ADMINISTRATIVE PROCEEDING
FILE NO. 3-5255

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	:
CHARLES MICHAEL WEST	:
	:

INITIAL DECISION

Sidney Ullman
Administrative Law Judge

Washington, D.C.
March 6, 1978

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APPEARANCES: Jane H. Heitman, of the Commission's Atlanta Regional Office, for the Division of Enforcement: Joseph L. Grant, of the Atlanta Regional Office, and Ms. Heitman, on the Division's Post-hearing Documents.

C. Thomas Cates, of Burch, Porter & Johnson, for Charles Michael West

BEFORE: Sidney Ullman, Administrative Law Judge

In these public proceedings instituted by order of the Commission ("Order") pursuant to Section 15(b) of the Securities Exchange Act ("Exchange Act") the issues for determination are whether Charles Michael West ("respondent" or "West") engaged in misconduct in transactions in municipal bonds as alleged by the Division of Enforcement ("Division"), and, if so, what if any remedial action is appropriate in the public interest.

The allegations of the Order relate to a period of approximately 15 months, from October 1974 through December 1975, during which time respondent was a salesman of municipal bonds for Shelby Bond Service Corporation ("Shelby"), a now defunct municipal bond dealer in Memphis, Tennessee.

The Division charges that West wilfully violated the antifraud provisions of the securities laws, i.e. Section 17(a) of the Securities Act of 1933 ("Securities Act") and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder: 1/

1/ The composite effect of the antifraud provisions, as applicable to this proceeding, is to make unlawful the use of the mails or facilities of interstate commerce in connection with the offer or sale of any security by means of a device to defraud, an untrue or misleading statement of a material fact or a failure to state such fact where necessary, or any act, practice or course of business which would operate as a fraud or deceit upon a customer, or by means of any other manipulative or fraudulent device.

also that on May 20, 1977, the United States District Court for the Western District of Tennessee entered an order by consent permanently enjoining West from further violations of the antifraud provisions. Respondent's answer admitted the entry of the injunction but denied the violations of the antifraud provisions.

Following a hearing in Memphis, counsel representing the respective parties filed proposed findings of fact, conclusions of law and supporting briefs, and counsel for the Division filed a reply brief. In his post-hearing filing West concedes some of the violations but contends that no sanction of bar or suspension from association with a broker-dealer is necessary in the public interest or for the protection of investors. The findings and conclusions herein are based on the record, including the post-hearing documents, and on observation of the demeanor of the witnesses.

The Respondent

West is a resident of Memphis, whose formal education ended with high school graduation in 1965. Thereafter, he was employed as a dispatcher in the cement business and then as a driver for several truck lines. In March 1973 he answered a newspaper advertisement offering a sales career, and he was employed as a municipal securities salesman by Lawyers Investment Service, a now defunct municipal secur-

ities broker-dealer in Memphis. This employment ended in mid-1974, when he left for similar work in Memphis at Sellers Investment. Three months later Sellers closed and West became employed in September or October 1974 by Shelby in the same capacity. He left when Shelby closed in December 1975.

West testified that during 21 months of employment as salesman for Lawyers Investment and Sellers Investment he received no training other than his practical experience in transactions in municipal securities and what he learned from the review of a book for "the Tennessee Law Examination" and a book described as Fundamentals of Municipal Bonds. He was licensed by the State of Tennessee to sell municipal bonds, no Federal license requirements being applicable at that time.2/ His training at Shelby apparently consisted

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2/ In 1975 Congress amended the Exchange Act by adding Section 15B, effective June 4, 1975, treating with a requirement for registration of municipal security dealers and the establishment of a Municipal Securities Rulemaking Board to propose and adopt rules with respect to transactions in municipal securities by brokers and dealers and municipal securities dealers. 15U.S.C.A. Section 78-0-4, CCH Bulletin No. 74, 6-4-75.

There is no question but that transactions in municipal securities always have been subject to the antifraud provisions of the Federal securities laws. Securities and Exchange Commission v. Charles A. Morris & Assoc., Inc., 386 F. Supp. 1327 (U.S.D.C., W.D. Tennessee, 1973); Doty & Petersen, The Federal Securities Laws and Transactions in Municipal Securities, 71 Northwestern University Law Review, No. 3, 1976; Walston & Co. Inc., 43 S.E.C. 508 (1967).

of the practical experience of selling, buying, and exchanging municipal bonds with and for customers, including other dealers, as well as discussion with and advice from other salesmen and the owners or management of Shelby on how to sell bonds, how to price bonds, and how to deal with customers in exchanging one issue of bonds for another. These activities by West are discussed below. Following the closing of Shelby in December 1975, West became employed by Carty & Company, of Memphis, a member firm of the National Association of Securities Dealers (NASD), to sell municipal bonds, and he was so employed at the time of the hearing.

The Fraud Charges

As indicated above, the charges against West relate to his activity at Shelby during the period October 1974 through December 1975. The Division asserts that he violated the antifraud provisions in offering, selling and purchasing municipal bonds (sometimes in "exchange" transactions for bonds previously sold by him). It is clear from the evidence that Shelby was conducting a boiler-room type operation during the 15-month period of West's employment, and that West was an integral part of that operation. The "cold canvassing" technique employed in soliciting purchases by telephoning persons unknown to him was exacerbated by West's persistence in repeated telephone calls with pressure on customers. He

knew nothing and apparently cared little about the underlying value of bonds which he offered and sold, and had no proper regard for the duty he owed customers, including at least two who expressed or showed their lack of sophistication in securities transactions and indicated that their trust and confidence was placed in him. The selling practices also included, as charged by the Division, egregiously excessive mark-ups in the price of bonds.

West was the "top man" of the 14 salesmen who were employed by Shelby at various times during the year 1975. In addition to small amounts he received as awards in sales contests, he was paid approximately $30,000 in commissions and received one payment on his automobile. He testified that he also earned in commissions but was never paid $8,000 additionally. The lack of proper training and direction of salesmen by Shelby's three principal officers, the excessive mark-ups discussed,infra, and the disrespect for a customer's financial health in the transactions are among the indicia of Shelby's boiler-room type activity. Also of significance are the material misrepresentations of the value of bonds sold by West, and the omissions to state material facts concerning the financial instability of the issuers. Furthermore, Max Baer the president of Shelby, is asserted to have posted on a blackboard used by the salesmen, false

purchase prices of bonds, but West testified that he did not know this until Shelby had closed. 3/ West also testified that at the time he engaged in exchanges of bonds with customers (actually purchase and sale transactions simultaneously executed) he thought they were for the benefit of both the customer and Shelby. He conceded in testimony, however, that the transactions were for the benefit of Shelby only, but asserted that he did not know this because of his inadequate knowledge of the value of the respective bonds being exchanged. But the evidence does not support his suggestion that he was trying to serve the customers' interests. The use of the above techniques in the sale of bonds of doubtful value despite their tax-free aspects clearly reflects the boiler-room activity of the firm. West's participation therein is discussed below in some detail.

The Investor Witnesses

The Division presented two investor witnesses who testified re-

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3/ West testified that Baer also orally stated falsely the prices Shelby paid for some bonds. At Tr. 210 he stated:

> "Unless you bought the bonds yourself, you never really knew how they owned the bonds. They would tell you they owned the bonds at "x" number of dollars, but in more than one situation . . . that we sold bonds, like these I sold from 60 to 65, ultimately the purchase ticket shows up and we own the bonds at 47 cents [on the dollar]. I don't know whether the corporation made the difference between 47 and 60, or Mr. Baer, or who made the money.

West stated that he learned of this only after his employment at Shelby. One of the burdens of his complaint was that he thus earned less commission on these sales than was actually due him.

The scope of West's statement is not credited, particularly in light of the testimony of Shelby's trader that he often posted purchase prices on a blackboard or provided the information to salesmen by announcement or other means. Moreover, the purchase tickets must have shown up during West's employment.

garding transactions with West.

Dr. B., a medical doctor of foreign extraction, testified that on November 5, 1975 he received a third or fourth telephone call from West. In each prior call he had refused to buy bonds. He had never known or heard of either Shelby or West. This call related to a municipal bond then owned by the doctor. West stated that he had "a good utility bond", which he recommended the doctor take as a "good exchange" for the doctor's bond, and he offered to pay $504 in addition. The doctor's bond was a $5,000 face amount Anderson County, Tennessee, Industrial Development Revenue Bond, with Commercial Envelope Company as lessee of a building ("Anderson County" bond). Revenues from the lease were required for payment of the 7.75% annual interest and for the principal due on 10/1/89. The bond was then, and had been since the purchase at par by Dr. B. in 1971, current in payment of interest.

In this call West stated that since his bond -- of Washington County Utility District, Tennessee (WCUD), was a utility bond, it was more secure than Dr. B.'s industrial revenue bond. He also said that the $504 was offered because the utility bond would mature ten years later than the doctor's bond.

Dr. B. was persuaded to make the exchange and sent his bond to Shelby, but received no bond or cash as agreed. Thereafter, he was unable to reach West on the telephone, he eventually wrote a letter to Shelby, and on January 9, 1976 (two months after the exchange), he received a letter from Max Baer promising to deliver the bond within 14 days. In March, 1976, after Dr. B. had contacted a lawyer, Max Baer delivered the bond(s) and a check for $500.

Dr. B. was told nothing by West about the financial condition of the Washington County Utility District and received no written material on it. He testified that he " . . . put his faith in [West's] word and did not check into it. Again, I am not experienced in this area, and I didn't know what to look for either." The issuer defaulted on the next interest payment and Dr. B. received no interest payments. (Both bond issues, the Anderson County and WCUD, went "flat" or in default. At least Dr. B., an extremely unsophisticated investor, received $500 in the exchange).

West failed to inform the doctor (1) that the Washington County Utility District was not in compliance with state laws requiring the filing of annual audited financial statements,[4/] (2) that as of the date of the transaction the

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4/ Official notice was taken of Chapter 248 of Tennessee Acts, 1937, requiring annual filings of such documents. Cf. Division Exhibit 1, p. 1.
The C.P.A. who filed an audit report on the Utility District on January 17, 1975 for fiscal years ending June 30, 1973 and 1974 refused certification of financial statements because of inadequacy of the District's records in several respects. Among other deficiencies noted in the report is the use of funds received from a bond issue for one operation, (e.g., for the Utility's garbage division,
(CONTINUED)

Utility District had made no provision for amortization of bond expense and was unable to comply with sinking fund requirements, (3) that West had been unable to obtain any financial information from officials of the Utility District over the course of a long period of time prior to his recommendation of the bond exchange to Dr. B., although he had much earlier been promised such information by the Utility District's operations manager. West testified about his unsuccessful efforts to obtain information on the Utility District's finances over a long period prior to transactions in its bonds with Dr. B. and others. 5/ Nevertheless, he pressured the doctor into the transaction. Further discussion of several WCUD bond transactions by West occurs, infra, in connection with sales at excessive mark-ups over contemporaneous costs in West's purchase of such bonds for the Shelby

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Footnote #4 continued

4/ for interest payments for another of the Utility's bond issues such as its CATV operation). This report, with the critical comments noted herein and others, was on file with the Comptroller of Tennessee as of January 17, 1975. West never saw it.

On the dates of the audits for 1973 and 1974, the Utility District's liabilities exceeded its assets by substantial amounts. Div. Ex. 1.

5/ The operating manager of the Utility District promised to send financial statements but never did. The most that West received from him was an oral statement that "everything was fine at Washington County", obviously an inadequate basis for West's representations and sales.

firm on November 5, 1975, the same day on which his transaction with Dr. B. was made.

West's misrepresentations of value and the omissions discussed above were of material facts and constituted willful violations of the antifraud provisions under the authorities discussed, infra.

The second investor witness for the Division, Mr. H.W., has been part owner of a casket manufacturing company in Loretto, Tennessee, since 1949. Respondent learned that H.W. wanted to buy bonds of the Scott Memorial Hospital and telephoned him. The bonds were purchased by H.W.

Thereafter, West called H.W. on several occasions in an effort to sell bonds of the Gallaway Industrial Development Board of Gallaway, Tennessee, ("Gallaway bonds"), issued in connection with the establishment of Precision Optical Laboratory, Inc. ("Precision"), as lessee. H.W. testified that West was persistent and kept calling him until he "finally gave in." On November 26, 1974, H.W. bought $20,000 face value of these bonds at par, as an initial purchase.

H.W. testified that West had described the bonds as having a 9% yield; they were "the best thing going in a bond issue"; that some 50 leading doctors were already obligated to do business with Precision; that the bonds would sell at a premium; that West would see to it that H.W. made money on them; and that if H.W. wanted to turn them back, West would make money on the bonds for him.

The issue was $315,000, 9% first mortgage revenue obligations for the land acquisition and construction of a plant for Precision, with funds for the interest and principal to be derived solely from payments to be received on the Precision lease. The bonds were serial in form, and those received by H.W. matured on 11/1/77 and 11/1/78. The following week H.W. bought from West another $5,000 bond of the same issue, with maturity date of 11/1/81, at 99% of par.

The exhibits and testimony indicate that on July 29 and August 2, 1975, possibly after H.W. expressed concern about the bonds, respondent took from H.W. $10,000 face amount of the bonds with maturity of 11/1/77 in exchange for $10,000 of the same issue with maturity of 11/1/82, and $5,000 face amount due 11/1/78 for $5,000 due 11/1/84. Div. Exs. 8-11. The witness received from West $100 for each $5,000 of bonds thus exchanged. H.W. believed that these exchanges were made when he reminded West of his earlier assurances that the purchases would be profitable and that he could get back his money with a profit whenever he wanted. He testified that West became vague and suggested the exchanges, stating that " ... he had some people that wanted the quicker maturity bonds. That he would get me $100 a piece to exchange them with them, and we exchanged four of them". 6/ (underscoring supplied).

6/ Division Exhibits 8 through 11 appear to indicate the exchange of $15,000 face value of the bonds rather than the $20,000 suggested by H.W. testimony.

H.W. also testified that thereafter, shortly prior to September 18, 1975, West called and said " . . . . he had a good buddy that was in income tax trouble and he had to get rid of some bonds. And he called me every day for about a week. He started out wanting par, and he come on down, and . . . he sold them to me for 92 cents [on the dollar]". These, also, were Gallaway bonds of the same issue.

It is not clear when H.W. became concerned about the bonds. It is clear that the paying agent advised by letter received by H.W. through his bank that the trust fund would lack sufficient funds for future interest payments. On receipt of this letter H.W. telephoned West, who asked that the letter be sent to him. The letter was sent, but H.W. heard nothing from West. Respondent admitted having received from H.W. a letter which indicated that the terms of the bond indenture had been violated because insufficient funds had been received. Neither H.W. nor West knew when the letter was transmitted and West no longer had it. H.W.'s confusion and lapse of memory are understandable, and although they were not confined to the timing of this particular letter, his testimony is credited as substantially accurate on the significant issues under consideration and discussion herein. H.W. still owns $40,000 face value Gallaway bonds, which are in default in principal and interest.

West's lack of concern for the financial welfare of this customer, to whom he'd continued to sell Gallaway bonds while Precision was losing money, is evidenced by his stated reliance on the vague and imprecise generalization of Max Baer, who was president of Precision (as well as Shelby), to the effect that the company was "doing fine". No financial statements and no detailed information on company business were received by respondent. However, the testimony and audit reports of H.B. Brock, Jr., a C.P.A. who performed accounting services for Precision, reflect that for the respective periods of three months ending March 31, 1975, six months ending June 30, 1975, and seven months ending July 31, 1975, Precision had total net losses of $25,645, $55,094 and $77,364. It was approximately during this period that West engaged in the exchange transactions in Gallaway bonds with H.W. And the sale on September 18, 1975 to H.W. of $15,000 tax free 9% bonds at the lower or reduced figure of 92% of par for his "buddy" suggests that West knew or suspected that Precision was not doing well. Precision had sustained losses in all audited periods since it commenced business in January 1975. Baer had received copies of Mr. Brock's financial statements and thus knew the firm's financial condition.7/

7/ West testified that he asked for statements but "Nobody at Precision Optical would give me anything without [Baer's] okay. All I could get from Baer was that everything was fine . . . . " Assuming that he made such requests and efforts, he should have been suspicious and of course should have refrained from selling the bonds.

H.W. also had purchased from respondent on April 4, 1975, $15,000 face amount of Anderson County bonds bearing interest of 7.75%, due 10-1-85. 8/ The price paid by H.W. was 75% of par. He testified that West represented to him, at the time of the transaction and in response to his question, that the Commerical Paper Company branch which was lessee of the Anderson County property was a part of the Commercial Paper Company in New York, and that the bond issue was secured by the New York company. H.W. learned thereafter that this was not a fact: the parent company in New York had no obligation on the bonds. The branch in Anderson County subsequently closed and, as indicated above in connection with West's exchange transaction with Dr. B., these Anderson County revenue bonds defaulted. Here again, H.W. testified that at the time of the purchase West had assured him that he could make money on the bonds and that he had relied on West's judgment. He also testified that West did not tell him that Shelby was a majority stockholder of Precision or that officers of Shelby were also officers and directors of Precision.

The false and erroneous statements of West to H.W. concerning the soundness of both of the above issues of bonds were made without reasonable basis. They were materially misleading and were willful violations of the antifraud provisions of the securities laws, as were West's omissions to relate facts he knew or should have known. These conclusions are supported by the cases and authorities discussed below.

Willfulness and Materiality of Violations

The sale (and exchange) transactions of West with both Dr. B. and H.W. were willful violations of the antifraud provisions. The term

8/ This was of the same issue, but with an earlier maturity, as the bond taken by West from Dr. B. in exchange for the "superior" WCUD bond.

"willful" within the meaning of the antifraud provisions means intentionally committing the acts which constitute the violations and does not require an awareness that the law is being violated. Tager v S.E.C. 344 F.2d 5, 8 (C.A. 2, 1965); Roman S. Gorski, 43 S.E.C. 618, 621 (1967).

The misrepresentations of value and price increases, made as they were without adequate basis, as well as the omissions mentioned above were of material facts, inasmuch as they were of such nature that a reasonable investor might have considered them important in deciding to purchase or sell the securities. Affiliated Ute Citizens v. United States, 406 U.S. 128, 154 (1972); cf. Litt v. Fashion Park, Inc., 340 F.2d 457 (2d Cir), cert. denied, 382 U.S. 811 (1965), and cases cited therein.9/

West's asserted reliance on Baer's opinions and instructions is no defense of his conduct and has little merit. After more than two years as a salesman of municipal bonds, significant reliance by West on Baer might be a negative rather than a positive factor in his favor. And some of West's flagrant transactions took place approximately three years after he'd begun to sell municipal bonds: e.g., his transaction with Dr. B. on November 5, 1975 (and Dr. B.'s inability to communicate with him thereafter); his transaction with H.W. on September 18, 1975 in Gallaway bonds at 92% of par for a friend in need or "buddy". In addition are markup transactions on November 5, 1975, evidenced by Division's Exhibit 16 and admitted by respondent in Admissions of Fact, as discussed in a later section.

9/ See Northwest Paper Corp. v. Thompson, 421 F.2d 137 (CA9, 1940), where the court applied a test of materiality differing somewhat but also clearly constituting authority for the conclusions reached herein as to omissions. There the court's test was whether a reasonable man would attach importance to a fact's existence or nonexistence in determining a choice of action. The same result is reached under either test.

The Commission recently stated in Willard G. Berge, et al., Securities Exchange Act Release No. 12846, September 30, 1976, 10 S.E.C. Docket 600, 602:

> "A professional who recommends the unknown securities of obscure issuers is under a duty to investigate and to see to it that his recommendations have a reasonable basis. In prior cases we pointed out that a salesman cannot recommend the equity securities of such issuers without reliable financial data. This proposition is even more compelling when we deal, as here, with debt securities. (footnotes omitted)."

And with respect to contentions by respondents that they had relied on the advice of their superiors in making the recommendations the Commission said at 602:

> ". . . . Each salesman has an obligation to deal fairly with his customers. Hence no salesman can recommend an unknown or little known security unless he has himself seen reliable financial data that supply him with a reasonable basis for his recommendation. This is especially true of debt securities. Having no current financial data, respondents could not possibly have had an adequate basis for recommending NLT's notes. (footnotes omitted)."

Recently, in Merrill Lynch, Pierce, Fenner & Smith, Inc., et al., Securities Exchange Release No. 14149 (November 9, 1977), 13 SEC Docket 646, the Commission quoted from Hanley v. SEC, 415 F.2d 589 (2d Cir. 1969), as follows:

> "He cannot recommend a security unless there is an adequate and reasonable basis for such recommendation. He must disclose facts which he knows and those which are reasonably ascertainable. By this recommendation he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation. Where the salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information. (footnote omitted)"

Excessive Mark-ups

Edward R. Hooten, a securities investigator employed at the Commission's Atlanta Regional Office, examined the books and records of Shelby and its purchase and sale confirmations of transactions made during the calendar year 1975. Division Exhibit 16 is his schedule and analysis of 28 transactions made by respondent during that year. The exhibit, together with Mr. Hooten's testimony, disclose that in 80 transactions during the calendar year 1975 Shelby salesmen sold municipal securities at prices in excess of 15% of the contemporaneous cost of acquisition.[10/] Of these 80 transactions 24 were made by West. On some occasions West sold bonds to customers at prices ranging from 10% to 50% above the cost to Shelby in transactions made on the same day as the sales. Several of these transactions were in securities which West himself had both purchased and sold.

The 24 transactions by West at markups of 15% or more which are disclosed by the Division's exhibit are conceded to have been made by respondent. Each of the 16 "same day" transactions and the others made at markups ranging from 15.9% to 38.3% above contemporaneous costs are found to have been made at excessive markups in violation of the antifraud

10/ The Commission has defined contemporaneous prices as those paid by a dealer in transactions closely related in time to his sales. Naftalin & Co., Inc., et al., 41 S.E.C. 823, 827-8 (1964); Boren & Co. et al., 40 S.E.C. 214(1960).

provisions.

One example of West's sophistication and of his intention to overcharge customers occurred in connection with Wellston, Oklahoma, Natural Gas Revenue Bonds. Shelby purchased $15,000 face value of these bonds, bearing interest of 6.25% and due 6/1/80 from a customer on March 24, 1975 at 62% of par. On the same day, West sold $5,000 face value of the bonds at 72% of par, a mark-up of 16.1%. West testified that he was told by Baer "to sell the bonds at 72. That that was a fair and equitable price for the bonds." However, on the same day he also sold $5,000 face value of 6% bonds of the same issuer, due one year earlier (9/1/79), at 79.871% of par. His testimony with respect to the second sale reads, in part:

> "I asked the gentleman what he would pay for the bonds. He told me he would pay a 12 percent yield. That's what I sold the bonds to the gentleman at. He was familiar with the credit."

On further questioning West admitted, with regard to the substantial difference in the selling prices, that the variance in maturity dates (one year) and in yield (1/4 of a point less on the second sale) were not of significance; that the second customer "wanted to pay that much for the bonds, and I sold the bonds at that price."

It is clear that both of these sales involved excessive mark-ups by West. Beyond that, West knew he flagrantly overcharged the second customer. This transaction, with others,

indicates that West's testimony of his asserted reliance on Baer's pricing of bonds lacks merit as justification for the excessive mark-up violations. Baer and perhaps others probably determined the broad pricing practices of Shelby, but the prices of specific bonds were not fixed or firm but were subject to change or negotiation by West.[11/]

Further examples of excessive mark-ups and of West's authority and sophistication as disclosed in Division's Exhibit 16 relate to a purchase by West for Shelby on November 5, 1975, of $60,000 par value WCUD bonds bearing 7% interest and due 4/1/99, at 50.50% of par value. On the same day West made the following sales of these bonds:

> To H.D. $5,000 par value at 64.50% of par, a markup of 27.7% producing profit of $700.
>
> To Dr. B. in the exchange transaction described above, at 63% of par[12/]
>
> To D.P.M. $10,000 par value at 60.50% of par, for a markup of 19.8% and a profit of $1,000.

And on the following day, November 6, West sold $10,000 of these bonds to Carty & Co., his current employer, at 52% of par.[13/] But on the next day, November 7, he sold $10,000 of these bonds to a customer, Dr. T.L.W., at 68% of par, for a

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11/ West's substantial purchases of bonds from individual customers and from dealers as disclosed in Division Exhibit 16 are among further indicia of his sophistication and his authority to use his own judgment in transactions. Some examples are discussed in the text.

12/ Respondent's Admission of Facts No. 34; cf. Div. Ex. 16

13/ Ibid, Admission No. 36.

markup of 34.6% and a profit of $1,750 over Shelby's contemporaneous cost.

Similarly, defaulted bonds purchased on April 23, 1975 by Shelby's trader for $1,000, issued by Barnwell County, South Carolina, with face value of $10,000 were sold by West on the same day (to a customer who had made several prior purchases from him) for $1,500, with a profit on the defaulted bonds of $500 on the markup of 50%.

The above are examples of the many trades and profits produced for Shelby and himself by West. In light of the host of court and Commission decisions, expert testimony to the effect that the mark-ups reflected on Division's Exhibit 16 were excessive was not required, and such ruling was made following the close of the Division's case in chief, in denial of a motion to dismiss the mark-up charge.

In his post-hearing brief respondent has persisted in the argument that the Division's case must fall because of the absence of expert testimony on excessive markups. The argument has acquired no merit. The courts and the Commission have spoken frequently and at length on the fraud involved in securities sales at excessive markups. The Commission has frequently asserted and the courts have sustained the position that the price paid contemporaneously by the broker-dealer is the best evidence of market price, absent persuasive coun-

tervailing evidence. In Matter of Investment Service Co., 41 S.E.C. 188 (1962), the Commission held that markups ranging from 25 percent to 67 percent over same day costs were clearly excessive and not reasonably related to the market prices established by registrant's purchases. At 197, the Commission said, at footnote 9:

> "In Boren & Co., supra, a proceeding to review disciplinary action by the NASD, we held that mark-ups of 33.3 percent to 66.7 percent in sales of stock at 4 cents to 5 cents per share, 9.1 percent to 19 percent in sales at $2 7/8 to $3 1/8 per share, 10 percent in a sale at 41 cents per share, and 25 percent in a sale at 10 cents per share were excessive."

In Boren, reported at 40 S.E.C. 217 (1960), the Commission said " . . . that the mark-ups of 10.8% to 25% were clearly excessive."

Support for the excessive markup conclusions reached herein is also found in Arnold Securities Corp., 42 S.E.C. 898 (1966), where the Commission considered contemporaneous prices paid by a dealer in transactions with other dealers as the best evidence of current market price, absent countervailing evidence, and stated at 902, footnote 9:

> "We have frequently held that mark-ups of more than 10 percent are unfair even in the sale of low-priced securities. Costello, Russoto & Co., 42 S.E.C. 798 (1965); J.A. Winston & Co., Inc., 42 S.E.C. 62 (1964); Ross Securities, Inc., 40 S.E.C. 1064 (1962) and cases cited at 1066 n. 5."

In J.A. Winston & Co., Inc., 42 S.E.C. 62 (1964), the Commission stated at 69:

> "We conclude that registrant's retail prices, at mark-ups ranging up to 20 percent over its same day purchase prices, were not reasonably related to the prevailing market prices and were unfair. We have repeatedly held, both in NASD disciplinary proceedings and in revocation or denial proceedings under Section 15(b) of the Exchange Act, that at the least mark-ups of more than 10 percent are unfair even in the sale of low-priced securities as to which NASD policy recognizes that mark-ups somewhat higher than 5 percent may be permissable." Citing Naftalin & Co., Inc., 41 S.E.C. 823 (1964).

In Linder Bilotti & Co. Inc., 42 S.E.C. 807 (1965), the market price used for calculation of markups was the price paid by the broker-dealer in same day transactions or, if none, the price of the nearest contemporary purchase within 3 days before or after the sale.

In Securities and Exchange Commission v. Seaboard Securities, CCH Fed. Sec. L. Rep. ¶ 91697, U.S.D.C., S.D.N.Y., (June 6, 1966), an injunction proceeding, the court found mark-ups of 11.1% to 22.2%, among others, to be excessive, and issued a broad injunction forbidding

> "the use of interstate instrumentalities and the mails to effect fraud or deceit upon defendants' customers by charging unfair prices not reasonably related to the current market for any securities, not merely the two to which the proof related."

The mark-ups obtained by West were in bond transactions of substantially greater dollar amounts than in most of the share sales discussed above, and the profits in several were unconscionable. In addition to those discussed above are, for example, a purchase by West on January 9, 1975 of $5,000

Harris County, Texas, bonds from an individual customer at 75% of par and a sale on the same day at 88% of par which yielded a $650 profit with its mark-up of 17.3%. Div. Ex. 16, p.1. Similarly, the two Wellston, Oklahoma, Natural Gas sales at substantially different prices discussed above yielded profits of $500 in the first and $893.55 in the second of these "same day" transactions.

No credible or substantial refutation of the mark-ups appears in respondent's post-hearing filing, nor in his testimony. Nor is there justification therefor in the testimony of West's current employer, Bill R. Carty, owner of the Memphis broker-dealer firm which, he stated, deals primarily in municipal bonds and to some extent in government securities.

Mr. Carty appeared at the hearing in the capacity of an expert witness on behalf of the respondent and was permitted to remain in the courtroom throughout the hearing, although other witnesses, excepting the Division's investigator, had been sequestered on agreement of counsel. Mr. Carty sat at the counsel table and assisted respondent's attorney in the defense. He also testified as an expert on pricing of the Shelby securities sold by West.[14/] His

14/ Mr. Carty also testified to a transaction which Mr. H.W. had with West as salesman at Carty & Co. after Shelby had closed. H.W. had denied that he had purchased certain bonds from West in June 1976. This is one of the instances mentioned, supra, in which the testimony of H.W. was not accurate because of confusion or faulty memory.

testimony fails to justify the mark-ups disclosed by Division Exhibit 16 and the testimony of Mr. Hooten. Mr. Carty, as an expert witness, agreed that although there is no "magic percentage" markup that is appropriate as a "high", beyond which a markup would be excessive in all transactions, the NASD has established a guideline or rule of thumb of 5 percent "from the bid, to spread, and markup from the ask." (sic.). He also agreed that a section of the NASD Manual states that debt securities would normally require a smaller percentage markup than equity securities.

When asked whether he considered the markups shown on Division Exhibit 16 reasonable the witness was equivocal. He expressed doubt that he would have approved all of the mark-ups, adding: "... but I don't know all the circumstances involved in these trades. They didn't happen in my shop." He also discussed the danger of default in these "very speculative type items" and the consequential justification for bigger spreads, stating that while he was "not trying to whitewash Shelby Bond" he knew that Baer once had some [bonds] that defaulted.

Certainly the bonds sold to Dr. B. and H.W. were "very speculative type items" but were not described as such by West.[15/] Respondent's brief

15/ The offering circular of the Gallaway (Precision) bonds contained the caveat "These Securities Involve A High Degree of Risk." H.W. did not receive an offering circular.

West believed that it was Shelby's practice to send an offering circular with the confirmation.

points out that H.W. testified that he had approximately $200,000 invested in tax free bonds and had been investing in such securities for approximately six years. If this is a suggestion of his sophistication it is rejected on the facts. Nor would sophistication be a legal defense to the violations, had it existed. Arnold Securities Corp., supra, at 901 and the cases cited therein. And H.W.'s asserted expressed interest, according to West, in bonds with the highest tax free income does not suggest that he was not relying on West's value judgments or that he was not interested in the security of his investments.

Standard of Proof and Nature of Violations

Collins Securities Corp. v. S.E.C., 562 F.2d 820 (C.A.D.C., 1977), held that certain findings of fraud in broker-dealer activity must be proven by "clear and convincing" evidence rather than by merely a preponderance. The evidence of West's fraudulent activity found above is clear and convincing not only with regard to the misrepresentations and omissions, but also with regard to the excessive markups, as to which there is little factual dispute.16/

16/ Respondent's evidence concerning asserted "Blue List" offering prices of speculative thinly traded bonds is rejected as not material and not controlling under the facts or the law discussed above. In addition, to the extent testimony suggests that West used and was influenced by Blue List price quotations in connection with and at the time of his sales to individual customers, it is not credited.

(The Blue List contains municipal bond offerings. It is published daily by a Division of Standard & Poor's.)

In opinions cited in the margin,[17/] among others, the Commission has disputed the applicability to administrative proceedings of the Supreme Court's interpretation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). The Court held that in that case, an action for money damages between private parties, that 'scienter', an intent to deceive, was an essential element of the plaintiff's claim.

Whether here applicable or not, the Hochfelder rule is satisfied. The facts reflect that West, a clever and sophisticated salesman, intended to deceive the investor witnesses and the purchasers of bonds. (If Hochfelder should be applicable and some less deliberate mental state would support the conclusions reached herein, certainly much of respondent's activity was so reckless as to be virtually indistinguishable from intentional fraud and deceit.)[18/]

Moreover, as pointed out by the Commission in the cases cited in the margin below, Hochfelder has no bearing on Section 17(a) of the Securities Act. Fully applicable here is the Commission's statement in Shaw Hooker (margin below) at footnote 9, that " ... every finding ... made in connection with

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17/ Steadman Security Corp., Securities Exchange Act Release 13695 (June 20, 1977), 12 S.E.C. Docket 1041, 1050; Shaw, Hooker & Co., Securities Exchange Release 14289, December 17, 1977, 13 S.E.C. Docket 117; Stanton L. Whitney, Securities Exchange Act Release No. 14468, February 14, 1978, 14 S.E.C. Docket 172.

18/ See Hochfelder, at 193, fn. 12; cf. Herzfeld v. Laventhol, Krekstein, et al., 540 F.2d 27, 37 (2d Cir., 1976)

[respondent's] sales ... is made not only under Section 10b-5 but also under Section 17(a). [citing Steadman]. The sanctions which we impose would be the same even if we made no findings under Section 10(b) and Rule 10b-5."

Sanctions

The matter of remedial action which is appropriate in the public interest remains for disposition. Sanctions are imposed by the Commission in an effort to protect the public interest by assuring, to the extent assurance can be achieved, that there will be no repetition of the conduct displayed by one who has defrauded the public. The imposition of sanctions on a salesman who has had substantial earnings from fraudulent transactions involves not only the function of preventing or dissuading him from similar activity but also the deterrence of others from following his style or pattern of activity. In Lamb Brothers, Inc., Securities Exchange Act Release No. 14017, October 3, 1977, 13 SEC Docket 265, 274 the Commission expressly recognized the salutary value of an appropriate sanction and referred to the effect which its action or inaction will have on standards of conduct in the securities business generally. It quoted with approval from a decision by the Court of Appeals for the Second Circuit, as follows:

> "The purpose of . . . sanctions must be to demonstrate not only to petitioners but to others that the Commission will deal harshly with egregious cases." Arthur Lipper Corporation v. S.E.C., 547 F.2d 171, 184 (2d Cir., 1976), cert. denied January 9, 1978, 46 U.S. Law Week 3425.

Moreover, fraudulent activity in municipal bond sales, if permitted to continue without imposition of appropriate sanctions, must have a seriously adverse effect on legitimate activities in money markets comprised, as here, of municipal bonds of lesser quality than those graded by Standard & Poors, Moody's and Fitch. Such money markets can serve a purpose in furnishing capital only if properly supervised and controlled.

Respondent's activity constitutes an egregious case and there is no real dispute on the facts. The use of the mails and interstate means of communication is admitted.

The injunction evidenced by respondent's Exhibit 21, in and of itself might serve as a basis for severe sanctions even though it was issued on consent.[19/] But the record in this proceeding, delineating the fraudulent activities enjoined and more, is significantly the basis for the sanction here deemed necessary and appropriate in the public interest.

Consideration has been given to the arguments in mitigation,[20/] and to the testimony of respondent's current employer regarding West's performance and the supervision under which he assertedly has been serving since January 1976. Counsel for respondent argues, on this basis, that no sanctions are appropriate in the public interest, but his argument is not

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19/ Cf. Balbrook Securities Corp., 42 S.E.C. 496 (1965); Kay, Real & Company, Inc., 36 S.E.C. 373 (1955); Todd, 40 S.E.C. 303, 306 (1940); Lamb Brothers, Inc., supra, at fn. 22 therein.

20/ During West's five years as salesman, only the injunction and the (same) charges in this proceeding have been made against him.

acceptable. West's conduct was continuing and pervasive and the sanction ordered below is deemed appropriate. 21/

Accordingly, IT IS ORDERED that Charles Michael West be and he hereby is barred from association with a broker or dealer, except that after a period of six months from the effective date of this order he may apply to the Commission to become so associated in a non-supervisory capacity upon a satisfactory showing that he will be appropriately supervised.

This order shall become effective in accordance with and subject to the provisions of Rule 17(f) of the Commission's Rules of Practice.

Pursuant to that rule, this initial decision shall become the final decision of the Commission as to each party who has not filed a petition for review pursuant to Rule 17(b) within fifteen days after service of the initial decision upon him, unless the Commission, pursuant to Rule 17(c), determines on its own initiative to review this initial decision as to him. If a party timely files a petition for review,

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21/ Apart from the public interest factors discussed above, the undersigned is not persuaded by the testimony and evidence that the current employment and supervision of respondent in selling municipal bonds constitute assurance that the public interest is adequately protected. The Commission through its staff can evaluate at the appropriate time the supervision and circumstances under which West, with reasonable assurance of protection for the public interest, may be permitted to be associated with a broker-dealer.

or the Commission takes action to review as to a party, the initial decision shall not become final with respect to that party.[22/]

Sidney Ullman
Administrative Law Judge

Washington, D.C.
March 6, 1978

22/ To the extent that the proposed findings and conclusions submitted by the parties, and the arguments made by them, are in accordance with the views herein they are accepted, and to the extent they are inconsistent therewith they are rejected.