NASD REGULATION, INC.
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. SFI INVESTMENTS, INC., (BD#21663), et al., KEVIN M. SMITH (CRD #428192) New York, New York, JEFFREY B. BRONFMAN (CRD #31423) Aventura, Florida, Respondents.	Disciplinary Proceeding No. C10970176 Hearing Officer - EAE **AMENDED HEARING PANEL DECISION AS TO RESPONDENTS SMITH AND BRONFMAN**[1] March 28, 2000

DIGEST

On November 21, 1997, the Department of Enforcement ("Enforcement" or "Complainant") filed a Complaint against eight Respondents. This Decision relates only to the Revised First Cause of Complaint[2] against Respondents Jeffrey Bronfman ("Bronfman") and Kevin Smith ("Smith") (both

[1] This Decision is amended to delete the word "business" from the second line of the second full paragraph on page 34.

[2] With leave of the Hearing Officer, Enforcement filed a Revised First Cause of Complaint on October 28, 1998. The original Complaint charged Respondents with violations of NASD Conduct Rules 2110 and 2120. The Revised First Cause added a citation to MSRB Rule G-17 ("Rule G-17"). Unless otherwise noted herein, all references to the Complaint are to the Revised First Cause.

referred to collectively as "Respondents").[3] Respondents were municipal bond traders at SFI Investments, Inc. ("SFI" or "the Firm"), an NASD member firm from 1988 to 1997.

Complainant alleges that Respondents engaged in the improper trading of municipal bonds which resulted in fraudulent and excessive markups and caused SFI to violate its Restriction Agreement with the Association. Specifically, Complainant alleges that, during the review period, January through June 1995, Respondents used two accounts controlled by Respondent Smith ("the Smith Accounts")[4] as *de facto* Firm trading accounts which resulted in excessive markups to SFI's customers. Complainant further alleges that in order to transfer the profits between them from their unlawful trading scheme, Respondents engaged in a series of fictitious transactions which resulted in the creation of false order tickets and confirmations reflecting trades that never occurred.[5] Complainant alleges that these activities violate NASD Conduct Rules 2110 and 2120 and MSRB Rule G-17.[6]

Respondents dispute that they used the Smith Accounts as *de facto* Firm trading accounts or engaged in a pattern of improper trading resulting in fraudulent and excessive markups. Further,

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[3] The other Respondents are SFI Investments, Inc. ("SFI" or "the Firm"), Frank Fasano ("Fasano"), the Chairman of SFI and its President, Barbara Halpern ("Halpern"), the Firm's Financial and Operations Principal, Robert Fitzpatrick ("Fitzpatrick"), the Firm's Director of Compliance, and Christopher Chu ("Chu") and Peter Haynes ("Haynes"), persons associated with SFI. The claims against Respondents Halpern and Chu were settled. A Default Decision was issued against Respondent Haynes. Enforcement's Motion for Entry of a Default Decision as to Respondents SFI and Fasano is stayed pending the conclusion of Respondent Fasano's Chapter 7 bankruptcy proceeding and the lifting of the automatic stay currently in effect. The claims against Respondent Fitzpatrick were severed for purposes of the Hearing. A Hearing Panel Decision as to Respondent Fitzpartrick issued on October 20, 1998. By Decision dated June 14, 1999, the National Adjudicatory Council affirmed the Panel's findings as to liability and modified the sanctions. Respondent Fitzpatrick has appealed that Decision to the SEC.

[4] One account was in the name of Respondent Smith and the other was in the name of his mother, Marjorie Parker Smith ("the MPS Account").

[5] See Complainant's Post-Hearing Submission on Claim Against Respondents Smith and Bronfman ("Complainant's Br.") at 10-12, 19-21.

[6] MSRB G-17 provides that "[i]n 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."

although Respondents admit using fictitious trades to distribute trading profits between them,[7] they argue that such trades had a *de minimis* impact on the market and are not relevant to the violations charged.[8] Respondents also deny any knowledge of the SFI Restriction Agreement.

Based on the evidence presented at the Hearing, the Hearing Panel determined that Respondents violated Rule G-17[9] by charging SFI's customers excessive markups and by engaging in fictitious trading resulting in the creation of false books and records. Taking into consideration all relevant factors, the Hearing Panel determined that the following sanctions are appropriate: (1) Respondents, jointly and severally, are fined $35,625.53, and (2) each Respondent is fined an additional $35,000 ($25,000 for excessive markups and $10,000 for fictitious trading and the creation of false books and records), required to requalify in all capacities within sixty (60) days, and suspended in all capacities for sixty (60) days, such suspension to run concurrently with requalification.

The Hearing Panel assessed the costs of the Hearing, $2,628.10, ($1,878.10 for transcripts and $750.00 administrative fee) against both Respondents, jointly and severally.

APPEARANCES

Andrew W. Reich, Esq., Regional Attorney, NASD Regulation, Inc., Department of Enforcement, District 10, New York, New York and Rory C. Flynn, Esq., Chief of Litigation, NASD Regulation, Inc., Department of Enforcement, Washington, D.C.

Martin H. Kaplan, Esq., Scott L. Silver, Esq., Gusrae, Kaplan & Bruno, New York, New York for Respondents Smith and Bronfman.

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[7] Joint Stipulations at ¶4.

[8] See Respondents' Post-Hearing Memorandum of Proposed Findings of Fact and Conclusions of Law ("Respondents' Br.") at 23-24.

[9] As discussed more fully herein, because the alleged violations relate only to transactions in municipal bonds, the NASD Conduct Rules are not applicable.

DECISION

I. SUMMARY OF THE CASE

Pursuant to a Restriction Agreement with the Association, SFI was not permitted to maintain a proprietary trading account. Complainant alleges that during the review period, in violation of SFI's Restriction Agreement, the Smith Accounts were used to maintain a ready inventory of municipal bonds until SFI located customers willing to purchase the bonds. [10]

Complainant charges that Respondents repeatedly bought municipal bonds from SFI or "the street,"[11] held the bonds in one of the Smith Accounts for a very short time, and then, typically, resold the bonds to SFI which immediately resold them to its customers.[12] Complainant contends that trading in the Smith Accounts, which admittedly constituted 90% of SFI's municipal bond business,[13] was, in effect, the municipal bond business of SFI.[14]

In addition, Complainant charges that since SFI bought the bonds from the Smith Accounts at a marked-up price and then resold the bonds to SFI's customers at a still higher price, the purchasing customers paid a "double markup."[15] As a result, Complainant charges that SFI customers were denied the best execution because the Smith Accounts were interpositioned between the customers and

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[10] The Restriction Agreement required SFI to maintain net capital and operate as a $5,000 broker-dealer in accordance with SEC Rule 15c3-1, prohibiting it from effecting more than ten transactions in any one calendar year for its own investment account.

[11] Throughout the Hearing, "the street" was used when referring to other broker-dealers from which Respondents either bought or sold municipal bonds or obtained quotations.

[12] Hearing Transcript ("Tr."), 12/8/98 at 180; 12/9/98 at 171; CX-10, 12, 15. Citations to Hearing Exhibits indicate whether the exhibit was introduced by Complainant ("CX") or Respondents ("RX").

[13] Tr., 12/9/98 at 35.

[14] Complainant's Br. at 14.

[15] Complainant's Br. at 2.

the best available market. Complainant charges that SFI's customers thereby were charged excessive markups for which Respondents are responsible.[16]

Complainant also alleges that, each month, Respondents shifted to Respondent Bronfman his share of the profits through a series of fictitious transactions which purportedly involved transfers of bonds between the MPS Account and one of the two accounts controlled by Bronfman. This process resulted in the creation of order tickets and confirmations that falsely portrayed the transactions as legitimate.[17]

Respondents deny that they used the Smith Accounts as the Firm's *de facto* trading accounts in order to circumvent SFI's Restriction Agreement. In fact, they deny any knowledge of the particular Agreement.[18] Further, they assert they were at risk for the trades in the Smith Accounts and that SFI did not participate in any of the profits from the trading in the Smith Accounts.[19]

Respondents also charge that Complainant's markup analysis is flawed since it is predicated on the Smith Accounts' acquisition costs of the bonds rather than the prices that SFI paid the Smith Accounts for the bonds.[20] Respondents assert that if Complainant had computed the markups from SFI's acquisition costs from the Smith Accounts, which they contend is at least as favorable to SFI's

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[16] Complainant's Post-Hearing Reply Submission On Claim Against Respondents Smith and Bronfman ("Complainant's Reply") at 1-2.

[17] Complainant's Br. at 10.

[18] Tr., 12/8/98 at 181-182; 12/9/98 at 95-95; 4/6/99 at 12-13, 34-35.

[19] Respondents' Br. at 3, 13-14; Tr., 12/8/98 at 182-183; 12/9/98 at 142.

[20] Respondents' Br. at 3, 5, 18-21. Respondents raised this argument for the first time in their Post-Hearing Br. At the Hearing they argued that acquisition costs were immaterial and that the prices charged customers were fair because they were reasonably related to then-prevailing offering quotations which were obtained from various sources. See Complainant's Reply at 3, 4; Tr., 12/9/98 at 11-12, 73-74; 4/6/99 at 44. Since Complainant had the opportunity to address the argument raised in Respondents' Post-Hearing Br., it was considered, but rejected, by the Hearing Panel.

retail customers as the best available market price, the prices generally would have reflected markups of between 2% to 3%, consistent with SFI's policy.[21]

As for the fictitious trades, Respondents admit they engaged in such transactions in order to transfer Respondent Bronfman's share of the profits from the Smith Accounts to Bronfman's personal accounts.[22] Respondents assert, however, that although these transactions "technically" were improper, because they "were not reported to any publicly disseminated disclosure system, * * * [they] did not effect the market price for any security nor otherwise upset the integrity of the market place by distorting volume or otherwise impacting market information."[23]

The Parties presented evidence to the Hearing Panel in a three (3) day Hearing at which three witnesses testified: Respondents and Nicole Bocra ("Bocra"), the staff examiner. Ms. Bocra's testimony focused on preparation of the various exhibits showing the transactions at issue and Complainant's calculation of the alleged excessive markups.[24]

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[21] Respondents' Br. at 15.

[22] Id. at 5; Joint Stipulations at ¶4.

[23] Id. at 5, 23-24; see also Tr., 12/8/98 at 214.

[24] At the conclusion of Complainant's direct case, Respondents moved to dismiss those aspects of the proceeding relating to excessive markups and interpositioning on the grounds that Enforcement had failed to make a *prima facie* case. Tr., 12/8/98 at 159-160. After hearing the arguments of counsel (id. at 159-164), the Panel denied Respondents' motion (id. at 170-172).

II. *FINDINGS OF FACT*

A. Improper Trading In The Smith Accounts Resulting In Excessive Markups

Enforcement presented undisputed evidence which demonstrates that, during the review period, over 400 sets of trades or transactions[25] were effected in the Smith Accounts using the same trading pattern.[26] In each instance, SFI (1) acting through Respondents purchased municipal bonds from SFI customers or other broker-dealers;[27] (2) simultaneously sold those bonds into the Smith Accounts at SFI's purchase price;[28] (3) after inventorying the bonds in the Smith Accounts for a very short time (usually no more than one business day),[29] bought the bonds back from the Smith Accounts at a marked-up price; and (4) immediately sold the bonds to SFI's customers at a higher price.[30] Respondents testified that they arranged to sell the bonds from the Smith Accounts to SFI and to give the SFI salesmen who originally brought in the bonds the first opportunity to re-sell the bonds to SFI's

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[25] CX-10, "Analysis Of Trading Activity Between The Smith Accounts And SFI," reflects 411 transactions in the Smith Accounts during the review period. Tr., 12/8/98 at 33. A transaction consists of at least four individual trades. Tr., 12/8/98 at 35, 37. Bocra testified that the Smith Accounts were involved in 100 additional transactions during the review period, but that those transactions are not reflected in CX-10 because complete documentation was not readily available. Tr., 12/8/98 at 47-49.

[26] Tr., 12/8/98 at 32-33; CX-10. CX-11 contains supporting documentation (order tickets and confirmations) for four representative sets of trades depicted in CX-10 (transactions 190, 364, 374, 408). Id. at 38-39. CX-15 is an "errata sheet" reflecting corrections to CX-10 and CX-14, Enforcement's "Markup Calculations." Id. at 51. Bocra testified that with the "errata sheet," CX-10 is accurate. Id. Bocra also testified that none of the corrections reflected on CX-15 impacts CX-14, the "Markup Calculations." Id. at 52, 80.

[27] Tr., 12/8/98 at 188-189; 12/9/98 at 152.

[28] Tr., 12/9/98 at 78; see CX-10. Respondent Bronfman testified that, in almost all instances, when an SFI customer sold bonds, the purchaser was the Smith Accounts. Tr., 12/9/98 at 153-154.

[29] CX-14; Tr., 12/8/98 at 62-63, 130; see also, Tr., 12/8/98 at 111.

[30] See CX-10; Tr., 12/8/98 at 37-38, 188-190.

customers.[31] Further, Respondents admitted that all ticket and processing charges for transactions in the Smith Accounts were paid by SFI.[32]

The evidence demonstrates that Respondents controlled all stages of the trading. Respondents testified that they determined which bonds SFI would buy, the prices SFI would pay for those bonds, the prices SFI would pay to repurchase the bonds from the Smith Accounts, and the prices SFI would charge its customers for the bonds.[33] Respondents testified that no one else from SFI was involved in these decisions.[34]

Based on the evidence, the Panel found that the trading in the Smith Accounts was, for all practical purposes, SFI's municipal bond business and that the Smith Accounts were *de facto* Firm trading accounts. Respondent Bronfman admitted that, during the review period, 90% of the bonds bought by SFI's customers passed through the Smith Accounts.[35]

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[31] Tr., 12/9/98 at 82-83, 147-148. When questioned by the Hearing Panel, Respondent Bronfman could not convincingly refute the contention that the involvement of SFI salesmen in buying and selling bonds to and from the Smith Accounts supports the conclusion that those Accounts were *de facto* Firm trading accounts. Id. at 147-148.

[32] Tr., 12/9/98 at 157-159; 4/6/99 at 9-10, 52. By comparison, Respondent Smith testified that when he effected trades for his own account, apart from Respondent Bronfman, he paid ticket charges. Tr., 4/6/99 at 9-10, 51-52.

[33] Tr., 12/9/98 at 154-155, 156-157; 4/6/99 at 45-47, 75-77. Respondent Bronfman testified that he and Respondent Smith determined the credits the SFI salesmen would receive for selling the bonds from the Smith Accounts. Tr., 12/9/98 at 156-157.

[34] Tr., 12/9/98 at 156-157; Tr., 4/6/99 at 75-78.

[35] Tr., 12/9/98 at 35.

The evidence demonstrates that the price of the bonds was marked up twice in the course of the sales to SFI's customers -- once when SFI purchased the bonds from the Smith Accounts and, again, when SFI sold the bonds to its customers.[36]

The Panel rejects Respondents' contention that markups should be calculated based on SFI's cost of acquiring the bonds from the Smith Accounts.[37] Because the Smith Accounts were *de facto* Firm trading accounts, and because all of the transactions in the bonds were so closely related in time, the Panel finds that the Smith Accounts' cost is the proper basis on which to calculate the markups paid by SFI's customers.[38] The Panel finds that the price paid by the Smith Accounts in acquiring the bonds was the prevailing market price on the date of sale to SFI's customers.[39] Based on this analysis, the evidence demonstrates that in over 40% of the transactions (174 of the 403 transactions reflected in

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[36] CX-14; see, e.g., Tr., 12/8/98 at 55. Respondent Bronfman testified that he and Respondent Smith would determine the markup when an SFI customer purchased the bond. Tr., 12/8/98 at 192-193; 12/9/98 at 155.

[37] Respondents' Brief at 5, 18-19.

[38] Tr., 12/8/98 at 61-65, 110-111. The prices paid by SFI's customers are reflected in the fourth section of CX-10, "SFI Sells to Customers." SFI's cost of acquisition is reflected in the first column of CX-10, "SFI Purchases from Customers or from the Street." Tr., 12/9/98 at 77. The second section of CX-10, "SFI Sells to the Smith Account," reflects the Smith Accounts' costs of acquisition of the bonds and is identical to SFI's cost of acquisition. Tr., 12/9/98 at 78.

[39] Tr., 12/8/98 at 111-113.

CX-14), the markups exceeded 4%.[40] The evidence further demonstrates that in 11 of the 174 transactions, the markups exceeded 8%.[41]

Based on the evidence, the Panel also found that the Smith Accounts and SFI profited on all but one transaction.[42] With respect to the first markup – when the Smith Accounts sold the bonds to SFI --- Respondents testified that they retained the entire amount.[43] With respect to the second markup – when SFI sold the bonds to its customers --- Respondent Bronfman received a 10% override and the remainder was split between SFI and its representatives.[44] The total markups were not disclosed to SFI's customers.

At the Hearing, Respondents argued that the bonds were not marked-up excessively and that acquisition costs are irrelevant in determining markups.[45] Rather, they testified that SFI sold the bonds

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[40] CX-14. For purposes of this disciplinary proceeding, Enforcement used 4% as a benchmark in preparing CX-14, the Markup Calculations. Tr., 12/8/98 at 75-76. Bocra testified that the Markup Calculations in CX-14 covered 403 transactions, consisting of the 411 transactions reflected on CX-10, excluding eight transactions that involved only the Smith Accounts or the two accounts controlled by Respondent Bronfman. Tr., 12/8/98 at 78-79. Summarizing from CX-14, Bocra testified that 44% of the transactions (176 of 403 transactions) reflected markups in excess of 4%. Id. at 82. The evidence demonstrates that two of those transactions (Nos. 44 and 270) involving markups in excess of 4% probably involved sales to the street. Tr., 12/8/98 at 177-178, 12/9/98 at 37-38; see also Respondents' Br. at 6, 11-12. Since, as Complainant recognizes (Complainant's Br. at 3 and Reply at 5), street trades are not subject to the markup rules, the Panel excluded them from its findings concerning the number of transactions with markups greater than 4%.

[41] CX-16 lists the transactions reflected on CX-14 involving markups in excess of 8%. Excluding the two transactions involving sales to the street, there are eleven (11) transactions (16 discrete sales) with markups greater than 8% for which the purchaser was identified as a public customer. Tr., 12/9/98 at 35-40.

[42] Of the 403 transactions included in CX-14, only one (No. 386) was unprofitable. Tr., 12/8/98 at 144-45.

[43] Tr., 12/8/98 at 182; 12/9/98 at 142; 4/6/99 at 42.

[44] Tr., 12/9/98 at 27-30; Tr., 4/6/99 at 95-100.

[45] Tr., 12/9/98 at 73-74; 4/6/99 at 44.

to its customers at or below then-prevailing offering quotations, which they obtained from various sources, on the date of sale.[46]

For example, Respondent Bronfman testified that Respondents determined the prevailing "market price" by checking the trade history of bonds, seeking outside bids from other dealers, and looking in the "blue list" for relevant offerings.[47] Respondent Bronfman also testified that bonds with certain characteristics are more risky and trade at greater spreads which impact their market price.[48] Respondents, however, presented no evidence concerning market or bond-specific events which actually affected the price of the particular bonds during the brief periods in which they were held in the Smith Accounts. In fact, with one exception, Respondents presented no evidence as to other actual trades in the bonds at issue.[49] Further, Respondent Bronfman conceded that quoted bids and asks are not evidence of actual trades, and that such quotations always are subject to negotiation and bargaining.[50]

Respondent Smith also testified that because he was able to take advantage of the purported spread between prevailing bid and ask prices, he could buy at the bid price and "[t]here's no doubt I

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[46] Tr., 12/9/98 at 11-12; see also Respondents' Br. at 13-14.

[47] Id.

[48] See, e.g., Tr., 12/8/98 at 198-211, Tr., 12/9/98 at 10-11. When questioned by the Hearing Panel on this point, Respondent Bronfman's response was less than satisfactory. See Tr., 12/9/98 at 150-151.

[49] The one exception, RX-9, an MSRB historical report of inter-dealer (not retail) bids, relates only to 19 of the 403 transactions in CX-14 and to only 10 of the transactions in which the markups exceed 4%. Respondents presented no evidence or explanation as to whether the information in RX-9 justifies the markups as to those 10 transactions. See, e.g., Tr., 12/8/98 at 235. Further, although RX-9 was admitted into evidence, it is of little probative value with respect to the markups at issue or the information considered by Respondents when pricing the bonds for sale to SFI customers. Respondents admitted that they had not looked at these reports in connection with the transactions at issue (Tr., 12/8/98 at 225-226, 230, 237) and could not testify as to the accuracy of the information reflected in the reports (id. at 237).

can resell it. * * * [I]t's really hard to lose money."[51] By comparison, Respondent Bronfman denied that profits in the Smith Accounts were due to the wide spreads in the bonds they traded.[52] Instead, he claimed that the profits on the bonds were attributable solely to a declining interest rate environment and the fact that bond prices were continually rising.[53] Respondents, however, did not establish that there were any interest rate changes affecting the prices of the bonds at issue during the specific periods when they were held in the Smith Accounts.

Respondent Bronfman, without any corroborating evidence, testified that some of the bonds had certain characteristics, e.g., possible loss of their tax exempt status, which caused them to be quoted at "abnormally large" spreads.[54] Respondent Bronfman, however, was unable to demonstrate that such unfavorable characteristics actually caused any of the bonds to be traded at unusually wide spreads on the transaction dates.[55]

Respondent Bronfman also testified that certain bonds were bearer bonds which tended to demand a slightly higher price than comparable bonds because certain purchasers found them more

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[50] Tr., 12/9/98 at 49-50.

[51] Tr., 4/6/99 at 54-55.

[52] Tr., 12/9/98 at 32.

[53] Tr., 12/9/98 at 31-32. This is the position that Respondents take in their post-hearing papers. See Respondents' Br. at 12.

[54] Tr., 12/8/98 at 199-200, 208-210.

[55] See Tr., 12/9/98 at 150-152. Respondent Bronfman was unable to respond convincingly to questions from the Hearing Panel as to why anyone would pay a premium for a risky bond. Id. Respondent Bronfman also testified that certain transactions reflected "sinking fund bonds"; that is, in all probability, the purchaser would not receive full face value at maturity. Respondent Bronfman testified that because of this characteristic, these bonds traded at greater spreads. Tr., 12/8/98 at 203-208, 211. Again, however, Respondents provided no evidence that sinking fund bonds actually traded at wider spreads on the transaction dates.

desirable.[56] Again, however, Respondents failed to provide any evidence that this purported "favorable characteristic" caused such bonds to be traded at unusually wide spreads on the transaction dates. Further, Respondent Bronfman admitted that he did not have any documents to demonstrate the best offering for the bonds.[57]

The Panel finds that Respondents failed to offer any credible countervailing evidence to refute the conclusion that the Smith Accounts' costs of acquisition of the bonds is the best evidence of prevailing market price on the date of sale to SFI's customers. Further, the Panel finds no evidence of abnormally large spreads to support the markups charged.

Based on the evidence presented at the Hearing, the Panel also concludes that Respondents intentionally interpositioned the Smith Accounts between SFI's customers' accounts and the fair market price of the bonds to conceal the markups. This resulted in SFI's customers paying more for the bonds as compared with prices they reasonably may have expected to pay if they bought the bonds directly from inventory without the intervention of the Smith Accounts.

Accordingly, based on the evidence of record, the Hearing Panel finds that SFI's customers paid excessive markups in the amount of $27,404.26.[58]

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[56] Tr., 12/8/98 at 200-202, 205-206.

[57] Tr., 12/9/98 at 71. In response to a direct question, Respondent Bronfman claimed that he disposed of all documents that would have supported his testimony. When asked whether he should not have saved documents which might support markups of 8% or greater, he replied, "[t]his is the market price on the securities. Market price speaks for itself." When further asked whether he had any proof supporting his claim that he sold the bonds at the market price, he admitted he did not. Tr., 12/9/98 at 60-61.

[58] See CX-14 and Respondents' Br. at 12. Pursuant to the Sanction Guidelines (at 12) Complainant introduced evidence as to the calculation of pre-judgment interest (Tr., 12/8/98 at 69-75) in accordance with 26 U.S.C. §6621(a)(2) which was not challenged by Respondents. Excluding the two street trades, the total pre-judgment interest calculated as of the date of the Hearing on markups of $27,404.26 is $8,221.27. See CX-14.

B. Fictitious Trading and Creation of False Books and Records

Respondents admitted using fictitious trades to distribute the trading profits from transactions in the Smith Accounts between them.[59] Every month Respondents calculated the profits they earned in the prior month from trading in the Smith Accounts[60] and then shifted Respondent Bronfman's share by purportedly transferring fictitious municipal bonds from the MPS Account to one of the two accounts controlled by Respondent Bronfman.[61] In the process of effecting these fictitious trades, Respondents created order tickets[62] and caused to be created confirmations and account statements which falsely portrayed such transactions as legitimate.[63]

Respondents admitted they created the false order tickets[64] and that they were aware that Cowen & Company, SFI's clearing firm, would generate confirmations and account statements based on the fictitious order tickets. They also admitted that they never told Cowen that these were fictitious trades.[65]

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[59] Respondents stipulated that they "distributed the trading profits generated in the Smith Accounts by effecting a series of fictitious trades on a monthly basis." Joint Stipulation at ¶4; Tr., 12/8/98 at 85. <u>See</u> <u>also</u> CX-12, CX-13, Tr., 12/8/98 at 85-100.

[60] Tr., 12/9/98 at 132-33.

[61] The two accounts were a joint account for Respondent Bronfman and his wife and Respondent's own IRA account. Tr., 12/9/98 at 135-136. The fictitious trading is reflected on CX-12 which shows seven sets of trades between January and June 1995. Transactions nos. 1-5 and 7 reflected on CX-12 involve transfers to the joint account; transaction no. 6 involves a transfer to Respondent's IRA account. <u>See</u> <u>also</u> CX-13.

[62] Tr., 12/9/98 at 125-126; 4/6/99 at 55.

[63] Each fictitious trade resulted in the creation of four sets of false books and records. Tr., 12/8/98 at 213. CX-13 contains the order tickets, confirmations, and account statements that falsely reflect the trades as *bona fide* transactions.

[64] Tr., 12/9/98 at 125-126; 4/6/99 at 55.

[65] Tr., 12/9/98 at 128-130, 140; 4/6/99 at 55-56.

Respondents acknowledged that neither they, nor their various accounts, ever owned the bonds or intended to effect a beneficial change in the ownership of the bonds. Rather, the sole purpose of the prearranged paper transfers was to distribute a certain amount of the profits to Respondent Bronfman with the corresponding tax liability.[66]

Based on the undisputed evidence of record, the Hearing Panel finds that Respondents engaged in a scheme of illicit fictitious trading and also finds that, in order to effect their unlawful trading scheme, Respondents created and caused to be created false books and records.

C. Violation of the SFI Restriction Agreement

SFI's Restriction Agreement with the Association prohibited it from engaging in proprietary trading. Respondents testified that they had no knowledge of any restriction on SFI's ability to engage in proprietary trading and also denied ever having seen the Restriction Agreement during the relevant time period.[67]

At his on-the-record interview, Respondent Smith testified that when he joined SFI he became aware that the Firm had a retail account and "that they could not position bonds, for whatever reason, but they couldn't."[68] He also testified that it was because SFI could not position bonds, that he began trading in the Smith Accounts.

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[66] Tr., 12/9/98 at 121-122. Respondents' argument that their "intention was to transfer profits in a manner which created a clear record" * * * "so the transfer would be transparent to any body that wanted to look" for it is not convincing. See Respondents' Br. at 23. These transfers were not disclosed as anything other than *bona fide* trades and certainly weren't "transparent" to SFI's clearing firm since it generated confirmations based on the fictitious trades. In fact, Respondent Bronfman admitted that nothing on the order tickets they created, or on the confirmations and account statements prepared by Cowen as a result of those order tickets, gave any indication of the true nature of the transactions. Tr., 12/8/98 at 213-214; 12/9/98 at 134-135.

[67] Tr., 12/8/98 at 181-182; 4/6/99 at 11-12.

[68] CX-7 (Smith OTR Testimony) at 33-34; Tr., 4/6/99 at 36-37.

Respondent Bronfman's testimony with respect to restrictions on SFI's trading activities was, at best, inconsistent and irrelevant. Respondent Bronfman first denied any knowledge of the term "$5,000 broker-dealer."[69] Then he admitted knowing that a $5,000 broker-dealer is not permitted to engage in proprietary trading, but denied knowing that SFI was a $5,000 broker-dealer.[70] Further, Respondent Bronfman testified that he believed SFI was doing more then ten proprietary risk transactions for its own account in a given year,[71] but then testified that he had "no idea" whether SFI engaged in risk principal transactions.[72]

Based on the foregoing testimony, their years in the securities industry,[73] the fact that they were the only municipal bond traders at SFI, and the extensive trading in the Smith Accounts, Complainant argues that Respondents should be held responsible for the violation of SFI's Restriction Agreement.[74] Complainant contends that Respondents' defense "is, at best, a claim of reckless or negligent failure to become apprised of the restrictions applicable to their work."[75]

The Panel disagrees. In essence, Complainant seeks to impose strict liability on Respondents because their conduct resulted in a violation of the Restriction Agreement. Complainant, however, provides no support for such a position and the Panel declines to impose such a standard. There is no

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69 Tr., 12/9/98 at 84.

70 Id.

71 Id. at 85-86.

72 Id. at 89.

73 Respondents each have approximately 30 years of experience in the securities industry. Tr., 12/8/98 at 173-174; 4/6/99 at 7.

74 Complainant's Br. at 13.

75 Id.

evidence that Respondents knew of the Restriction Agreement or that they were in a position to know of the Agreement. They were neither SFI officers nor supervisors. Respondents were municipal bond traders. They were not responsible for the Restriction Agreement nor can the Panel reasonably conclude that, as municipal bond traders, they should have known of its existence.

Based on the foregoing, and in the absence of any evidence that Respondents knew of the Restriction Agreement, the Hearing Panel finds that Complainant failed to meet its burden to prove that Respondents should be charged with causing SFI to violate its Restriction Agreement.

III. CONCLUSIONS OF LAW

A. Legal Discussion: MSRB Rule G-17

Complainant charged Respondents with violations of NASD Conduct Rules 2110, 2120, and MSRB Rule G-17. It did not charge Respondents with violating any specific MSRB Rule, including G-30, which is the Rule directed to the pricing of municipal securities.

Since this disciplinary proceeding involves transactions only in municipal securities, NASD Conduct Rules 2110 and 2120 are not applicable. NASD Rule 114 states "[t]he Rules shall not be construed to apply to * * * transactions in municipal securities." Thus, the only applicable Rule which Respondents' conduct is alleged to violate is G-17 which requires municipal securities dealers to deal fairly with all persons and not to engage in any deceptive, dishonest, or unfair practices. The question arises whether, as a matter of law, the violations alleged in the Complaint, can be predicated only on Rule G-17.[76] The Panel finds that they can.

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[76] The Hearing Officer's December 22, 1999 Order required the Parties to file supplemental briefs addressing this issue. The Order stated "[i]t is evident from the filings of the Parties and the evidence presented at the Hearing, that the transactions at issue only involve municipal bonds. Accordingly, NASD Conduct Rules 2110 and 2120 are inapplicable to Respondents' conduct. See NASD Rule 114." Complainant's Supplemental Brief ("CS Br.") was filed

Decisional law supports the conclusion that Rule G-17, standing alone, is sufficient to support the types of violations alleged in the Complaint. Rule G-17, which requires that dealers deal fairly with all persons, was intended to reach the type of conduct at issue here.[77] As the Association previously has found, Rule G-17, like Conduct Rule 2110, "seek[s] to discourage not only fraudulent conduct, but also conduct that is unfair or unethical * * *."[78] In fact, with respect to the charge of interpositioning and fictitious trading, there are no specific MSRB Rules which address such conduct. Thus, Rule G-17 clearly is the applicable Rule under which this conduct should be charged.[79]

Whether Respondents can be sanctioned for their conduct pursuant to Rule G-17 turns on whether they were given fair notice of the charges against them and had an opportunity to defend against those charges. Even though the Complaint never specifically alleged that Respondents charged fraudulent and excessive markups or engaged in unlawful interpositioning,[80] the Panel finds that

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on January 12, 2000. Respondents Supplemental Brief ("RS Br.") was filed on February 4, 2000. In its CS Br., Complainant does not dispute that the NASD Conduct Rules are inapplicable to this proceeding.

[77] See, e.g., District Bus. Conduct Comm. No. 7 v. Escalator Securities ("Escalator Securities"), 1997 NASD Discip. LEXIS 78, *16 (NBCC December 31, 1997); In re Investment Planning, Inc. ("Investment Planning"), Exchange Act Rel. No. 32687, 51 SEC 592, 1993 SEC LEXIS 1897 (July 28, 1993); In re DMR Securities, Inc., Exchange Act Rel. No. 16990, 47 SEC 350, 1980 SEC LEXIS 1071 (July 21, 1980). Unlike MSRB G-30, Rule G-17 does not require a finding of scienter. See, e.g., District Bus. Conduct Comm. No. 7 v. Northridge Capital Corp. ("Northridge"), 1995 NASD Discip. LEXIS 231, *19, 20 (NBCC May 24, 1995). See also In re Eliezer Gurfel ("Gurfel"), Exchange Act Rel. No. 41229, 1999 SEC LEXIS 640, *13 (March 30, 1999); In re Litwin Securities, Inc., Exchange Act Rel. No. 38673, 1997 SEC LEXIS 1146, *16 (May 27, 1997); District Bus. Conduct Comm. No. 2 v. Peters, 1998 NASD Discip. LEXIS 42, *7 (NAC November 13, 1998). Respondents' contention that a violation of an omnibus rule, such as Rule G-17, requires a showing that respondent acted with scienter (RS Br. at 10-11) simply is wrong as a matter of law. Indeed, the cases cited by Respondents do not stand for this proposition.

[78] Northridge, 1995 NASD Discip. LEXIS 231 at *19. Cases concerning the application of NASD Conduct Rule 2110 are relevant to an analysis under Rule G-17 because the two provisions are analogous and are interpreted and applied in a similar manner. As the Association stated in Northridge, "it is our understanding that the MSRB itself regards Rule G-17 as a counterpart to Article III, Section 1 of the NASD Rules, and looks to the case law which has construed the NASD provision for guidance in applying the MSRB counterpart." Id.

[79] See, e.g., District Business Conduct Comm. No. 12 v. Joseph A. Gallagher, Complaint No. NY-6028, 1989 NASD Discip. LEXIS 69, *4-5, 16 (Bd. of Govs., August 29, 1989).

[80] See ¶16 of Complaint.

Respondents were on notice that these were issues and the case was tried and defended on these charges.[81]

Respondents first addressed excessive markups and interpositioning in a Motion in Limine ("Limine Motion") filed on October 19, 1998. Respondents sought to exclude Complainant's pre-hearing Exhibit 14 captioned "Markup Calculations Based on Schedule A (C-10)." Respondents argued that there were "no specific allegations in the Complaint alleging violations of the Association's Markup Policy or of Rule 10b-5 based on markups."[82] Respondents contended that the first notice they had of a charge of improper markups and interpositioning was when Complainant filed its Pre-Hearing Submission on October 14, 1998.[83]

In opposing the Limine Motion, Complainant argued that Paragraph 16 of the Complaint gave sufficient notice that markups were at issue.[84] In further support of its position, Complainant relied on "Schedule A" to the Complaint, which details the trades during the last month of the review period.[85] Complainant further argued that any ambiguity respecting whether Respondents were charged with

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[81] There is no dispute that Respondents knew of the charge of fictitious trading since they entered into a stipulation admitting such conduct.

[82] Limine Motion at 1.

[83] Id. at 2.

[84] Complainant's Opposition To Motion In Limine Concerning Markups And Interpositioning, And Complainant's Motion In Limine Concerning Bronfman's Trading At A Prior Firm. ("Complainant's Opp.") at 2. Paragraph 16 of the Complaint provides, "[a]fter paying the premium to the Smith accounts, SFI typically charged markups to its subsequent purchasers. As a result, SFI's customers paid markups to SFI and (indirectly) premiums to the Smith accounts. However, the firm only disclosed the price the customer paid to SFI on the trade confirmations, not the premium the customer effectively paid to the Smith accounts."

[85] Complainant's Opp. at 3-4.

excessive markups was eliminated in August 1998 in Complainant's opposition to Respondents' Motion To Compel,[86] in which Complainant stated

> 'respondents engaged in a trading scheme in which they repeatedly * * * stepped-up the price not once, but twice, before selling the bonds to SFI's customers,' with the result that 'SFI's customers were charged well in excess of prevailing market prices.'[87]

As to the charge of interpositioning, Complainant conceded that the term was not used in the Complaint, but argued that the trading scheme detailed in the Complaint described interpositioning.[88]

Based on the arguments of the Parties, and relying on Paragraph 16 of the Complaint, the Hearing Officer found that the Complaint complied with Code of Procedure Rule 9212(a) and that Respondents had sufficient notice that markups were at issue.[89] The Hearing Officer also found that paragraphs 14-17 of the Complaint, whether read individually or collectively, alleged a trading scheme which described interpositioning since the Smith Accounts were inserted between the initial purchase of the bonds by SFI and the sales of those same bonds at a premium to SFI's retail customers.[90] The Hearing Officer concluded that that Complainant's Pre-Hearing Submission did not raise any new issues "which would unfairly expand the claims in this disciplinary proceeding beyond those charged in the

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[86] Among other things, Respondents' Motion requested that Complainant be required to enter into a stipulation that "'[a]ll municipal bonds sold to public customers through the Smith accounts were sold at or below then existing best market prices.'" See Complainant's Opp. at 3.

[87] Complainant's Opp. at 3-4.

[88] Complainant's Opp. at 2.

[89] See November 30, 1998 Order at 5. Further, the Hearing Officer noted that Paragraph 17 provided an example of the alleged unlawful trades evidencing markups.

[90] Id. at 6. In District Business Conduct Comm. No. 8 v. Johansen ("Johansen I"), Complaint No. C8A940047, 1996 NASD Discip. LEXIS 16, *35-36 (NBCC, January 5, 1996), the NBCC made a similar finding. Although interpositioning was not specifically charged in the complaint, the NBCC found that the pattern of trading activity described interpositioning. See also District Business Conduct Comm. No. 8. V. Johansen ("Johansen II"), 1997 NASD Discip. LEXIS 54, *18-23 (September 18, 1997)(on partial remand).

Complaint."[91] At the Hearing, Complainant offered evidence of excessive and fraudulent markups and Respondents vigorously defended against those charges.

Decisional law supports the conclusion that where, as here, Respondents were on notice of the charges at issue, the Hearing Panel is not precluded from finding that Respondents violated Rule G-17 by charging improper markups even in the absence of an alleged violation of the specific rule, G-30.[92]

The analysis of the NBCC in Euripides[93] is instructive. In Euripides, Respondent argued that he could not be sanctioned for unsuitable recommendations because the Complaint only charged a violation of Rule 2110 and did not allege a violation of Rule 2310, which specifically addresses unsuitability. The NBCC rejected this argument, finding that the allegations of the complaint provided respondent with sufficient notice that he was being charged with making unsuitable recommendations and that, given such notice, he could be sanctioned for making unsuitable recommendations under the general standards of conduct imposed by Rule 2110. The NBCC explained:

> We find that Euripides received the notice required by Rule 9212, The complaint signaled Euripides that his recommendations * * * were suspect. Euripides must have understood this allegation because he spent considerable energy attempting to persuade the DBCC that he had a reasonable basis for [his recommendations] * * *." The complaint also stated the provision which Euripides violated – Conduct Rule 2110. The complaint could also have alleged that Euripides' conduct violated Conduct Rule 2310. It is sufficient, however, that the complaint alleged a violation of Conduct Rule 2110 and that we analyze Euripides' conduct under the rubric of Conduct Rule 2110.[94]

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[91] November 30, 1998 Order at 5.

[92] See, e.g., In re Micah C. Douglas, Exchange Act Rel. No. 37865, 1996 SEC LEXIS 3008 (October 25, 1996) [sanctions imposed for failure to give notice of outside business activities charged under Rule 2110, not Rule 3040]; In re Martin J. Cunnane, Jr., Exchange Act Rel. No. 39242, 1997 SEC LEXIS 2167 (October 15, 1997)[sanctions imposed for unauthorized transactions charged under Rule 2110, not 2310]; Gurfel, 1999 SEC LEXIS 640 (March 30, 1999)[sanctions imposed for conversion charged under Rule 2110, not 2330].

[93] District Business Conduct Comm. No. 9 v. Michael R. Euripides ("Euripides"), No. C9B950014, 1997 NASD Discip. LEXIS 45, *11 (NBCC, July 28, 1997).

[94] Id. at 10-11.

Similarly, the Panel finds that Respondents received sufficient notice of the charges in this case. The Complaint "signaled" Respondents that their conduct in marking-up bonds and in interpositioning the Smith Accounts were at issue. Moreover, any ambiguity in this respect certainly was resolved well before the Hearing. The record demonstrates that Respondents understood the charges against which they were defending,[95] since they spent "considerable energy" attempting to convince the Panel that the prices charged SFI's customers were fair and reasonable.[96] Therefore, as in Euripides, the Panel finds that Respondents' conduct may be addressed under the general standards of Rule G-17.[97]

B. Excessive Markups/Interpositioning

Rule G-17 requires a dealer to deal fairly with customers and not to engage in deceptive, dishonest, or unfair practices. Inherent in this responsibility is that dealers charge fair prices in

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95 Although the Hearing Panel does not find that the Complaint was defective in failing to give Respondents notice of the charges against them, the SEC has stated "even if an administrative pleading is defective, the defect can be remedied if the record demonstrates that respondent understood the issue and was afforded a sufficient opportunity to justify his conduct with respect thereto." In re Thomas E. Warren, III, Exchange Act Rel. No. 33677, 1994 SEC LEXIS 508, *11 (February 24, 1994), citing In re James L. Owsley, Exchange Act Rel. No. 32491, 1993 SEC LEXIS 1525, *10 (June 18, 1993).

96 See, e.g., In re Daniel Joseph Avant, Exchange Act Rel. No. 36423, 1995 SEC LEXIS 2816, *5 (October 26, 1995). See also In re Larry Ira Klein, Exchange Act Rel. No. 37835, 1996 SEC LEXIS 2922, *24 (October 17, 1996); In re Joseph H. O'Brien II, Exchange Act Rel. No. 34105, 1994 SEC LEXIS 1562, *10-11 (May 25, 1994).

97 The Panel does not agree with Respondents' contention that the amendment to the First Cause to add a citation to Rule G-17 changed the theories of liability. RS Br. at 9-10. This issue already was decided by the Hearing Officer: "The amendment does not change either the nature of the allegations alleged or the theories of liability on which this disciplinary proceeding will proceed." See October 26, 1998 Order at 3. Further, at the time of the amendment, Respondents did not object or argue that it changed theories of liability.

transactions with their customers.[98] Accordingly, SFI violates Rule G-17 when retail customers are charged prices not reasonably related to the prevailing market price at the time of sale.[99]

Decisional law establishes that when a dealer is not a market maker, "in the absence of countervailing evidence, a dealer's contemporaneous cost [of acquiring the security] is the best evidence of current market."[100] This standard "recognizes that prices paid for a security by a dealer in actual transactions closely related in time to its sales are normally a highly reliable indication of prevailing market."[101] As noted by the Association, "[t]he Commission has looked to a dealer's purchase occurring within five business days either before or after the retail transaction at issue for determining contemporaneous costs."[102]

Further, recognizing that quotations often are the subject of negotiations, the SEC has noted that in thinly or inactively traded securities, such as municipal bonds, quotations may not accurately reflect

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98 See, e.g., Grandon v. Merrill Lynch & Co. ("Grandon"), 147 F.3d. 184, 189, 1998 U.S. App. LEXIS 13027,*12. (2d Cir. 1998); In re Zero-Coupon Securities ("Zero Coupon Securities"), Exchange Act Rel. No. 24368, 1987 SEC LEXIS 2005, *4 (1987).

99 Id. at 8. See also In re First Honolulu Securities, Inc. ("First Honolulu"), Exchange Act Rel. No. 32933, 51 SEC 685, 1993 SEC LEXIS 2422, *3 (Sept. 21, 1993); In re Alstead Dempsey & Co. ("Alstead Dempsey"), Exchange Act Rel. No. 20825, 47 S.E.C. 1034, 1984 SEC LEXIS 1847, *2 (April 5, 1984).

100 See, e.g., Escalator Securities, 1997 NASD Discip. LEXIS 78 at *19; First Honolulu, 1993 SEC LEXIS 2422 at *4; Zero-Coupon Securities, 1987 SEC LEXIS 2005 at *7; In re Nicholas Codisopti ("Codisopti"), Exchange Act Rel. No. 24926, 1987 SEC LEXIS 3593,*6-7 (Sept. 29, 1987). Respondents' contention that the '"contemporaneous cost' cases cited by DOE relate to equities which are different in scope, makeup and markup standards than municipal securities" is unavailing (Respondents' Reply at 1-2). The case law makes clear that the same considerations apply in determining contemporaneous costs and that the standards for determining appropriate markups are even stricter when applied to debt instruments.

101 First Honolulu, 1993 SEC LEXIS 2422 at *4; Codisopti, 1987 SEC LEXIS at *7 (1987) ("The burden is on the respondent to establish the contrary"). "Contemporaneous cost" has been defined to include "the retail market price that the dealer paid for the securities in actual transactions close in time to retail sales." Grandon, 147 F.3d. at 187, 1998 U.S. App. LEXIS 13027 at *3. See also In re DMR Securities, Inc., Exchange Act Rel. No. 16990, 47 SEC 350, 1980 SEC LEXIS 1071, *2-3 (July 21, 1980) ("[C]ontemporaneous cost is not limited to same-day cost. [T]he prices a broker-dealer pays must * * * be 'closely related in time' to the retail sales in question in order to constitute evidence of market price at the time of those sales.").

the prevailing market price for the security.[103] Accordingly, use of quotations, including published quotations in the "Blue List," has been viewed as an unvalidated "ask" price and not as a reliable basis for determining the actual price at which the securities will trade.[104]

Markups on debt instruments, including municipal securities, generally are expected to be lower than markups on equity securities[105] The SEC has stated that "although some markups on municipal bonds may reach 5%, that figure might be acceptable in only the most exceptional cases."[106]

Based on the contemporaneous costs of the bonds at issue, the prices charged to SFI's retail customers resulted in 174 transactions with excessive markups ranging from over 4% to over 8%.[107] Absent exceptional circumstances, this is well above any acceptable benchmark for markups on municipal bonds.[108]

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[102] Escalator Securities, 1997 NASD Discip. LEXIS 78 at *20; see also First Honolulu, 1993 SEC LEXIS 2422 at *9-10.

[103] First Honolulu, 1993 SEC LEXIS 2422 at *13 ("By their very nature, quotations only propose a transaction; they do not reflect the result of a completed arms-length sale. * * * ."); Zero-Coupon Securities, 1987 SEC LEXIS 2005 at *7. See also In re Network 1 Financial Securities, Inc. ("Network 1"), Exchange Act Rel. No. 34930, 1994 SEC LEXIS 3425, *7 (November 3, 1994)("[Q]uotations are not a reliable indication of market price * * *. [Q]uotations only propose a transaction."). In fact, Respondent Bronfman recognized that the pricing of municipal bonds is subject to negotiation and bargaining and that the bid and ask prices from a blue list or any other source are not evidence of actual trades. Tr., 12/9/98 at 49-50.

[104] First Honolulu, 1993 SEC LEXIS 2422 at *13. ("[S]ecurities with limited inter-dealer trading * * * often show wide spreads between bid and ask prices and are likely to be subject to negotiation.").

[105] Zero-Coupon Securities, 1987 SEC LEXIS 2005 at *4-5, 6, 11; First Honolulu, 1993 SEC LEXIS 2422 at *5, 8; see also Grandon, 147 F.3d at 191, 1998 U.S. App. LEXIS 13027 at *16-17; In re Horner & Associates ("Horner"), Exchange Act Rel. No. 30884, 50 SEC 1063, 1992 SEC LEXIS 1568, *4 (July 2, 1992), aff'd, 994 F.2d 61, 1993 U.S. App. LEXIS 11562 (2d Cir. 1993); Alstead Dempsey, 1984 SEC LEXIS at *6.

[106] First Honolulu, at *8; Investment Planning, 1993 SEC LEXIS 1897 at *9 (July 28, 1993)(the SEC found markups of 4% and above on various corporate bonds and municipal securities improper stating that such markups "represent extraordinary charges for ordinary transactions.") Id. at *4. See also Codisopti, 1987 SEC LEXIS 3593 at *4.

[107] This represents over 40% of the transactions which took place during the review period.

[108] Sheldon, 1992 SEC LEXIS 3052 at *45. In fact, Exhibit A to Respondents' Br. is instructive on acceptable markups for municipal bonds stating that easily traded bonds usually carry a markup from ½% to 3% and that bonds for which it may be harder to find a buyer, ***may*** justify a markup above 3%. Here, however, Respondents presented no

Contrary to Respondents' assertions, Complainant did not impose an arbitrary "brightline" for determining excessive markups.[109] Rather, Complainant met its burden of proving excessive markups by presenting evidence of the transactions at issue, the size of the transactions, the nature of the securities, the contemporaneous retail prices paid for acquisition of the bonds at issue, and the prices charged to the customers. Once Complainant presented evidence of excessive markups, the burden shifted to Respondents to refute this evidence and to justify the markups charged.[110]

Here, Respondents failed to present any credible countervailing evidence that other factors should be considered in evaluating the markups or that the Smith Accounts' acquisition costs were not a valid basis for calculating the markups.[111] Respondents failed to demonstrate that intervening market events caused the prices of the bonds to change markedly during the short time they were held in the Smith Accounts.[112] Respondents introduced no evidence of other transactions for purposes of establishing prevailing market prices different from the Smith Accounts' costs.[113]

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justification for markups in excess of 4%. There is no evidence of record that finding buyers was difficult. In fact, Respondent Smith testified to the contrary.

[109] Respondents' Br. at 19. Moreover, the cases cited herein demonstrate that the SEC has endorsed the use of threshold guidelines for determining acceptable markups with respect to municipal bonds.

[110] Sheldon, 1992 SEC LEXIS 3052 at *46; First Honolulu, 1993 SEC LEXIS 2422 at *14; In re Investment Planning, 1993 SEC LEXIS 1897 at *11 ("A pattern of high markups establishes a prima facie case of improper prices.").

[111] See Sheldon, 1992 SEC LEXIS 3052 at *46.

[112] See, e.g., Codisopti, 1987 SEC LEXIS 3593 at *3. Further Respondents cannot, as they attempt to do, justify the markups based on their contention that these were story bonds with an intrinsic risk of volatility. See Respondents' Br. at 17-18. As the SEC recognized in First Honolulu, "whatever the potential volatility of the securities at issue * * *, volatility cannot justify unfair markups. Just as Applicants were able to enjoy the chance that the bonds could increase in value * * *, they similarly accepted the risk of decrease in value. Applicants were not entitled to pass that risk on to its customers in the form of higher prices." 1993 SEC LEXIS 2422 at *16. See also Investment Planning, 1993 SEC LEXIS 1897 at *12-13; In re Crosby & Elkin, Inc., Exchange Act Rel. No. 17709; 47 SEC 526, 1981 SEC LEXIS 1655, *12 (April 13, 1981).

[113] The cases relied upon by Respondents for the proposition that "[t]ransactions involving small amounts of securities * * * carry greater markups," (Respondents' Br. at 20) are easily distinguishable from the facts presented

Respondents' trading scheme also constitutes unlawful interpositioning.[114] The Smith Accounts were interposed between SFI's customer accounts and the fair market price of the bonds resulting in the excessive markups.[115] Through interpositioning, Respondents exploited the ignorance of SFI's customers "'to exact unreasonable profits resulting from a price which bears no reasonable relation to the prevailing price.'"[116]

Respondents seek to distinguish SEC v. Ridenour,[117] relied upon by Complainant, by asserting that interpositioning exists only if a dealer, at the time it buys securities for a favored account, already has a customer order to purchase the securities.[118] They also seek to distinguish their activity by asserting that unlike the situation presented in In re Sheldon,[119] all transactions between the Smith Accounts and SFI were *bona fide* transactions and that Respondents were at risk since they did not have both sides of the trade in their possession at the time they purchased the bonds.[120]

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here. In MMAR Group, the NBCC made clear that its decision was limited to "the unique facts and circumstances of this case * * * ." 1996 NASD Discip. LEXIS 66 at *32. The NBCC found that the securities at issue, CMO's, were new to the industry and that the market for them was not yet established. Id. at *37. It also noted that all of the markups were less than 5% and the vast majority was less than 4% (id. at 36). The decision in In re Century Capital Corp., Exchange Act Rel. No. 32404, 51 SEC 486, 1993 SEC LEXIS 1291 (June 2, 1993), aff'd, 22 F.3d 1184 (D.C. Cir. 1994), relied upon by Respondents, actually supports the Panel's decision. The SEC affirmed the NASD's findings that the prices charged to customers were unfair and excessive. It simply noted that "a markup higher than 5% may be appropriate" when the sale concerns "penny stocks" (id. at *7).

114 Unlawful interpositioning is a violation of Rule G-17 since it constitutes an abrogation of a dealer's fundamental duty to treat customers fairly. See In re Protective Group Securities Corp. ("Protective Group Securities") , Exchange Act Rel. No. 34547, 51 SEC 1233, 1994 SEC LEXIS 2516, *17 (1994). See also Johansen II, 1997 NASD Discip. LEXIS 54 at *19.

115 See, e.g., Johansen I, 1996 NASD Discip. LEXIS 16 at 35-35; Johansen II, 1997 NASD Discip. LEXIS 54 at *17-23.

116 Id. at *19.

117 913 F.2d 515 (8th Cir. 1990). In Ridenour, respondent was charged with violating the federal securities laws by interposing his undisclosed personal account in bond transactions with his customers and his employer.

118 Respondents' Br. at 17-18.

119 1992 SEC LEXIS 3052.

The Panel rejects Respondents' narrow interpretation of what constitutes unlawful interpositioning. Here, as in Ridenour, SFI's customers were not informed that the Smith Accounts were interpositioned between purchase of the bonds by SFI and their purchases in order to enable Respondents to earn a profit.[121] And notwithstanding Respondents' position, unlawful interpositioning does not require "matched orders." It only requires that the purchase and sale transactions be closely related in time.[122] Here, as in Sheldon, the interpositioning of the Smith Accounts between the market and SFI's customers resulted in excessive markups.[123]

Respondents' role in controlling all aspects of trading of the bonds at issue resulted in SFI's customers being charged excessive markups. Accordingly, the Hearing Panel concludes that Respondents' conduct represents a high departure from the standards both the Association and the MSRB demand of their members. Accordingly, the Hearing Panel concludes that Respondents violated Rule G-17 by charging excessive markups and engaging in interpositioning.

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[120] Respondents' Br. at 18.

[121] See Ridenour, 913 F.2d at 516. In fact, Respondents' statement, that "Ridenour knew at the moment he received his customer's order that he would interpose his nominee account and promptly resell the bonds at a profit to a dealer at a higher price," (Respondents' Br. at 17) closely describes the trading scheme here. Respondent Smith testified that he knew at the time the Smith Accounts purchased the bonds from SFI that he could resell them and that "it's really hard to lose money." Tr., 4/6/99 at 54-55. For the same reason, Respondents' effort to distinguish their activity from that in In re Sheldon because "[t]he favored accounts were never at risk because they knew that the firm would be re-purchasing the bonds at an even higher price" (Respondents' Br. at 18) is equally unavailing. Rather, this description of the trading scheme in Sheldon accurately describes the situation here.

[122] See Sheldon, 1992 SEC LEXIS 3052 at *49.

[123] Id. The unlawful trading scheme here is analogous to that presented in Protective Group Securities, 1994 SEC LEXIS at *7, 16-17. There, the SEC, quoting the decision of the National Adjudicatory Council, stated that respondent '"skim[med] off the difference between the bid and ask prices, interposed as they were between [the selling customer] and the ultimate retail purchasers. They did so by buying [the] stock at the bid, then selling that stock first to the firm's inventory account at an increased price, and almost immediately thereafter, to retail customers at an even higher price.'" The SEC concluded that by "arranging transactions to allocate the benefit of [the] sales price [of the stock] to the firm and [the favored accounts] rather than to [the] retail customers, [respondent] violated the broker-dealer's fundamental duty to treat its customers fairly." Id. at 17.

C. Fictitious Trading and Creation Of False Books And Records

Implicit in the rule which requires members and associated persons to make and maintain various books and records, including order tickets and confirmations,[124] is the obligation that such documents be accurate and complete.[125] The SEC has noted that the need for accurate records is especially compelling for transactions for which there is no centralized real-time reporting, because the records maintained by the broker-dealer in such instances "are the principal means by which the regulatory authorities may reconstruct market activity."[126]

Conduct such as that at issue here – fictitious trades to transfer money and corresponding tax liability – violates the record-keeping requirements and such transactions should not be recorded as trades.[127] Respondents created and caused to be created books and records which were inaccurate since they did not, among other things, reflect that there was any connection between the trades at issue. Moreover, they "improperly reflected changes in beneficial ownership of [the] securities * * * , when in fact no change in beneficial ownership of the securities occurred."[128]

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[124] See SEC Rule 17a-3 and 17a-4, 17 C.F.R. §§ 240.17a-3, 240-17a-4. SEC Rule 17a was promulgated pursuant to Section 17(a) of the Securities Exchange Act, 15 U.S.C. § 78q(a).

[125] See, e.g., In re Goldman, Sachs & Co., ("Goldman Sachs") Exchange Act Rel. No. 33576, 1994 SEC LEXIS 302, *13-14 (February 3, 1994); In re Boston Stock Exchange, Inc., Exchange Act Rel. No. 17183, 1980 SEC LEXIS 615, *8-9 (October 1, 1980).

[126] Goldman, Sachs, 1994 SEC LEXIS at *16-17.

[127] See, e.g., id. at *10, n.9. Goldman, Sachs involved prearranged trading and the simultaneous purchase and sale of U.S. Treasury securities at different prices intended as a means to transfer funds and realize losses for income tax purposes. See also In re Wunsch, Exchange Act Rel. No. 8714, 44 SEC 95, 1969 SEC LEXIS 290, *4, 7 (October 7, 1969)("to facilitate and conceal these transactions, respondent caused the preparation of false * * * order tickets, confirmations and blotters which reflected the trades as normal trades * * * in the ordinary course of business, and which did not disclose the * * * interest of respondent."). Id. at *7.

[128] See Goldman Sachs at *15. See also In re Mozer, Litigation Release No. 13453, 1992 SEC LEXIS 3004 (December 2, 1992)(announcement of filing of complaint) and Exchange Act Release No. 34930, 1994 SEC LEXIS 2032 (July14, 1994)(order making findings). In Mozer, Respondent consented to findings and the imposition of a bar based on the

The Hearing Panel rejects Respondents' contention that since there was no impact on the market nor harm to any reporting system that this violation should be viewed as a "mere technical violation, *de minimis* in nature * * *."[129] This result would make a mockery of the policy underlying the record-keeping provisions which, among other things, "is to ensure that [the regulatory authorities have] access to certain basic information about securities transactions to allow [them] to police the markets subject to [their] jurisdiction and to protect investors."[130]

Accordingly, the Hearing Panel concludes that Respondents violated Rule G-17 by entering into fictitious trades and by creating and causing to be created books and records which falsely reflected those trades as *bona fide* transactions.

IV. SANCTIONS

A. Principal Considerations

The Sanction Guidelines ("Guidelines") list a number of principal considerations that adjudicators should consider in conjunction with the imposition of sanctions in addition to those which may be specified for particular violations.[131] In imposing sanctions, the Hearing Panel considered the seriousness of Respondents' misconduct, including their seemingly intentional disregard for their obligations to SFI's customers. The Hearing Panel also considered that the purpose of the Guidelines is

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SEC's allegations that he engaged in prearranged trading to create the appearance of losses for tax purposes and caused the creation of documents which falsely recorded such trades as *bona fide* market transactions.

[129] Respondents' Br. at 24.

[130] Goldman, Sachs, 1994 SEC LEXIS 302 at *14.

[131] Guidelines at 8-9. The Hearing Panel applied the relevant considerations set forth in the Guidelines for the specific violations as well as the general principals applicable to all sanction determinations (at 3-7) and the principle considerations adjudicators always should consider (at 8-9).

not punitive, but "designed to deter future misconduct and to improve overall business standards in the securities industry."[132]

Applying the Principal Considerations set forth in the Guidelines, the Hearing Panel considered the following as aggravating factors:

- Respondents engaged in an intentional and widespread pattern of misconduct over a period of time;[133]

- The public was directly and adversely affected because of the excessive and fraudulent markups charged by SFI as a result of Respondents' conduct;[134]

- Respondents were motivated by pecuniary gain;[135]

- Respondents made no attempt to pay restitution or otherwise to remedy their misconduct;[136]

- Respondents created or caused to be created false books and records to reflect their fictitious trades as *bona fide* transactions;[137]

- Respondents still have failed to accept responsibility for, or acknowledge, their misconduct;[138]

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[132] Guidelines at 3, ¶1.

[133] Principal Considerations ("PC") Nos. 8, 13.

[134] PC No. 11.

[135] PC No. 17. Over a six month period, Respondent Bronfman's profit was $73,516 and Respondent Smith's profit was $49,011. CX-12.

[136] PC No. 4.

[137] PC No. 10.

[138] PC No. 2. Notwithstanding Respondents' purported representations to the contrary (Respondents' Reply at 4), their testimony at the Hearing demonstrates that they still do not believe they did anything wrong, only that their attorney told them there was a better way to handle the transactions. Tr., 12/9/98 at 125, 130-131 (Bronfman: "Q: Are you changing your testimony as to whether as you sit here today you believe it was proper or improper conduct. A: I believe it was proper conduct."); 4/6/99 at 57 (Smith: "Q: As you sit here today, do you consider that this method of trading was appropriate." A: "On the advice of counsel, no. * * * And, personally I don't see anything wrong with it.").

- Respondents did not accept responsibility for or acknowledge their misconduct to NASD prior to detection;[139] and

- Respondents both have over thirty years' experience in the securities industry and, at a minimum, should have known that their conduct was violative of MSRB Rules.

By comparison, the Hearing Panel finds no mitigating factors present in this case. Notwithstanding Respondents' position to the contrary, the absence of prior disciplinary history is not a mitigating factor.[140]

The Hearing Panel also rejects as a mitigating factor the claim that Respondent Bronfman's prior trading experiences at member firm Nori Hennion justified Respondents' conduct at SFI.[141] Based on the evidence presented at the Hearing, the Panel finds that the arrangement Respondent Bronfman may have had with Nori Hennion is not similar to the situation here or that this type of trading arrangement ever was approved by the NASD.[142]

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[139] GP No. 2. The fact that Respondents disclosed their conduct during the investigation by NASD staff (see Respondents' Reply Br. at 5, n.6) is not a mitigating factor. See In re Balbirer, Complaint No. C07980011 at 5 (NAC October 18, 1999).

[140] Id. Originally, Respondents made no such representation as to Respondent Bronfman. See Respondents' Br. at 5. They state in their Reply Br at 5, n.6, however, that the Panel should "recognize that Responden***ts have no disciplinary history.*"** This statement is not true. In 1991, Respondent Bronfman agreed to accept a censure and fine of $5,000 for violating MSRB Rules G-17 and G-19. See CX-5. The Hearing Panel did not consider this an aggravating factor since it appears to be an isolated incident and was attenuated in time to the conduct at issue.

[141] Respondent Br. at 10, 18, 22, n.27. Respondent Bronfman testified that he had a similar trading arrangement while associated with Nori Hennion which was approved by the NASD. Tr., 12/8/98 at 217-218; 12/9/98 at 99-115, 141-142.

[142] Id. at 101-105. In fact, Respondent Bronfman contradicted himself with respect to whether there was an agreement between the NASD and Nori Hennion which allowed him to engage in this type of trading. Cf. Tr., 12/9/98 at 105 with 107-08. He first testified that the first two pages of RX-4 constituted an agreement between Nori Hennion and the NASD with respect to his trading. Id. at 103-104. Several minutes later, however, he testified that he could not recall whether any one told him it was such an agreement. Id. at 107-108.

B. Specific Sanctions

Excessive Markups

The applicable Guideline for excessive markups provides that adjudicators consider suspending the individual respondent for 30 business days and in egregious cases consider imposing a suspension for up to two years or barring the individual.[143] It also suggests the imposition of fines ranging from $5,000 to $100,000, plus the gross amount of the excessive markups if restitution is not ordered.[144] The Guideline lists the relevant principal consideration of "whether respondent had discretion as to the amount of markups, markdowns, or commissions on each trade."[145]

Respondents had complete discretion as to the amounts of the markups. They admittedly controlled the prices SFI paid to its customers for the bonds, the prices charged when SFI sold the bonds to the Smith Accounts, the prices (including markups) the Smith Accounts charged in reselling the bonds to SFI, and the prices (including markups) that SFI charged its customers when it resold the bonds.

Respondents engaged in serious misconduct. The charge of excessive markups is a serious breach of a registered representative's obligation to deal fairly with members of the investing public and, under the circumstances here, that obligation rested squarely on the shoulders of Respondents.[146]

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143 Guidelines at 82.

144 Id.

145 Id.

146 See, e.g., Codispoti, 1987 SEC LEXIS 3593 at *8. See also Investment Planning, 1993 SEC LEXIS 1897 at *17.

Under the circumstances of this case, the Hearing Panel finds that the following sanctions are appropriate for charging excessive markups in violation of Rule G-17: each Respondent is fined $25,000, required to requalify by examination in all capacities within sixty (60) days, and suspended in all capacities for sixty (60) days, such suspension to run concurrently with requalification.[147] Respondents, jointly and severally, are fined an additional $35,625.53[148] to eliminate the financial benefit to them from their violative conduct.

Fictitious Trading and Creation of False Books and Records

Respondents knowingly entered into and continued to engage in a fictitious trading scheme knowing that records reflecting transactions that never occurred were being generated and disseminated. Decisional law firmly establishes that fictitious trades violate the record-keeping requirements to maintain accurate books and records.

The most applicable Guideline for fictitious trading resulting in falsification of records[149] provides that, where mitigating factors exist, adjudicators should consider suspending the respondent in any or all capacities for up to two years and, in an egregious case, consider a bar. It also suggests fines ranging from $5,000 to $100,000. The Guideline lists the relevant principal consideration of the "nature of the documents forged or falsified."[150]

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[147] In the absence of a requalification requirement, the Panel would increase the suspension period.

[148] This amount represents those markups in excess of 4% ($27,404.26), excluding the two street trades, plus pre-judgment interest as of the date of the Hearing ($8,221.27). The Panel is imposing joint and several liability since there is no evidence of the individual financial benefit to each Respondent. Complainant did not make a sufficient showing to support restitution.

[149] See Guidelines at 35.

[150] Id.

The documents falsified, order tickets and trade confirmations, clearly are important. They are essential documents for record-keeping purposes since they permit member firms and the regulators to review market activity in order to protect investors. Further, Respondents knowingly allowed false records to be created in order to reflect the fictitious trades as *bona fide* transactions.

Accordingly, under the circumstances of this case, the Panel finds that the following are appropriate sanctions for the creation of false books and records in violation of Rule G-17: each Respondent is fined $10,000, required to requalify in all capacities by examination within sixty (60) days, and suspended in all capacities for sixty (60) days, such suspension to run concurrently with requalification.[151]

CONCLUSION

For excessive markups in violation of Rule G-17 each Respondent is fined $25,000, required to requalify in all capacities within sixty (60) days, and suspended for sixty (60) days, such suspension to run concurrently with requalification. In addition, Respondents, jointly and severally, are fined an additional $35,625.53.

For fictitious trading resulting in the creation of false books and records in violation of Rule G-17, each Respondent is fined $10,000, required to requalify in all capacities within sixty (60) days, and suspended for sixty (60) days, such suspension to run concurrently with requalification.

[151] These sanctions would be increased if the Panel had not already imposed a fine for other violations. Similarly, if liability and sanctions for the markup violations were not affirmed, Respondents still would be fined $35,625.53 representing the gains from their violative activity.

In summary, each Respondent is fined a total of $35,000, required to requalify by examination in all capacities within sixty (60) days, and suspended for 60 days,[152] such suspension to run concurrently with requalification. Further, Respondents, jointly and severally are fined an additional $35,625.53.

The costs of the Hearing, $2,628.10 ($1,878.10 for transcripts and $750.00 administrative fee) are assessed jointly and severally against both Respondents.

These sanctions shall become effective on a date determined by the Association, but no sooner than thirty (30) days from the date this decision becomes the final disciplinary action of the Association.[153]

Hearing Panel

By___________________
Ellen A. Efros
Hearing Officer

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Rory C. Flynn, Esq. (via first class and electronic mail)

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[152] The separate suspensions imposed for excessive markups and false books and records shall run concurrently and not consecutively.

[153] The Hearing Panel considered all the arguments of the Parties. They are rejected or sustained to the extent that are inconsistent or in accord with the findings herein.