BEFORE THE NATIONAL BUSINESS CONDUCT COMMITTEE

NASD REGULATION, INC.

In the Matter of District Business Conduct Committee For District No. 7, Complainant, vs. Escalator Securities, Inc. Tarpon Sprins, Florida and Howard A. Scala Escalator Securities, Inc. Tarpon Springs, Florida, Respondents.	DECISION Complaint No. C07930034 District No. 7 Dated: February 19, 1998

Escalator Securities, Inc. ("Escalator" or "the Firm") and Howard A. Scala ("Scala") have appealed the May 12, 1997 decision of the District Business Conduct Committee for District No. 7 ("DBCC") pursuant to Procedural Rule 9310. After a review of the entire record in this matter, we order Escalator to pay restitution to the public customers identified in the schedules to the complaint in the amount of $106,359.16, with interest at a rate of nine percent per annum or the rate set forth at 26 U.S.C. § 6621 (A)(2), whichever is less, commencing on July 16, 1992, and continuing until paid. Escalator is required to provide proof of payment to NASD Regulation District No. 7 staff; if Escalator cannot locate a customer, the Firm must provide proof that it has made a bona fide attempt to locate the customer. We further order that any amount of restitution not paid to customers shall be paid to NASD Regulation, Inc. ("NASD Regulation") in the form of a fine. We eliminate the interest requirement on any sums paid to NASD Regulation as a fine. The ordered restitution must be paid within six months of the date of this decision, and must be accompanied by a letter to each customer as described in the DBCC's decision of May 12, 1997. During this six-month period, NASD Regulation shall suspend installment payments of the

$50,000 fine imposed by the NBCC on March 2, 1995, and affirmed by the Securities and Exchange Commission ("SEC") in this matter on August 26, 1996.

Procedural Background. This matter is on appeal to us from the DBCC pursuant to a decision issued by the Securities and Exchange Commission ("SEC") on August 26, 1996, in which the SEC found that Escalator, acting through Scala, effected principal sales of 12 securities listed in the National Quotation Bureau, Inc.'s Pink Sheets ("Pink Sheets") and on the Over-the-Counter Bulletin Board ("OTCBB") (causes one and three) and principal sales of convertible subordinated debentures (cause two) to public customers at unfair and excessive prices in violation of Article III, Sections 1, 4, and 18 of the NASD Rules of Fair Practice (now Conduct Rules 2110, 2440, and 2120).

The SEC dismissed 13 of the NASD's findings of violation (10 in cause one and three in cause three) and reduced five mark-ups (causes one and three). The SEC also eliminated from the restitution requirement the excessive mark-ups on two transactions about which the NBCC made no findings and reduced the excessive mark-ups as to five transactions (four in cause one and one in cause three). The SEC affirmed the censure, $50,000 joint and several fine, and the bar against Scala in any principal, proprietary, or supervisory capacity. The SEC also barred Escalator from executing principal transactions in equity securities with retail customers, except for unsolicited liquidating transactions.

The SEC remanded the proceedings to NASD Regulation for the purpose of recalculating the amount of restitution and addressing the Firm's ability to pay. The SEC also found that it would be improper for NASD Regulation to add any amount of unpaid restitution to the joint and several fine imposed on Escalator and Scala, since the National Business Conduct Committee ("NBCC") imposed the restitution requirement only on Escalator, and not Scala. The decision states:

> In light of our determination to reduce the number of violative transactions, we remand the proceedings to the NASD for the purpose of recalculating the amount of restitution. We note that only the Firm was ordered to make restitution. However, any restitution that is not paid because a customer cannot be located is to be added to the fine, which is assessed jointly against Scala and Escalator. We believe it is improper to increase the amount of the fine, on which Scala is jointly liable, by any unpaid restitution, for which Escalator is solely liable. On remand, we direct the NASD to consider the remaining arguments that Escalator has made concerning restitution, as well as any evidence the Firm presents concerning the proper amount of restitution and the Firm's ability to pay.

In re Escalator Securities, Inc., Exchange Act Rel. No. 37601 at 14 (Aug. 26, 1996).

Background. Scala entered the securities industry in 1976 and formed Escalator in 1986. During the period relevant to the complaint, Scala was registered as a general securities principal. As a result of the NBCC's and SEC's findings in this matter, Scala is barred from associating with any member of the Association in any principal, proprietary, or supervisory capacity.

Discussion

Calculation of restitution. The DBCC recalculated the restitution award based on the SEC's dismissal of certain trades and its establishment of a higher prevailing market price for certain trades in causes one and three, and determined that respondents owed $106,359.16 in restitution. The DBCC determined that the excessive profits on reduced and dismissed trades amounted to $10,872.75 ($9,228 as to cause one and $1,644.75 as to cause two). The DBCC further reduced the restitution ordered by the NBCC by $2,700 (trades neither dismissed nor affirmed by the NBCC, including $595.99, an amount that staff could not reconcile). The DBCC made no change to the NBCC's award of restitution based on respondents' excessive mark-ups of trades in cause two.

Respondents did not dispute District No. 7 staff's recalculation of restitution as to causes one and three. Respondents did, however, dispute the NBCC's calculation of restitution as to cause two. Respondents contended that restitution should be limited to the Firm's actual profits. We find that this issue is not open on remand. We rely on the SEC's decision, in which the SEC specifically stated that it was remanding this matter to the NASD for the purpose of recalculating the amount of restitution "[i]n light of [its] determination to reduce the number of violative transactions." Escalator, supra, at 14. Further, the SEC affirmed the NBCC's findings as to cause two without change.

We will nevertheless address the issues raised by respondents in connection with cause two. Cause two concerns 18 retail sales of Semicon, Inc. ("Semicon") convertible subordinated debentures to public customers. On July 16, 1991, Escalator purchased 20,000 bonds from a retail customer at $5 per bond. On July 23, Escalator purchased 20,000 bonds from an account owned by Scala and his wife at $5.25 per bond. On August 9, the Firm purchased 15,000 bonds from a broker/dealer at $7 per bond. Starting on August 2, Escalator created a wholly artificial market for these bonds by cross-trading them between retail customers, buying at $28.50 and selling at $30 per bond. This market had no relationship to the prices at which other dealers were buying and selling the debentures in the inter-dealer market, in which the prices for Semicon bonds ranged from $2 to $5 per bond, with a few sales occurring at $8 and $10 per bond. The NBCC found that while the effect of Escalator's cross-trading was to give the Firm's selling customers an extraordinarily good price, thereby presumably giving them the impression that their investment had held its value, the Firm's buying customers were buying at an unnecessarily inflated price. The NBCC concluded that Escalator's mark-ups should have been based on inter-dealer transactions, and that the Firm's retail customers paid a total of $49,050 in excess mark-ups based on prevailing inter-dealer prices.

The SEC stated that "[a]lthough the Semicon market was illiquid, inter-dealer transactions were effected at prices ranging from $2.00 to $10.00, certainly not at the artificially-inflated $28.50 to $30.00 range at which the Firm was effecting retail transactions." Escalator, supra, at 11. The SEC affirmed the NBCC's finding that Escalator created its own market for the Semicon debentures, i.e., cross-traded between retail customers, buying at $28.50 and selling at $30 per bond. Scala made an initial retail purchase of the debentures at $5; Semicon was paying only

$6.25 to redeem the debentures, a fact of which Scala was aware. On one occasion, Escalator bought Semicon in the inter-dealer market at $7; other inter-dealer transactions were effected at prices ranging from $2 to $10 per bond. No inter-dealer transactions occurred at the "artificially-inflated" $28.50 to $30.00 range at which Escalator was effecting retail transactions. Escalator, supra, at 11. The SEC stated that "[a]pplicants' behavior demonstrate[d] a grave lack of understanding of their obligation to the Firm's retail customers to sell at a fair price." Id. at 12. The SEC described the Firm's pricing pattern in Semicon as "particularly questionable," and stated that the Firm had an obligation to its retail purchasers to sell them securities at prices reasonably related to the prevailing market price. Escalator, supra, at 11. Further, the SEC specifically rejected respondents' argument that Escalator should not be liable for restitution in excess of the amount that the Firm was enriched. Escalator, supra, at 14 n.36.[1]

We therefore reject respondents' argument that the NBCC wrongly ordered restitution of "phantom profits" as to cause two. Their argument that any restitution order should be limited to Escalator's actual profits on the Semicon bonds belies the true issue, i.e., the cost to the unsuspecting retail customer. Escalator chose to create an artificial market by buying at $28.50 per bond and selling at $30 per bond. The Firm's reasons for doing so are not articulated in the record. The retail customers who purchased 195,000 bonds from Escalator at $30 per bond should not bear the cost of Escalator's misconduct. These customers, had they paid prices that were reasonably related to the inter-dealer market, would have paid $49,050 less than Escalator charged them. We therefore find that the amount of Escalator's restitution as to the Semicon bonds was properly calculated at $49,050.

Ability to pay. We next address the issue of Escalator's ability to pay. In its decision, the SEC directed the NASD to consider evidence presented by Escalator concerning the Firm's ability to pay restitution. This request is consistent with the position that the SEC took in Toney Reed I , supra, in which the SEC remanded the proceedings to the NBCC to consider the individual

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[1] The SEC has repeatedly rejected this argument. See, e.g., In re Toney Reed, Exchange Act Rel. No. 37572 (Aug. 14, 1996) (hereinafter referred to as "Toney Reed I") (order for restitution properly may seek to restore customers' respective positions by returning to them the funds of which they were deprived); In re Hibbard, Brown & Company, Inc., Exchange Act Rel. No. 35476 (March 13, 1995). The SEC stated in Hibbard:

> As we have repeatedly held, restitution . . . prevents a wrongdoer from being unjustly enriched by his wrongdoing, or requires the wrongdoer to restore his victim to the status quo ante." An order for restitution may exceed the amount by which the wrongdoer was unjustly enriched, if equity would demand that the wrongdoer, rather than the customer, bear the loss. (Emphasis added; citations omitted).

Id. at 19-20.

respondent's ability to pay the order of restitution.[2] In In re Toney L. Reed, Exchange Act Rel. No. 39354 (Nov. 25, 1997) (Order Denying Request for Reconsideration) (hereinafter referred to as "Toney Reed II"), however, the SEC distinguished between considering an individual respondent's claim of bona fide inability to pay an award of restitution and a similar claim made by a broker/dealer. The SEC stated: "We have not considered whether a different analysis should apply where a broker-dealer (as opposed to an individual respondent) claims that it is not financially able to pay a restitution award." Thus, the SEC has not yet ruled on the issue of whether the NASD should consider a broker/dealer's claim of inability to pay.

In previous cases, the SEC has consistently held that the amount of a fine against a member firm does not have to be related to or limited by a firm's minimum required capital. Associated Securities, Inc. v. SEC, 283 F.2d 773, 775 (10th Cir. 1960) (personal injury to applicants is not of controlling importance as primary consideration must be given to the statutory intent to protect investors); In re First Heritage Investment Company, 51 S.E.C. 953 (1994) (fine affirmed as necessary to protect public interest notwithstanding any potential impact on the firm's capital); In re F.B. Horner & Associates, Inc., 50 S.E.C. 1063 (1992), aff'd, 994 F.2d 61 (2d Cir.) (per curiam) ($1 million fine need not be connected to or related to firm's $150,000 net capital); In re Matanky Securities Corp., 50 S.E.C. 823 (1991) (same). We note that the SEC did not explicitly overturn this line of cases in Toney Reed I and Toney Reed II. Because restitution involves the return of money to customers, as opposed to fines, which are paid to the NASD, this line of reasoning should apply a fortiori to restitution.

Reading this line of cases in conjunction with Toney Reed I and II, we conclude that: (1) although we must consider Escalator's claim of inability to pay in determining the amount of the restitution award and the conditions under which the Firm must pay such an award, the impact of a restitution award on the Firm's capital cannot be the controlling factor in determining the amount of restitution to be awarded to public customers; (2) NASD Regulation's duty to protect public investors is of paramount importance; and (3) a fine that otherwise appropriately sanctions a firm's violative conduct, or an order of disgorgement that forces the violator firm to give up the amount by which it was unjustly enriched may not be limited by claims that the payment will cause the firm to be in noncompliance with its net capital requirement, or to close its doors. Because of the overriding public interest, member firms should be appropriately sanctioned based on their violative conduct, and not merely on the projected effect of the monetary sanction on the firm's balance sheet.

In sum, reading these cases together, we hold Escalator to a very high standard of proof, i.e., the Firm must be required to demonstrate that the fine or award is so large in relation to its

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[2] The SEC questioned in Toney Reed I whether the NASD "might wish to consider moderating the financial impact of restitution awards [on member firms] by making available a program similar to the installment payment program for payment of disciplinary decisions." Id. at 4 n.11. We note that even if the NASD established a payment installment program for restitution awards, a firm would be obligated to charge the entire award against capital, and this charge would be reduced only as payments were actually made to customers.

actual capital that it is unable to obtain the additional capital to pay the fine or award by, among other things, reducing expenses and salaries, raising capital, and/or borrowing money.

In the instant matter, the SEC specifically requested the NASD to consider any evidence presented by Escalator concerning the Firm's ability to pay. Escalator, supra, at 14. Applying these principles, we have considered respondents' evidence in support of their contention that Escalator is unable to pay the restitution award, and we have concluded that the Firm has not proved its inability to pay. At the outset, we have considered that Escalator has a minimum net capital requirement of $5,000, but that the Firm reported net capital of approximately $40,000 in January 1997.[3] For the periods ended February 28 and May 31, 1997, Escalator reported on its balance sheet current assets of $61,273.35 and $61,985.19, respectively. Escalator reported total equity of $26,994.22 as of May 31, 1997. Respondents complained of an aggregate loss of $177,275.54 as of February 28, 1997, and $209,288.78 as of May 31, 1997. For the 11 months ended May 31, 1997, however, Escalator paid Scala a total of $139,749.94 in salary. We note that in May 1997, Scala did not draw a salary. As a result, the Firm reported net income of approximately $4,000 instead of a loss in that month.

Escalator began as a broker/dealer in 1986 with $1,000 in capital stock. Since then, the Firm has received additional paid in capital of approximately $865,000. Scala testified that Escalator raised $250,000 in a private placement of common stock in 1986, and $350,000 in 1987 in the form of 10 percent convertible notes due June 1, 1997. Although respondents argued to the DBCC that the bondholders would suffer if the Firm were forced to pay restitution, 37 of the 40 bondholders have accepted Escalator common stock in return for their bonds, leaving only $35,000 of the original $350,000 outstanding.[4] At present, Escalator's only liability is money owed to the NASD in the form of accrued fines ($35,896.70 as of May 31, 1997), which Escalator is paying in installments of $1,270 per month.

We find that Escalator has made certain choices, and continues to make choices, that would make the Firm appear less able to pay the ordered restitution. We have already discussed the Firm's decision to pay Scala a salary that causes the Firm to operate at a deficit. We also note that Escalator has made no effort to set aside funds in contemplation of paying restitution since

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[3] We do not believe that it is the SEC's intent to peg ability to pay on a broker/dealer's minimum capital requirement. A determination of ability to pay based solely on a firm's minimum capital requirement would mean that both the SEC and NASD Regulation would be precluded from imposing any monetary sanction on a broker/dealer in excess of its minimum capital requirement, thereby precluding them from effectuating the deterrence objective of appropriate sanctions. See First Jersey Securities Inc. v. SEC, 101 F.2d 1450 (2d Cir. 1996), cert. denied, 65 USLW 2440 (Oct. 6, 1997) (affirming disgorgement order of approximately $22 million, comprising First Jersey's unlawful profits, plus interest of approximately $53 million).

[4] Scala testified that the original conversion rate was $10 per share, but that the Firm exchanged the bonds for common stock at a rate of $1 per share, thereby diluting his ownership of the Firm. He stated that, as a result, he was no longer the majority shareholder of Escalator.

the NBCC's original decision was issued in March 1995 or since the SEC's decision in August 1996. Further, Escalator has made no plan, and seems to be contemplating no plan, to seek additional capital or to negotiate a subordinated loan. Since the respondents have not demonstrated that the amount of restitution ordered in this matter is so large that the Firm is unable to raise sufficient funds to satisfy the award by raising additional capital and/or by cutting expenses, we find that respondents have not demonstrated Escalator's inability to pay $106,359.16 in restitution.[5]

Sanctions. We order Escalator to pay restitution to the public customers identified in the schedules to the complaint in the amount of $106,359.16, with interest at a rate of nine percent per annum or the rate set forth at 26 U.S.C. § 6621(A)(2), whichever is less, commencing on July 16, 1992, and continuing until paid. Escalator is required to provide proof of payment to NASD Regulation District No. 7 staff; if Escalator cannot locate a customer, the Firm must provide proof that it has made a bona fide attempt to locate the customer. Each payment shall be accompanied by a letter that explains the reason for the payment, in the form that is attached to the DBCC's May 12, 1997 decision.

We further order that any amount of restitution not paid to customers shall be paid to NASD Regulation by Escalator in the form of a fine. Escalator shall not, however, be charged interest on such amounts. We have considered Escalator's argument that converting such sums to a fine contravenes the SEC's determination that it would be improper to convert restitution owed solely by Escalator into a joint and several fine against Escalator and Scala. By causing Escalator to pay as a fine any sums not paid in restitution, we are imposing a monetary sanction on the Firm alone, and not Scala. We believe that this modification adequately addresses the SEC's concerns.

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[5] We deny respondents' request that NBCC Subcommittee member Robert L. Clark be recused from this matter on the ground that he has been a member of other NBCC subcommittees that have considered other NASD complaints against respondents. We have considered that Mr. Clark served on the NBCC subcommittee that considered this case originally on appeal from the DBCC in 1995 and is therefore familiar with the substantial record in this matter. For this reason, like other adjudicatory fora such as courts and the SEC, NASD Regulation assigns cases on remand to the original panelists, unless not available. Further, respondents have presented no evidence whatsoever of any bias on the part of Mr. Clark. They have based their request solely upon a presumed appearance of impropriety.

We note that we too have knowledge of and have considered earlier as well as subsequent disciplinary matters brought by the NASD against respondents. We, like the SEC, consider other disciplinary actions against respondents only as they pertain to a determination of sanctions. See, e.g., Escalator, supra at 14 (NASD sanctions found neither to be excessive nor oppressive in light of the fact that respondents have twice been disciplined for similar misconduct and have demonstrated a complete lack of familiarity with their obligation to price securities fairly). Further, we are reviewing this case only as to the recalculation of restitution and Escalator's ability to pay.

Notwithstanding our finding that Escalator has not demonstrated its inability to pay the restitution award, we find that it is appropriate to modify the terms of the DBCC's decision in order to give Escalator additional time in which to make appropriate arrangements to pay the award. Therefore, we order that Escalator be given six months (in lieu of the 90 days ordered by the DBCC) to complete the restitution payments. We also order that installment payments of any NASD Regulation fines be suspended during this six months. These modifications are consistent with the SEC's suggestion in Toney Reed I that the NASD consider steps that would moderate the financial impact of restitution. Id. at 4-5 n.11. We also affirm the assessment of costs of the initial DBCC proceeding in the amount of $1,248.70.[6]

On Behalf of the National Business Conduct Committee,

Joan C. Conley, Corporate Secretary

[6] The sanctions are consistent with the Guideline for mark-up violations. See NASD Sanctions Guidelines (1993 ed.) at 28.

We have considered all of the arguments of the parties. They are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed herein.

Pursuant to NASD Procedural Rule 8320, any member who fails to pay any fine, costs, or other monetary sanction imposed in this decision, after seven days' notice in writing, will summarily be suspended or expelled from membership for non-payment. Similarly, the registration of any person associated with a member who fails to pay any fine, costs, or other monetary sanction, after seven days' notice in writing, will summarily be revoked for non-payment.

Direct: (202) 728-8381
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Joan C. Conley
Corporate Secretary

February 19, 1998

VIA FIRST-CLASS/CERTIFIED
RETURN RECEIPT REQUESTED

Howard A. Scala
Escalator Securities, Inc.
Tarpon Springs, Florida

Re: Complaint No. C0790034: Escalator Securities, Inc. and Howard A. Scala

Dear Respondents:

Enclosed herewith is the Decision of the National Business Conduct Committee in connection with the above-referenced matter. Any fine and costs assessed should be made payable and remitted to the National Association of Securities Dealers, Inc., Department #0651, Washington, D.C. 20073-0651.

You may appeal this decision to the U.S. Securities and Exchange Commission ("SEC"). To do so, you must file an application with the Commission within thirty days of your receipt of this decision. A copy of this application must be sent to the NASD Regulation, Inc. ("NASD Regulation") Office of General Counsel as must copies of all documents filed with the SEC. Any documents provided to the SEC via fax or overnight mail should also be provided to NASD Regulation by similar means.

Your application must identify the NASD Regulation case number, and set forth in summary form a brief statement of alleged errors in the determination and supporting reasons therefor. You must include an address where you may be served and phone number where you may be reached during business hours. If your address or phone number changes, you must advise the SEC and NASD Regulation. If you are represented by an attorney, he or she must file a notice of appearance.

The address of the SEC is:
Office of the Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W., Stop 6-9
Washington, D.C. 20549

The address of NASD Regulation is:
Office of General Counsel
NASD Regulation, Inc.
1735 K Street, N.W.
Washington, D.C. 20006

Questions regarding the appeal process may be directed to the Office of the Secretary at the SEC. The phone number of that office is 202-942-7070.

Very truly yours,

Joan C. Conley
Corporate Secretary

Enclosure

cc:W. Brice LaHue, Esq.
(NASD Regulation, Inc. - District No. 7)

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