or a civil money penalty. The Commission has reviewed the sworn financial statement and other evidence provided by Orosey and has determined that Orosey does not have the financial ability to pay disgorgement of $134,111 plus prejudgment interest or a civil money penalty.

In view of the foregoing, the Commission deems it appropriate and in the public interest to accept the Offer submitted by Orosey and impose the remedial sanctions specified therein.

Accordingly, IT IS ORDERED that Orosey be, and hereby is, barred from association with any broker, dealer, municipal securities dealer, investment adviser or investment company, with a right to reapply for association after five years to the appropriate self-regulatory organization, or if there is none to the Commission;

IT IS FURTHER ORDERED that Orosey shall cease and desist from committing or causing any violation or any future violation of Sections 17(a)(1), 17(a)(2) or 17(a)(3) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder;

IT IS FURTHER ORDERED that Orosey shall be liable for and pay disgorgement of $134,111 plus prejudgment interest, but that the payment of such amount be waived and a civil money penalty will not be imposed against Orosey, based on Orosey's demonstrated financial inability to pay; and

IT IS FURTHER ORDERED that the Division of Enforcement ("Division") may, at any time following entry of this Order, petition the Commission to: (1) reopen this matter to consider whether Respondent provided accurate and complete financial information at the time such representations were made; (2) determine the amount of disgorgement and prejudgment interest to be imposed; (3) determine the amount of civil penalty to be imposed; and (4) seek any additional remedies that the Commission would be authorized to impose in this proceeding if Respondent's Offer had not been accepted. No other issues shall be considered in connection with this petition other than whether the financial information provided by the Respondent was fraudulent, misleading, inaccurate or incomplete in any material respect and whether additional remedies should be imposed.

Respondent may not, by way of defense to any such petition, contest the findings in this Order or the Commission's authority to impose any additional remedies that were available in the original proceeding.

By the Commission.
Jonathan G. Katz
Secretary

<u>In the Matter of Joseph O. Fallin</u>, Securities Act Release No. 7675, Exchange Act Release No. 41369, A.P. File No. 3-9702 (May 5, 1999).

I.

The Securities and Exchange Commission ("Commission") instituted public administrative and cease-and-desist proceedings pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Sections 15(b), 19(h) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Respondent Joseph O. Fallin ("Fallin") on September 10, 1998.

II.

Respondent Fallin has submitted an Offer of Settlement ("Offer") to the Commission, which the Commission has determined to accept. Solely for the purpose of this proceeding and any other proceeding brought by or on behalf of the Commission, or in which the Commission is a party, and without admitting or denying the findings herein, except as to the jurisdiction of the Commission over Respondent and over the subject matter of this proceeding and as to Section III.A., which is admitted, Respondent Fallin by his Offer consents to the entry of findings and remedial sanctions set forth below.

III.

On the basis of this Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order as to Joseph O. Fallin ("Order") and the Offer submitted by Respondent Fallin the Commission finds n1 that:

- - - - - - - - - - - - - - - - - -FOOTNOTES- - - - - - - - - - - - - - - - - -

n1 The findings herein are not binding on anyone other than Fallin.

- - - - - - - - - - - - - - - - -END FOOTNOTES- - - - - - - - - - - - - - - - -

A. At all relevant times, Joseph O. Fallin ("Fallin") was a registered representative associated with MGSI Securities, Inc. ("MGSI") and, prior to that, with another registered broker-dealer. Fallin serviced an account for the City of Williamsburg, Virginia, to which he sold CMOs.

B. CMOs are a type of mortgage-backed derivative security. CMOs are created by pooling individual mortgages and dividing the cash flows of principal and interest into

various classes or tranches which pay principal and interest cash flows from the mortgage pool to investors. The timing and amount of payments of principal and interest for various tranches have varying degrees of sensitivity to fluctuations in interest rates. Due to their sensitivity to changes in interest rates, certain risks are generally associated with an investment in CMOs, including market, extension, prepayment and liquidity risks, among others.

C. The CMOs sold by Fallin to the City of Williamsburg were Support Class Inverse Floaters ("Inverse Floaters") and Principal Onlys ("POs"), the value of which plummeted when interest rates rose throughout 1994. Inverse Floaters and POs are some of the riskiest and most volatile tranches of CMOs, and investments in these tranches involve a great deal of market, extension, and liquidity risks.

D. From September 1992 through April 1994, Fallin, in connection with the purchase and sale of securities to the City of Williamsburg, namely CMOs, omitted to state material facts necessary to make the positive statements he made regarding projected performance not misleading. Fallin knowingly misrepresented and failed to fully disclose the nature and characteristics of the CMOs and the risks concerning volatility, extension, market value and liquidity associated with such investments. In his solicitations, Fallin misrepresented maturity dates for these securities by omitting to disclose that they were subject to dramatic fluctuations in duration, yield and market value; instead, in his solicitations Fallin used a single yield, coupon interest rate and cash-flow and never disclosed other potential yields that a particular security could incur at other likely interest rate scenarios. In addition, Fallin utilized yield tables in his solicitations that failed to fluctuate the coupon rate thereby misrepresenting the projected performance of the securities. Fallin's statements concerning the CMOs were misleading inasmuch as he failed to provide his clients with the basic disclosure materials, such as yield tables, necessary to fully evaluate the risks associated with an investment in these securities. Fallin also knowingly misrepresented his background and experience in the securities industry. In his solicitations, Fallin failed to disclose the average life and duration of certain CMOs. In 1994, Fallin refused to provide timely information concerning the value of Williamsburg's CMOs and his fraudulent omission of this information prevented Williamsburg from taking timely corrective action. As a result of Fallin's fraudulent misrepresentations and omissions, the City of Williamsburg was fraudulently induced to stock its investment portfolio with numerous high risk CMOs which incurred a significant decline in value.

E. Respondent Fallin has submitted a sworn financial statement and other evidence and has asserted his financial inability to pay disgorgement plus prejudgment interest or a civil money penalty. The Commission has reviewed the sworn financial statement and other evidence provided by Fallin and has determined that Fallin does not have the financial ability to pay disgorgement of $ 26,059 plus prejudgment interest or a civil money penalty.

F. As a result of the conduct described above, Fallin committed or caused violations of, and willfully violated, Sections 17(a)(1), 17(a)(2) and 17(a)(3) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to accept the Offer submitted by Fallin and impose the remedial sanctions specified therein.
Accordingly, IT IS ORDERED that Fallin be, and hereby is, suspended from association with any broker, dealer, municipal securities dealer, investment adviser or investment company for a period of twelve months;

IT IS FURTHER ORDERED that Fallin shall cease and desist from committing or causing any violation or any future violation of Sections 17(a)(1), 17(a)(2) or 17(a)(3) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder;

IT IS FURTHER ORDERED that Fallin shall be liable for and pay disgorgement of $ 26,059 plus prejudgment interest, but that the payment of such amount be waived and a civil money penalty will not be imposed against Fallin, based on Fallin's demonstrated financial inability to pay; and

IT IS FURTHER ORDERED that the Division of Enforcement ("Division") may, at any time following entry of this Order, petition the Commission to: (1) reopen this matter to consider whether Respondent provided accurate and complete financial information at the time such representations were made; (2) determine the amount of disgorgement and prejudgment interest to be imposed; (3) determine the amount of civil penalty to be imposed; and (4) seek any additional remedies that the Commission would be authorized to impose in this proceeding if Respondent's Offer had not been accepted. No other issues shall be considered in connection with this petition other than whether the financial information provided by the Respondent was fraudulent, misleading, inaccurate or incomplete in any material respect and whether additional remedies should be imposed. Respondent may not, by way of defense to any such petition, contest the findings in this Order or the Commission's authority to impose any additional remedies that were available in the original proceeding.

By the Commission.

DISMISSALS

<u>In the Matter of James W. Ogg</u>, Securities Act Release No. 7894, Exchange Act Release No. 43320, A.P. File No. 3-9702 (September 21, 2000).

ACTION: ORDER DISMISSING PROCEEDING WITH RESPECT TO JAMES W. OGG

The Commission has determined that it is in the public interest to dismiss this proceeding with respect to Respondent James W. Ogg. Therefore,

IT IS HEREBY ORDERED, that this proceeding be, and hereby is, dismissed with respect to Respondent James W. Ogg.

By the Commission.

REINVESTMENT OF PROCEEDS

COMMISSION ORDERS - SETTLED ADMINISTRATIVE PROCEEDINGS

YIELD BURNING CASES

<u>In the Matter of Rauscher Pierce Refsnes, Inc., Dain Rauscher Inc., and James R. Feltham,</u> Securities Act Release No. 7844, Exchange Act Release No. 42644, A.P. File No. 3-10182 (April 6, 2000).
See "UNDERWRITERS" Section.
<u>In the Matter of Morgan Stanley & Co., Inc.,</u> Securities Act Release No. 7841, Exchange Act Release No. 42642, A.P. File No. 3-10181 (April 6, 2000).
See "UNDERWRITERS" Section.

<u>In the Matter of Merrill Lynch, Pierce, Fenner & Smith Inc.,</u> Securities Act Release No. 7838, Exchange Act Release No. 42640, A.P. File No. 3-10180 (April 6, 2000).
See "UNDERWRITERS" Section.

<u>In the Matter of Lehman Brothers Inc.,</u> Securities Act Release No. 7835, Exchange Act Release No. 42638, A.P. File No. 3-10179 (April 6, 2000).
See "UNDERWRITERS" Section.

<u>In the Matter of Goldman, Sachs & Co.,</u> Securities Act Release No. 7832, Exchange Act Release No. 42636, A.P. File No. 3-10178 (April 6, 2000).
See "UNDERWRITERS" Section.

<u>In the Matter of Salomon Smith Barney Inc.,</u> Securities Act Release No. 7829, Exchange Act Release No. 42634, A.P. File No. 3-10177 (April 6, 2000).
See "UNDERWRITERS" Section.

In the Matter of William R. Hough & Co., Securities Act Release No. 7826, Exchange Act Release No. 42632, A.P. File No. 3-10176 (April 6, 2000).
See "UNDERWRITERS" Section.

In the Matter of Painewebber Inc., Securities Act Release No. 7823, Exchange Act Release No. 42630, A.P. File No. 3-1017 (April 6, 2000).
See "UNDERWRITERS" Section.

<u>In the Matter of Warburg Dillon Read LLC,</u> Securities Act Release No. 7820, Exchange Act Release No. 42628, A.P. File No. 3-10174 (April 6, 2000).
See "UNDERWRITERS" Section.

<u>In the Matter of Prudential Securities Inc.,</u> Securities Act Release No. 7817, Exchange Act Release No. 42626, A.P. File No. 3-10173 (April 6, 2000).
See "UNDERWRITERS" Section.

<u>In the Matter of BT Alex Brown Incorporated</u>, Securities Act Release No. 7772, Exchange Act Release No. 42145, A.P. File No. 3-10097 (November 17, 1999).
See "UNDERWRITERS" Section.