IN THE MATTER OF

GEORGE A. BROWN

doing business as

BROWN AND COMPANY, ET AL.*

File No. 8–7953. Promulgated September 19, 1967

Securities Exchange Act of 1934—Sections 15(b) and 15A

BROKER-DEALER PROCEEDINGS

Interpositioning

Failure to Record Times of Entry of Brokerage Orders

Charge that two broker-dealer firms executed customers' orders in listed securities off the exchange had followed practice of interpositioning each other in such transactions to detriment of customers, *held*, not supported by record.

Where broker-dealer failed to record times of entry of brokerage orders despite previous warnings of inadequacies in his books and records, *held, in* public interest to suspend registration for 15 days.

APPEARANCES:

Edward P. Delaney, Michael S. Yesley and *Willis H. Riccio* of the Boston Regional Office, for the Division of Trading and Markets of the Commission.

Carlos L. Israels and *Jesse R. Meer*, of Berlack, Israels & Liberman, for Markoff, Sterman & Gowell, Incorporated, Leon F. Markoff, Marshall S. Sterman and David C. Gowell.

George A. Brown, pro se.

FINDINGS, OPINION AND ORDER

Following hearings in these private consolidated proceedings instituted pursuant to Sections 15(b) and 15A of the Securities Exchange Act of 1934 ("Act"), the hearing examiner filed an initial decision in which he concluded that the registrations as

* Markoff, Sterman & Gowell, Incorporated; Leon F. Markoff; Marshall S. Sterman; David C. Gowell, 8–10948.

brokers and dealers of George A. Brown, doing business as Brown and Company, and Markoff, Sterman & Gowell, Incorporated ("MSG") be revoked; that Brown and MSG be expelled from the National Association of Securities Dealers, Inc., and that Leon F. Markoff, Marshall S. Sterman and David C. Gowell, officers and directors of MSG, be found causes of MSG's revocation and expulsion. We granted respondents' petitions for review, they and our Division of Trading and Markets ("Division") filed briefs, and we heard oral argument. Our findings are based upon an independent review of the record.

TRANSACTIONS IN LISTED SECURITIES

The principal charge raised by the order for proceedings is that during the period from approximately August 1, 1963 to August 30, 1964, the respondents willfully violated Section 10(b) of the Act and Rule 17 CFR 240.10b–5 thereunder in that in executing their respective customers' orders to buy and sell securities listed on the New York Stock Exchange ("NYSE") and American Stock Exchange ("ASE") Brown and MSG, neither of whom were members of those exchanges, interposed each other between the customers and the exchange market for the purpose of concealing from customers the commissions paid by the interposed dealer in executing orders with members of the exchanges and the effect thereof on the amounts paid or received by the customers.

The record shows that during the period involved, MSG in 187 transactions and Brown in 307, in which each acted as agent for its customers, purchased from or sold to the other acting as a dealer various securities listed on national exchanges. In connection with 159 of the MSG instances and 280 of the Brown transactions, the executions with the exchange member involved the same number of shares as were involved in the corresponding transactions between MSG and Brown. In the transactions with MSG in which Brown acted as dealer, he realized trading profits of $795 on 95 transactions and trading losses of $446 on 64 transactions, for a net profit of $349. In the transactions with Brown in which MSG acted as dealer, it realized profits of $1,253 in 139 transactions and losses of $495 in 86 transactions for a net profit of $758. Brown and MSG received gross commissions from their customers, in the transactions in which they acted as agents for such customers, of $9,000 and $6,011, respectively.[1]

Respondents assert that in trading with each other in the instances described above they were able to service their customers'

[1] Following our staff's investigation in this case and before these proceedings were instituted respondents voluntarily discontinued trading with each other in listed securities.

brokerage orders for securities listed on the NYSE and ASE on a competitive basis and at the same time have an opportunity to realize brokerage commissions. Gowell, who did most of the trading for MSG, and Brown testified that each firm upon receipt of a customer's order would independently ascertain relevant market information, including prevailing price quotations on the exchange.[2] Then acting as agent for the customer, the retail broker firm would seek to execute the customer's order on the third market, either with another firm or with the other respondent acting as a dealer if the latter was willing to trade at a price competitive with the prevailing market. They testified that if a trade was thus agreed upon between respondents the customer's order was thereupon executed at that price, and the dealer respondent firm would thereafter at its own risk seek to cover the transaction later during the same day or sometimes on the next day. The willingness of one respondent firm to act as dealer in any particular transaction originating with the other firm's customer was assertedly based on the dealer firm's assessment of the probable price behavior of the security during the rest of the day or the next day, so that a trade was rejected if the would-be dealer firm did not believe that there would be an opportunity to make a later covering purchase or sale at a price which would permit it approximately to break even.

The Division, on the other hand, contends that each respondent firm acted as a dealer on a riskless basis in connection with the orders of customers of the originating broker. The Division claims that an order of the originating broker's customer was not executed by the dealer firm until after the latter had already made an offsetting transaction with an exchange member, and that the dealer firm then confirmed to the originating broker at the price already determined in the offsetting transaction with the exchange member plus or minus the commission he paid the exchange member. Since the originating broker then confirmed to his customer at the price confirmed by the dealer firm plus or minus the originating broker's own commission, in the Division's view of the case the customer paid two commissions, one disclosed to him by his broker, and another concealed in the base price representing the commission paid by the dealer firm to the exchange member. The Division urges, and we would agree, that such a practice would involve an improper interpositioning of the intermediate firm inconsistent with a broker's obligation to make a reasonable and

[2] Gowell testified that MSG had direct lines to four NYSE member firms, from which MSG obtained current market information, either through electronic equipment used by the members showing among other things the bid and ask quotations and the last actual trade price on the exchange, or through floor checks.

bona fide effort to obtain the best prices for its customers and would constitute a willful violation of Section 10(b) of the Act and Rule 17 CFR 240.10b–5 thereunder, as charged in the order for proceedings.[3]

The order for proceedings does not charge that off-board trading in listed securities is improper or illegal *per se* nor does it charge that the respondents' transactions were improper if such transactions were executed in the way respondents say they were. The narrow issue presented by the order for proceedings in connection with this aspect of the case is: did each respondent firm, when acting as dealer in connection with orders of the other's customers, execute those orders on a riskless basis only after having effected corresponding or offsetting transactions through an exchange member so that the customers were deprived of the best execution of their orders?

MSG's records show times represented to be the times of receipt of orders from MSG customers and the times of execution of such orders with Brown, and the times of receipt of orders from Brown and the times MSG executed such orders with Brown. Brown's corresponding records did not consistently show or identify these times,[4] and where times were shown Brown was unable to explain their meaning. He admitted that his records of times of entry and execution of orders for customers were not properly kept, and we find that such failure constituted a willful violation of the record-keeping requirements of Section 17(a) of the Act and Rule CFR 240.17a–3 thereunder.[5]

The evidence in the record includes number of timed order slips and execution memoranda of Josephthal & Co. ("Josephthal"), a member of the NYSE and the ASE, concerning transactions on those exchanges through it by both Brown and MSG, as well as a schedule showing the time of entry and execution in a number of other such transactions through it by Brown. The transactions by Brown covered by this time data appear to offset 109 transactions originating from MSG customers on which Brown acted as the intermediate dealer, and those by MSG to offset 46 transactions originating from Brown customers on which MSG acted as the intermediate dealer.

A reciprocal practice between two nonmember securities firms

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[3] Cf. *H. C. Keister & Company*, 43 S.E.C. 164, 168 (1966). See also Investment Service Co., 41 S.E.C. 188,198 (1962). *Arleen W. Hughes*, 27 S.E.C. 629, 636 (1948), *aff'd* 174 F.2d 969 (C.A.D.C., 1949); *W. K. Archer & Company*, 11 S.E.C. 635, 642 (1942), *aff'd* 133 F.2d 795 (C.A. 8, 1943).

[4] In 29 instances Brown's tickets bore only one time, which might have referred either to entry or to execution, and in 12 others bore no time indication at all.

[5] The record, however, does not support the charge that MSG also violated those provisions.

whereby one firm acting as broker secured execution of its customers' orders for listed securities with the other firm, with the latter acting as dealer and obtaining for itself better prices in effecting offsetting transactions on the exchange than the broker's customers received, would on its face suggest the inference that the firms were not making bona fide efforts to get the best executions for their customers and would justify a searching inquiry into such activity. After a careful review of the record in these proceedings, however, we conclude that the evidence presented does not establish the charge that the respondents had an arrangement under which they executed each other's customers' orders on a riskless basis in a manner which denied the customers the best execution.

Respondents very often did not comply with each other's requests to execute their customers' orders in listed securities. Gowell testified that on at least 500 occasions MSG had been unable to execute its customers' orders for listed stocks with Brown because Brown was either unwilling to deal at all in the stock involved or because he was unwilling to deal at a price acceptable to MSG. During the period under consideration, out of a total of 1,470 brokerage trades in listed securities effected by MSG for its customers, 809 were with other dealers in the third market, as compared with only 187 transactions executed with Brown, and 474, or nearly one-third of the total, were executed directly on the exchanges through member firms, with MSG receiving no compensation.[6] Gowell also testified that MSG had refused to act as dealer on more than 300 occasions when Brown was seeking executions for his customers. In this period Josephthal received numerous requests from Brown and MSG for quotations and market information, a particularly high percentage of such requests being for "floor quotes" which gave a closely current report on the market quotations and also indicated the "size" of the market. The respondent firms often asked for quotes several times a day on the same stock and in many instances requests for quotations were not followed by actual orders. These practices are consistent with and tend to support respondents' testimony and contentions that they were diligent in seeking to obtain good executions for their customers rather than acting on a riskless basis.

Further, although most of the orders received by respondents

[6] The Report of the Special Study of Securities Markets, H. Doc. No. 95, 88th Cong., 1st Sess. (1963) noted at p. 891 of Part 2 thereof that not all trades by brokers operating in the third market on behalf of retail customers are completed on the third market, and that in a substantial number of instances where apparently the broker is unable to obtain a competitive price from a market maker on the third market, the broker will execute the transaction on the exchange, in which case the exchange member receives the full commission paid by the broker's customer.

from their customers were "market" orders calling for prompt execution, when a respondent executed such an order with the other respondent the latter, in a substantial number of cases, placed an offseting exchange order which was a "limit" order.[7] As the respondents point out, a dealer firm acting for its own account and risk may seek to obtain a better execution through a limit order even though this may result in his remaining at risk for an interval of time until the limit price is obtainable. A broker receiving a market order from his customer, however, cannot delay execution for such periods of time but must execute reasonably promptly and be in a position to report the details to the customer or his salesman without undue delay. Josephthal's records show the nature of the orders placed with it by respondents corresponding to 89 customers' transactions. Of these 63, or over 70 percent, were limit orders, which in many instances Josephthal was not able to execute at the limit price until after several hours or until the next day or until they had been modified. Moreover, a comparison between Josephthal's time records, which cover 155 of the transactions, with MSG's time records of its corresponding executions with Brown shows that in 133 cases the execution between MSG and Brown took place before the offsetting transactions through Josephthal on the exchange.

Finally, the fact that, as previously noted, Brown and MSG realized trading losses in 64 and 86 transactions, respectively, in which they acted as dealer is in itself further indication that respondents did not follow a practice of first executing the offsetting exchange transactions.[8] The record does not support the Division's contention that the losses resulted from the necessity of confirming a price to the customer which was within the range for the day on the exchange. In a substantial number of instances the range for the day was wide enough to have permitted the dealer respondent incurring the loss, if it were acting on a riskless basis, to confirm to the retail respondent at a price within that range more favorable to itself which would have avoided all or part of the trading loss. Thus the losses would appear more logically explainable on the assumption that they resulted, as respondents assert, from the fact that the dealer respondent attempted subsequently to effecting the transaction with the retail respondent, to

[7] A "limit" or "limited" order, may be executed only at the price specified or better. See Special Study, pp. 40–42, 72.

[8] In some of the instances when the dealer respondent suffered a loss in his subsequent trade, he would request the retailing respondent to make an adjustment in the price and thus share part of the loss. Such an adjustment was made in some of the transactions and in such event the confirmation between the retail broker and the dealer would be at the original price plus or minus a differential, and the customer's price would not be affected.

cover that transaction on the exchange during the same or the next day but was unable to do so except at a trading loss.

In view of the foregoing no inference can be drawn that it was the general practice of each respondent firm to deal with each other in the riskless manner charged in the order for proceedings. We also do not find any impropriety in any of the questioned transactions as to which there is no evidence in the record with respect to their timing or other significant facts concerning their executions, including those as to which the offsetting exchange transaction was executed through a firm other than Josephthal. Nor are we justified on this record in making any adverse finding with regard to the 133 transactions which Josephthal's time records show were effected on the exchange after the customer's order was filled.

In 21 transactions executed through Josephthal, Josephthal's time records when matched against those of MSG show that the dealer respondent's corresponding exchange transaction was executed by Josephthal before the customer's order was executed. The recorded timing of these transactions suggest that the dealer respondent was interposed in a riskless transaction to the customer's detriment. Respondents have not undertaken to explain these cases individually. We note however that as to 10 of the cases the record shows the orders placed with Josephthal were limit orders, and in 5 others the dealer respondent actually suffered a loss or would have except for an adjustment by the broker respondent. These factors cast substantial doubt upon whether the dealer respondent in fact acted on a riskless basis in these 15 cases, and we are therefore unable to find that the proof preponderates against respondents as to them. The remaining 6 transactions, which involve minimal profits to the respondents and very small indicated losses to the customers,[9] have the characteristics of riskless transactions. However, both the Division and the respondents presented and argued this case on the basis of the presence or absence of a course of conduct which violated Section 10(b) of the Act and Rule 10b–5 thereunder, and we are not prepared to say that the Division has established that respondents engaged in such a course of conduct, considering that between 4 and 5 hundred transactions were involved here.[10]

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[9] Brown's total profit in his five transactions was $37.18 and MSG's in its one was $2.02. The difference between the price to the customer and that obtained by the dealer respondent in the exchange execution totaled $170 in Brown's transactions and $14 in MSG's.

[10] Even as to the six apparently, riskless transactions, the over-all time sequences or the closeness of the times involved suggest that they may not have really been riskless or that there was an error in the recordation of time by MSG or Josephthal. In the same category may be placed one transaction as to which the time records indicate that the execution between MSG and Brown took place at the same time as an offsetting transaction through Josephthal on the exchange.

ALLEGED NET CAPITAL VIOLATIONS BY BROWN

The order for proceedings charges that during the period from May 28, to at least July 1, 1964, Brown did business while his aggregate indebtedness exceeded 2,000 percent of his net capital, in willful violation of Section 15(c)(3) of the Act and Rule 17 240.15c3-1 thereunder. The hearing examiner found that on May 28, June 29, June 30, and July 1, 1964, respectively, Brown had net capital deficiencies of $2,580, $11,784, $13,710 and $14,208.

Brown contends that the alleged capital deficiencies did not exist because he had a checking account in his name in a bank and certain securities not recorded on his broker-dealer books, which were erroneously excluded from the net capital computations by the Division and the hearing examiner.

Since Brown was a sole proprietor, his current indebtedness and his ability to cover such indebtedness would properly take into account all his assets and liabilities, whether or not they are related to his broker-dealer business or are reflected in the records he keeps of that business.[11] In the absence of information to the contrary, it is reasonable as a starting point to test a broker-dealer's compliance with the net capital requirements on the basis of the assets he himself has listed in his broker-dealer records. However, if he demonstrates that he has funds in a bank account and securities which are includable under the tests set forth in the rule, they should not be excluded from the net capital calculations solely on the ground that they were not recorded in his broker-dealer books, although his failure to record these assets would constitute a violation of the record-keeping provisions.[12]

The amount in Brown's bank account in question was $2,916 on May 28, 1964, and was sufficient to eliminate the net capital deficiency computed as of that date. The securities pointed to by Brown, consisting of 114 shares of the common stock of Bestpak, Inc. ("Bestpak"), would, if includable as assets for net capital purposes, cure the deficiency found on June 29, 1964, and taken together with the amounts in the bank account cure those found on the two following days.

The net capital rule, in keeping with its principal purpose of

[11] See Securities Exchange Act Release No. 8024, pp. 13-14 (January 18, 1967).

Of course a corporate registrant, even though it has a single shareholder, presents a different situation since the assets of the shareholder are not subject to the claims of customers and creditors of the registrant, and the latter's assets are not subject to the claims of the shareholder's personal creditors. *Kenneth E. Goodman & Co.*, 38 S.E.C. 309 (1958).

[12] See *Wendell Maro Weston*, 30 S.E.C. 296, 312 (1949).

requiring broker-dealers to maintain a capital position sufficiently liquid to permit them to meet their obligations to customers on reasonable demand, provides that assets not readily convertible into cash are to be excluded from the computation of net capital.[13] Acting under this provision, we have excluded securities for which there was no ready market,[14] and have viewed securities for which no exchange or over-the-counter market exists as *prima facie* lacking the expectation or capability of liquidity contemplated by the rule.[15] Clear proof of ready convertibility into cash is required to overcome the absence of a professional market.

The treasurer of Bestpak testified that there was no independent market for the Bestpak stock, which by its terms was restricted so that it could be sold only to Bestpak. He also testified: *However,* That the company had on various occasions purchased substantial amounts of such stock at its current book value and resold them to its employees; that in May 1964, in response to an inquiry by Brown as to the value of the stock, he told Brown that the company was desirous of purchasing his stock at its book value at any time; and that the company at all times pertinent here was willing and able to purchase Brown's stock at the prevailing book value and resell it to at least seven named officers and employees on a day's notice. Neither the Division nor the examiner[16] challenged the credibility of Bestpak's treasurer or controverted Brown's contention and evidence that the company and its officers and employees desired and were able to purchase Brown's shares at the stated book value. We find that the proof of ready convertibility into cash notwithstanding the lack of an ordinary trading market for Bestpak stock has been adequate under the special circumstances of this case,[17] and that stock was accordingly includable in the net capital computations.

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[13] Rule 15c3-1(c)(2)(B).

[14] *Charters & Co. of Miami, Inc.*, 43 S.E.C. 175, 176 (1966); *John W. Yeaman, Inc.*, 42 S.E.C. 500, 503 (1965), see also *Pioneer Enterprises, Inc.*, 36 S.E.C. 199, 207 (1955); Securities Exchange Act Release No. 8024, p. 9 (January 18, 1967).

[15] See *Charters & Co. of Miami, Inc., supra.*

[16] The examiner did not treat specifically with the issue of the includability of this stock.

[17] Bestpak, which had been in business since about 1951, was engaged in the manufacture and sale nationally except for the West Coast of food packaging products. It had 2,800 shares of common stock outstanding and had net earnings of $24.10 per share in its fiscal year ending June 30, 1964. These facts are relevant, not in that they bear upon the existence of an intrinsic or long-term value of the Bestpak stock, factors we rejected in *John W. Yeaman, Inc., supra,* as not determinative on the net capital issue, but rather in that they tend to support Brown's contention and the evidence advanced by him to the effect that there were in fact ready purchasers of the stock at its current book value, which was slightly over seven times current earnings at the time in question.

We therefore conclude that the examiner's findings of net capital violations are not established by the record.[18]

PUBLIC INTEREST

As we have set forth above, the record does not support the principal charge against respondents that they engaged in a practice of handling their customers' orders through each other in a manner which denied the customers the best execution.

As respects Brown, we have found that he failed to record accurately the times brokerage orders were entered. While Brown has not previously been the subject of any sanction by us or the NASD, he has been previously warned of prior record-keeping inadequacies on a number of occasions and the violations found here indicate that at least as of 1963 and 1964 he had not put his house completely in order. Under all the circumstances, it is appropriate in the public interest to suspend Brown's registration as a broker and dealer for 15 days.[19]

Accordingly, IT IS ORDERED that the registration as a broker and dealer of George A. Brown, doing business as Brown and Company, be, and it hereby is, suspended for 15 days, to commence at the opening of business on October 2, 1967, and that in all other respects these proceedings be, and they hereby are, dismissed.

By the Commission (Chairman COHEN and Commissioners OWENS, BUDGE, and WHEAT), Commissioner SMITH not participating.

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[18] In view of our conclusion that the alleged net capital deficiencies did not exist because of the presence of the bank account and the Bestpak securities, we need not consider various other contentions advanced by Brown with respect to the net capital issue. We may note however that in our opinion the record does not support the findings of the examiner that a purchase by Brown from MSG on June 30, 1964, of securities which Brown was short and an offsetting sale by MSG to Brown of the same securities the next day were effected for the purpose of eliminating Brown's short position so as to avoid a deduction from net capital on that date of 30 percent of the value of those securities as required by the net capital rule. These transactions could at best have cured a deficiency on that day without affecting the other dates in question. Brown's contention that the transactions were effected for the purpose of establishing a tax loss on the last day of his fiscal year is supported among other things by the fact that the transactions were considerably more extensive in scope than would have been required to conceal the net capital deficiency charged. We may further note, on the other hand, that there is no merit in Brown's argument that the Division's computations of aggregate indebtedness improperly included nonfree credit balances in customers' accounts and indebtedness collateralized by securities in customers' margin accounts.

[19] To whatever extent the exceptions to the initial decision of the hearing examiner involve issues which are relevant and material to our decision, we have by our findings and opinion sustained or overruled such exceptions to the extent that they are in accord or inconsistent with the views herein.