U.S. Securities and Exchange Commission

Initial Decision of an SEC Administrative Law Judge

In the Matter of
Mark David Anderson

INITIAL DECISION RELEASE NO. 203
ADMINISTRATIVE PROCEEDING
FILE NO. 3-9499

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

In the Matter of MARK DAVID ANDERSON	: : : : :	INITIAL DECISION April 30, 2002

Appearances:	Aimee Dominguez Silvers and Michael R. Wilner for the Division of Enforcement, Securities and Exchange Commission Elizabeth Lowery for Respondent Mark David Anderson
Before:	Lillian A. McEwen, Administrative Law Judge

Summary

This Decision concludes that Respondent Anderson did not violate the federal securities laws as alleged in the instant case and dismisses the proceeding against him.

Procedural History

On December 4, 1997, the Securities and Exchange Commission (Commission) issued an Order Instituting Proceedings (OIP) pursuant to Section 8A of the Securities Act of 1933 (Securities Act) and Sections 15(b), 15B, 19(h), and 21C of the Securities Exchange Act of 1934 (Exchange Act). On July 7 through 9, 1998, a public hearing was held in Los Angeles, California.

The Division of Enforcement (Division) called four witnesses, including Respondent Mark David Anderson (Anderson). Anderson testified on his

own behalf and called one additional witness. I admitted twenty-four joint exhibits, four exhibits for the Division, and ten exhibits for Anderson.[1]

Pursuant to the Administrative Procedure Act, 5 U.S.C. § 557(c), and the Commission's Rules of Practice, 17 C.F.R. § 201.340, the following posthearing pleadings were considered: (1) the Division's Post-Hearing Brief, dated September 10, 1998; (2) Anderson's Post-Hearing Brief, dated October 9, 1998; and (3) the Division's Post-Hearing Reply Brief, dated November 18, 1998.

Issues Presented

The OIP alleges that Anderson charged undisclosed, excessive markups and markdowns that violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. It also alleges that Anderson's undisclosed, excessive markups and markdowns aided and abetted and caused Armscott Securities Ltd. (Armscott) to violate Sections 15(c)(1) and 15B(c)(1) of the Exchange Act and Rule 15c1-2 thereunder, and Rules G-17 and G-30 of the Municipal Securities Rulemaking Board (MSRB). If I conclude that the allegations in the OIP are true, I must then determine what, if any, remedial sanctions are appropriate pursuant to the federal securities laws. The Division requests a cease-and-desist order, a third-tier civil penalty in the amount of $188,050, and disgorgement of $182,195 with prejudgment interest of $20,854. It also seeks a bar from owning or being associated with a broker, dealer, or municipal securities dealer, with the right to reapply after no less than three years.

Findings of Fact

The findings and conclusions in this Decision are based on the record and the demeanor of the witnesses who testified at the hearing. Preponderance of the evidence was applied as the standard of proof. *See Steadman v. SEC*, 450 U.S. 91 (1981). All arguments and proposed findings and conclusions that were inconsistent with this Decision were rejected. I find the following facts to be true.

Respondent Mark David Anderson

Anderson earned a bachelor's degree in business and marketing from Indiana University. From 1981 until 1984 he was an investment manager for a small conservative pension fund. In 1983, he acquired his general securities representative license, or Series 7. (Tr. 410.) Anderson worked at various brokerage firms from 1984 through 1988, performing back office functions such as processing and settling trades, opening accounts, coordinating activities with the clearing firm, and wiring money. (Tr. 412-13.) He also learned how to research bonds and participate in the bond market. (Tr. 414.) During the mid-1980s, Anderson obtained the following securities licenses: Series 24, the general securities principal license that allows you to supervise people who have a Series 7 and manage the securities business of a brokerage firm; Series 27, the financial and operations principal license that allows you to be a financial principal of a broker-dealer, and gives you responsibility for the firm's books and records; Series 53, the municipal securities principal license that allows you to supervise registered representatives or brokers who trade municipal securities, and requires you to be familiar with the rules in the area of municipal securities; Series 63, a general state license; and Series 4, the options principal license. (Tr. 388-92, 414.) Anderson was a registered representative for a brokerage firm based out of Santa Barbara, California for about a year and then in 1989, he went to Annandale Securities, Inc. (Annandale), another brokerage firm. (Tr. 417.)

Initially, Anderson served as a registered principal at Annandale. (Tr. 395.) Anderson later bought the firm from the original owner and became its president from the early 1990s until December 1994, when the firm withdrew its registration. (Tr. 394-95, 417.) For about 90% of the time, the only employees of Annandale were Anderson, an assistant, and a part-time receptionist. (Tr. 419.) At Annandale, Anderson dealt directly with the customers and was responsible for executing the trades. (Tr. 396.) Bonds were purchased for customers only if there was already a customer order in hand. (Tr. 398.) Anderson purchased the bonds from other dealers, temporarily placed the bonds into Annandale's trading account, and shortly thereafter sold the bonds to customers. (Tr. 397.) Customers were charged a higher price than what Anderson paid the other dealers to get the bond. The difference between the price Anderson paid for a security and the price it was sold to the customer is the markup. The process was reversed when a client wanted to sell bonds. Anderson bought the bond from a customer, placed it in Annandale's trading account, and then sold it to another dealer at a higher price. The difference between the price paid to the customer for the bond and the price Anderson sold it to another dealer is the markdown. (Tr. 396-99, 586.) Anderson determined the size of the markup or markdown charged. (Tr. 396.) He received 100% of the markup or markdown charged to Annandale customers. (Tr. 420.) Annandale was not a market maker for any of the bond trades that occurred in 1992 through 1994. By taking securities into inventory for a very short period of time, Annandale acted in a riskless principal capacity. (Tr. 397-99.)

From 1990 through March 1997, Anderson was the president and registered principal of Armscott, a registered broker-dealer. Armscott "sub-cleared" through Annandale; Armscott used Annandale's relationship with a clearing firm to process its trades until December 1994. (Tr. 396, 418, 422, 425; Jt. Ex. 24 at 2.) Armscott was owned by A. Morgan Maree (AMM), a registered investment adviser. (Tr. 423, 425.) Anderson was responsible for executing trades at Armscott, and determining the size of the markup or markdown charged; however, he did not deal directly with Armscott's customers. (Tr. 396, 426, 430.) All of Armscott's customers were clients of AMM, the investment adviser. AMM would request that Anderson find bonds. He would then report to the investment adviser, who would decide whether or not to buy the bonds for its clients. (Tr. 426; Jt. Ex. 24 at 2.) Anderson received 20% of the markups or markdowns charged to Armscott's customers. (Tr. 426; Resp. Ex. 2.) Armscott also acted as a riskless principal and was not a market maker. (Tr. 397, 400.) In March 1997, Anderson went to Euro Pacific Capital, Inc. (Tr. 418.)

Anderson's Practice

From 1992 to 1997, Anderson had only 15 clients, out of a total of 300 to 400 clients, who traded bonds. His clients were knowledgeable investors with safety of principal being the most important factor for investment. (Tr. 453-57, 457-59, 535.) Anderson acquired a niche by prospecting registered investment advisers and financial planners for Fortune 500 company executives, who were looking for tax-free bonds for wealthy clients. (Tr. 484-85.) He showed them offerings in unique areas, at more of a discount. Eventually, the executives retired or left the planning service, and Anderson acquired them as clients by referral. (Tr. 484-85.) The bonds that Anderson traded were unique because they were either smaller issues or had features that were confusing and required experience. As a result, the bonds were usually underpriced or undervalued in the marketplace. Anderson believed that additional yield could be obtained by buying something that most brokers had not taken the time to evaluate. (Tr. 488-89.)

The primary factor that Anderson used to calculate the markup or markdown was the yield to the client. (Tr. 473-74.) He defined yield as "what the client receives on his investment dollars," with the price paid for

the bond being "a component of the yield." Every markup differed in percentage because Anderson intentionally "factored yield into it." (Tr. 474.) Anderson believed he charged "a fair price" because he picked a point "somewhere in the middle of the yield charts, between non-rated and AAA, and what [he] thought was competitive to the client." He then "saw what was left over," after he "stayed under the NASD guidelines." (Tr. 474-75.) Thus, if Anderson and the client agreed on the yield, Anderson considered them to have "agreed on the price." Anderson acquired this method of pricing the markup or markdown from two brokers who taught him how to run a small firm. He was not aware of any other way to calculate a markup on a municipal bond transaction, and always assumed that if "the yield was not competitive, the client would not buy it." (Tr. 588.) The same method to calculate markdowns for municipal bond trades was used when a client wished to sell a security. (Tr. 589.)

Anderson did not subscribe to Bloomberg, Thompson, or Munifax data information services because the Bloomberg service alone would cost him $5,000 a month. He also did not subscribe to the Blue Sheet, Bond Buyer, or other publications of bond offerings, and lacked a functioning bond-yield calculator. (Tr. 582-85.) However, Anderson read five to twelve financial publications a month. (Tr. 540.) He also had a computer with quotations and clearing firm information accessible on it, and he calculated his markups and markdowns by locating a bond, describing it to his client, offering a yield to the client and then buying the security from another dealer and selling it to the client. (Tr. 584-85.) For municipal bonds, Anderson had other dealers use their bond yield calculators to quote for him "different yields at different prices," and from them he selected a yield to present to the client. In this manner, Anderson determined the price to the client and his own compensation, which might be as low as 1% or any figure up to 5% for municipal bonds. (Tr. 586-87.) Anderson believed he communicated his markups and markdowns by letting his clients know what their yield would be on the bonds if they bought or sold them. (Tr. 457-60.) Anderson did not keep his working notes, faxes from other dealers, or rate yield tables because he never thought he would need them to explain his trades. (Tr. 459.)

Anderson knew that the dealers quoted him accurate yields in these conversations because the next day Anderson's clearing firm routinely calculated the yield-to-call and the yield-to-maturity on the sale, as well as the price to the client. (Tr. 480-81.) He never asked another dealer what a competitive markup or markdown would be for a bond, because "you know what's competitive by the yield. . . . [T]he yield is a function of price, so the yield is what it is and the price is what it is. So, it doesn't matter if they're saying I'm charging [1%] or I'm charging [5%], if the yield's no good, it doesn't matter." (Tr. 482.) Whether a bond was rated AAA or non-rated was therefore not a factor in the amount of the markup or markdown. For Anderson, every trade was unique, although he could not recall their circumstances. (Tr. 483.)

Anderson also knew that he was selling bonds to his clients at competitive rates because he compared yields by searching the daily financial services for Treasury and tax-free bond trades. (Tr. 475-76.) There is no quoted market for municipal bonds, so institutional rate charts, which give a compilation of where all the tax-free instruments are trading for different maturities and qualities on that day, were used. Because Anderson did not have a bond-yield calculator, and "could never figure" the yield out with a regular calculator, other dealers helped him calculate markups. They might tell him that a certain markup would be too high because "it's going to kill the yield." Anderson thought that the "input" that he obtained from various dealers and the range of points he discussed with them to arrive at his

markup and markdown figures for his clients were consistent with industry standards. (Tr. 476-79.)

The Thompson yield chart for September 24, 1993, is a typical source that Anderson used for a compilation of bond prices that generated a matrix yield curve for the industry. (Tr. 494-95; Resp. Ex. 4.) Anderson used a chart like it to begin his search for bonds in 1993 so that he would know what the institutional market was before markup or markdown. (Tr. 496-98.) He knew that the markup or markdown always reduced the principal amount that the holder could earn interest on and that it thus reduced the benefit of compounding; the total yield therefore changes, up to the maturity date, although the stated coupon bond rate never changes. (Tr. 498-500.) He also knew that the higher the markup the lower the yield. Anderson thought that he generally charged a smaller commission on a shorter-yield-time bond. (Tr. 501.) The Thompson yield chart for December 23, 1993, on the buy side is an example of sources Anderson used in making trades. (Tr. 521-22; Resp. Ex. 5.) Anderson believed that the clearing-statement yield after Anderson's markup was consistent with the yield for the industry. (Tr. 524-28; Jt. Ex. 6 at 4.) Anderson believed that he used common sense, the "interest rates of the day," and the yield calculations of the dealers from whom he bought bonds to determine what fair compensation should be. (Tr. 533-534.)

Anderson priced his markups and markdowns on municipal business, government obligations, agency business, "Ginnie Maes, and CMOs and the Freddie Macs" in the same way, calculating the paydown history for mortgage tranches and evaluating interest rates. He based all of his markup and markdown percentages on yield calculations, just as he understood other brokers did. (Tr. 616-17.) Anderson was the only registered representative at the firms who traded the bonds at issue, and no compliance officer or other executive reviewed Anderson's trades at Annandale or Armscott. (Tr. 625-26.)

The following table summarizes the number of the ninety-six trades at issue in the instant case at each percentage of markup or markdowns ranked from highest to lowest. (Jt. Ex. 24 at 7-12.)

The Trades

U.S. Treasury Securities		Government Agency Securities	
Markups		*Markups*	
No. @	%	No. @	%
1	4.01	1	4.07
2	4.00	1	4.04
1	2.99	1	4.01
		3	4.00
Markdowns		4	3.50
No. @	%	1	3.36
1	3.87	3	2.99
1	3.78	1	2.93
2	2.99	1	2.50
1	2.94	1	2.29
1	2.91	1	2.04
1	2.88	1	1.91
1	2.86	1	1.42

1	2.82
1	2.79
1	2.76
1	2.75

Municipal Securities

Markups No. @	%	*Markups (cont'd)* No. @	%
2	5.00	1	3.76
1	4.88	2	3.75
1	4.81	1	3.73
1	4.78	1	3.66
1	4.66	1	3.60
1	4.59	1	3.52
1	4.49	3	3.50
1	4.48	1	3.46
1	4.38	1	3.40
1	4.31	1	3.39
3	4.30	1	3.25
2	4.29	1	2.98
1	4.26	1	1.87
1	4.24		
1	4.21	*Markdowns*	
1	4.12	No. @	%
1	4.09	1	5.64
1	4.05	1	5.16
1	4.04	1	4.99
3	4.00	1	4.83
2	3.99	1	4.71
2	3.96	1	4.52
1	3.93	1	4.32
1	3.92	1	3.97
1	3.85	1	3.29
1	3.79	1	3.02

Anderson was aware of his responsibility to price securities "to the worst possible circumstances," but he believed that he could price a bond as if it would be a twenty-year bond in spite of a possible one-year call feature. This belief was based on his knowledge of the practice of other smaller regional firms. (Tr. 594.) Anderson also believed that his obligation to set a fair and reasonable price for a security allowed him to inform his client of his opinion that the first call date was irrelevant and then to ignore that call feature and price the bond as a twenty or thirty-five-year bond instead of a four-year bond. Although the "price to the first call was a factor," Anderson priced bonds for his clients based on his estimate of the "ultimate maturity" of the bond. (Tr. 595.) Anderson would still inform the client of the yield in "the worst case possible thing that could happen" however. (Tr. 592-94.) The customer confirmation slip states the yield to call, or the "worst-possible return" to the investor. (Tr. 636.)

Factors such as nature and availability of the bonds in the market and the size of the trades were all computed in the yield for the markup. (Tr. 635-36.) Bonds are more likely to be called when interest rates move down, because debt may be refinanced at a lower rate. For the last three years, interest rates have moved drastically downward. (Tr. 637-38.) If Anderson's clients had bought bonds through a mutual fund, they would have paid higher fixed fees and costs and higher management and sales fees than Anderson charged for his commissions. (Tr. 640-41.) Anderson earned $55,000 in 1993 and 1994; he earned $70,000 in 1995; and in 1996 and 1997, he earned in the mid-sixties. (Tr. 648-49.)

The NASD Reviews

In a November 29, 1993, NASD exit interview Anderson had markups of 4.3% to 5.6% brought to his attention in nine municipal trades at Annandale. (Tr. 546-47; Resp. Ex. 6 at 2.) He was also notified of "40 of 140 riskless principal trades reviewed" where markups and markdowns were between 5% and 5.3%. (Resp. Ex. 6 at 1.) Anderson made some refunds to clients. (Resp. Ex. 6 at 2-9.) On January 19, 1995, a consent order was entered by the NASD against Anderson and Annandale; they neither admitted nor denied making eleven sales with markups of 15% to 87.5% where all occurred over four days and all involved a single security. Anderson and Annandale were fined jointly and severally in the amount of $5,000, ordered to reimburse the firm's share of 20% of the total markups charged, and censured. (Jt. Ex. 23 at 4-5.) An NASD letter to Anderson, dated June 8, 1995, showed gross profit of $8,511 from a sample of markups and markdowns of 4.32% to 5.64%, and was the basis for Anderson's refund of charges over 5% to clients. (Resp. Ex. 7 at 6.) Most markups and markdowns were between 3.5% and 5.0%. (Tr. 555-559; Resp. Ex. 7.) On February 1, 1996, Anderson received a letter of caution from NASD associate director Daniel Stefak requesting a written response from Anderson recounting steps "to ensure future compliance" in reference to twelve municipal transactions with "excessive" markups and markdowns from 4.32% to 5.64%. It included a schedule of the municipal trades with a column titled "DBCC Guideline Markup," which listed 3% to 3.5% as the acceptable markup range. Anderson interpreted this subsequent letter to mean that a markdown or markup of 3% to 3.5% "is where they've moved it to now, and this is what I should use." (Tr. 563, 566-67, 572-73; Resp. Ex. 8.)

Anderson began to use the new, lower figure for his bond markups and markdowns. (Tr. 563.) However, he never reviewed his earlier bond trades to ensure that those markups and markdowns were rebated to clients pursuant to the schedule generated by NASD reviewers because he believed that the new standard applied to future bond trades, not past ones. (Tr. 565-67.) Anderson did give "a real good break" to three or four clients on future trades to make up for the old markups and markdowns that the NASD found excessive. (Tr. 568.) Thus Anderson refunded markups and markdowns over 5% back to 1993 because that was what he interpreted the NASD instruction to be. (Tr. 568-69.) Anderson thought that he was asked to rebate past markups and markdowns over 5% and that he was to use 3% to 3.5% as a guideline for future bond markups and markdowns, pursuant to the NASD exit interview and the subsequent letter. (Tr. 564.) On November 26, 1996, an exit interview also transpired between Armscott and an NASD reviewer. It refers to two municipal trades at 3.4% and 5.5% that exceed the NBCC guideline but not the DBCC guideline. (Resp. Ex. 9.)

In June 1998, Anderson contacted the Commission and requested its policy on markups and markdowns on municipal bonds and government obligations. The Commission responded with fee guidelines that Anderson

did not find helpful. He believes that his fees from 1992 through 1997 were fair and reasonable (Tr. 573-77; Resp. Ex. 10.)

From December 15, 1992, through March 5, 1997, Anderson's bond trades included markups and markdowns ranging from 1.42% to 5.64%. (Jt. Exs. 1-22, Jt. Ex. 24 at 7-12.) Anderson received only 20% of commissions from many sales because of his fee-splitting arrangement with the investment adviser. (Tr. 426; Resp. Ex. 2.) The OIP was issued on December 4, 1997.

Industry Practice

The following witnesses were qualified as experts and testified as to industry practice: Fred Schwarz was qualified as an expert on sales practices regulated by the NASD; Robert MacLaverty was qualified as an expert on how the industry determines markups and markdowns for Treasury notes, Treasury strips, specified pools, and CMOs; Peter McCabe Jr. was qualified as an expert in the area of trading municipal securities, including markups and markdowns and sales practices; and Allissa Johnson qualified as an expert in the area of sales practices in the securities industry and NASD procedures. (Tr. 47, 100, 195, 359.) I have adopted the opinions of the experts only to the degree that they are described here.

One of the responsibilities of the NASD is to keep member firms informed of the guidelines and rules that apply to the securities industry through monthly notices and a manual that is periodically updated. (Tr. 50.) The NASD has a 5% markup and markdown guideline for equities, but deviations below 5% do not automatically mean the transaction was priced correctly, and deviations above 5% do not necessarily mean the price was wrong. (Tr. 52-53.) There is no similar guideline for municipal securities. (Tr. 54.)

In August 1994, an internal NASD staff memorandum sent to district directors from the staff committee on municipal markups discussed the range of threshold markup and markdown percentages, from 2.5% to 5%, for municipal securities among the eleven NASD district offices. (Tr. 56-57; Resp. Ex. 1.) The memorandum was part of an NASD plan to establish a national, consistent standard for municipal securities markup so that NASD examiners could have a baseline for a determination of reasonableness. (Tr. 79-82.) Once a baseline is determined, all NASD examiners would be operating within the same parameters and could then consider the reasonableness of anything outside of those parameters. For example, the effort involved in locating the specific number of certain bonds would be a consideration that may justify a higher markup. Large firms that can afford to subscribe to information services, or that have bond desks would put forth less effort to locate specific bonds and as a result, charge a lower markup. (Tr. 80-83.) Smaller denominations of bonds would be marked up higher than a large block of bonds. (Tr. 84-85.) It is also not unusual for small, retail investors to be charged larger markups than large institutional investors. (Tr. 85.)

Between December 1992 and March 1997, thirty-six out of a total of 111 of Anderson's bond transactions failed to conform to markup custom and practice in the securities industry. (Tr. 106-07.) Some markdown amounts also deviated from industry practice. When customers came to Anderson to sell Treasury notes, he quoted a bid that was lower than the price he in turn sold them for, to another dealer; the bid and ask prices are the prices at which dealers trade, not the public. (Tr. 106-07, 168, 204-11.) The markups for CMOs were also deviations from industry custom and practice for markups. (Tr. 109.) The bid-ask spread for U.S. Treasury notes of 2/32 to 3/32 has not changed since 1992. U.S. Treasury notes, strips, and mortgage pools usually have a spread of 4/32 to 6/32. (Tr. 109-13.) CMOs have bid-ask spreads of 1/4 to 3/4. (Tr. 113-14.) Brokers know the bid-ask

spread for a bond by attending seminars, talking to dealers, and learning about the bond from computer research techniques and market makers. (Tr. 113-16.)

A single percentage cutoff to determine the appropriateness of a markup or markdown is not a good idea in fixed-income securities because each sector of the market behaves very differently. (Tr. 118.) The transactions in the instant case were riskless principal transactions, for Anderson, and carried only execution risk, which is minimal; Anderson traded "with an order in hand and he leaned on that order when he bought them in from another dealer and just filled it." (Tr. 119.) For analysis of the retail market, one should double "what would have been fair in the institutional world" to arrive at the standard for a markup in the instant case. (Tr. 120.) The spread between the bid and ask prices "would give you a guideline as to what a markup, a reasonable markup, could and should be. . . . At that particular time, under those market circumstances." (Tr. 122.) One should use "various wire services" to determine "market environment at the time of these transactions" as part of the data. (Tr. 123.) Anderson should have understood the features of the securities he traded. He is entitled to a reasonable profit, and he should have executed buys from the clearing firm at prices "that were executed to the best of his ability." (Tr. 124.)

For the markdowns, Anderson sold the U.S. Treasury notes on the open market, but he had not "crossed trades in-house with another customer," to collect fees "on both sides of the transaction." (Tr. 125.) Anderson's disclosed commission, of $100 for a $50,000 Treasury bond, was his usual minimum ticket cost for his services. (Tr. 126-27, 140-43.) Anderson executed twelve trades where he charged a markdown to his clients upon the sale of their Treasury notes. (Tr. 129-30.) Because the market for U.S. Treasury notes is "so deep and liquid," custom and practice in the securities business do not justify "any additional cost" for trading. (Tr. 130-31.) For these trades, the markdown consistent with industry practice would be $13,087. Anderson charged his customers $80,062 for the trades, however. (Tr. 132-33.) As for U.S. Treasury strips, Anderson's trades, if performed consistently with industry practice, should have resulted in a maximum markup of $1,594. Anderson assessed a markup fee of $11,489, however. (Tr. 134.)

In some specific bond pools Anderson charged markups totaling $25,000 more than that charged consistently with industry practice. (Tr. 133-35.) Some CMOs are sequential bonds, which entitled Anderson to a larger percentage markup upon sale for this volatile security. A total markup of $9,443 would have been consistent with industry practices, whereas Anderson charged $26,604 in aggregate markups. (Tr. 136-38.) Mortgage-backed securities are more back-office intensive then Treasury bonds. The settlement process is more complex, due to problems that might arise with mortgage payments and guarantees that must be reduced to writing and other factors. (Tr. 155.) For twelve U.S. Treasury notes; four U.S. Treasury strips; twelve mortgage-related specified pools; and eight CMOs traded by Anderson, industry standards dictated that commissions should not have exceeded 1% of the purchase price in reference to these thirty-six trades at issue. (Div. Ex. 2 at 2.) Markups and markdowns exceeded industry standards by $67,000 for U.S. Treasury note trades alone, and by $10,000 for U.S. Treasury strip trades. (Div. Ex. 2 at 3-7.) For mortgage-related specified pools, markups exceeded industry standards by $25,000. (Div. Ex. 2 at 8.) Markups exceeded industry standards by $17,000 for CMO sector trades. (Div. Ex. 2 at 9.)

Anderson also purchased municipal bonds for his clients through riskless transactions. (Tr. 203-04.) When he had a purchase order he either had to do the legwork himself to find the appropriate bond or call an intermediary such as a broker's broker. (Tr. 298.) Anderson also liquidated his clients'

municipal bonds by obtaining bids through another dealer or broker's broker, purchasing them from his own clients at one price, and then selling them "to dealers with his markdown at a higher price." (Tr. 203-04.) The intermediary broker's broker would charge $2 per $50,000 bond transaction, a charge that is usually passed on to the customer. (Tr. 204-06.) There is nothing inconsistent or inherently unusual in the practice of buying a bond, marking it up, and selling it to a customer, or on a markdown, paying a customer a lower price than the bond ultimately sells for. (Tr. 210-11.)

Anderson traded some AAA-rated municipal securities in the instant case. (Tr. 214-15.) Usually, dealers charge less for trading higher-rated securities than they do for non-rated securities, which are more difficult to get information about. However, Anderson's "markup seemed to be the same in a given time frame" for all municipal bonds regardless of their rating. (Tr. 214-16, 320.) About a third of the municipal bond transactions in the instant case were of AAA grade. Over half were of investment grade, of Baa or higher. (Tr. 227.) Usually, the larger the transaction, the lower the markup. A trade of $5,000 to $10,000 would be considered a small trade and entitled to a larger markup because of "transaction costs and the effort expended by the broker." (Tr. 227-28.) The usual practice is that the markup on a longer-term bond is greater than the markup on short-term bonds, because the markup does not affect the yield on the longer-term bond as it does the short-term bond. (Tr. 238.) Also, markups on callable and prefunded bonds are, by industry practice, lower. Anderson made no distinction in his markup assessments, however, between prefunded bonds, callable, and long-term municipal securities. (Tr. 240-42.) Industry practice dictates that the broker charge less on customer sells than on customer purchases, because no salesmanship is required to consummate the trade. The broker's sole obligation is therefore to obtain the best price for the client. (Tr. 243-44.) Extraordinary service in the way of research or analytical materials provided to the client is worth something. (Tr. 245-46, 334.)

An NASD examiner might use guidelines to identify markups for closer scrutiny. (Tr. 357-59, 362-64.) When a trade was identified that exceeded the threshold, a representative of the NASD might contact an industry person, a member of the DBCC, or a large broker-dealer in an effort to determine the market price for the bond in question to determine whether the markup was truly excessive. (Tr. 365-66.) The guidelines are not for use by brokers, however. (Tr. 367.) Brokers never had a numerical guideline, but always had the "fair and reasonable" guideline. (Tr. 381-82.) The threshold guidelines for markups on municipal bonds were established by the NASD merely for consistency in conducting examinations throughout the country when reviewing markups. (Tr. 383.) NASD never changed its general standard that markups on municipal bonds must be related to the market price for the bonds and must be fair and reasonable. (Tr. 383-84.)

Conclusions of Law

The OIP alleges that Anderson willfully violated Section 17(a) of the Securities Act and Sections 10(b) of the Exchange Act and Rule 10b-5 thereunder. Section 17(a) of the Securities Act prohibits any person from committing fraud in the offer or sale of securities. Section 17(a)(1) makes it unlawful to directly or indirectly employ any device, scheme, or artifice to defraud; Section 17(a)(2) provides that no one shall obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary to make the statements made not misleading; Section 17(a)(3) proscribes any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon a purchaser of securities. Section 10(b) of the Exchange Act outlaws the direct or indirect employment of manipulative and deceptive devices in

connection with the purchase or sale of securities. Rule 10b-5 of the Exchange Act makes it unlawful for any person, directly or indirectly, in connection with the purchase or sale of a security, to make an untrue statement of material fact; omit to state a material fact; use any device, scheme, or artifice to defraud; or engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person.

To prove a violation of Section 17(a)(1) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5, the Division must show (1) that a misrepresented or omitted statement of fact was made in an offer, attempt to induce a purchase or sale, or an actual purchase or sale of a security; (2) that the misrepresented or omitted fact was material; and (3) that the respondent acted with the requisite scienter. *See Basic Inc. v. Levinson*, 485 U.S. 224, 240 (1988); *Aaron v. SEC*, 446 U.S. 680, 701-02 (1980). Scienter is "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). It is established by a showing that the respondent acted intentionally or with severe recklessness, defined as highly unreasonable conduct involving not merely simple or inexcusable negligence, but "an extreme departure from the standards of ordinary care." *Meyer Blinder*, 50 S.E.C. 1215, 1229-30 (1992) (quoting *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977)); *see also Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 (9th Cir. 1990); *SEC v. Carriba Air, Inc.*, 681 F.2d 1318, 1324 (11th Cir. 1982). Proof of recklessness may be inferred from circumstantial evidence. *See Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir. 1978). A finding of negligence is adequate to establish a violation of Sections 17(a)(2) and 17(a)(3) of the Securities Act. *See Jay Houston Meadows*, 52 S.E.C. 778, 785 & n.16 (1996), aff'd, 119 F.3d 1219 (5th Cir. 1997); see also *SEC v. Steadman*, 967 F.2d 636, 643 & n.5 (D.C. Cir. 1992) (citing *Aaron*, 446 U.S. at 701-02); *Newcome v. Esrey*, 862 F.2d 1099, 1102 n.7 (4th Cir. 1988).

Section 17(a)(2) of the Securities Act and Rule 10b-5 of the Exchange Act provide that only material misstatements and omissions are actionable. The materiality element is satisfied where there is a substantial likelihood that under all circumstances, a reasonable investor would consider the omitted or misstated information significant in making an investment decision. *See Basic Inc.*, 485 U.S. at 231-32 (citing *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)). A statement is misleading if the information disclosed does not accurately describe the facts, or if insufficient data is revealed. See *Basic Inc.*, 485 U.S. at 232; *United States v. Koenig*, 388 F. Supp. 670, 700 (S.D.N.Y. 1974).

In *SEC v. American Commodity Exchange*, 546 F.2d 1361, 1365 (10th Cir. 1976), the court indicated that actual sales by the defendant were not necessary to establish a violation of the antifraud provisions of Section 17(a) of the Securities Act. To the same effect, see *United States v. Dukow*, 330 F. Supp. 360 (W.D. Pa. 1971), and *Fund of Funds Ltd. v. Arthur Andersen & Co.*, 545 F. Supp. 1314 (S.D.N.Y. 1982). The *Dukow* court held that even though the defendant was not a party to sales made by brokerage personnel, he was part of the scheme and was not exonerated from charges of securities fraud. 330 F. Supp. at 364. "[T]he securities laws include as a seller entities which proximately cause the sale . . . or whose conduct is a substantial factor in causing a purchaser to buy a security.'" *Fund of Funds Ltd.*, 545 F. Supp. at 1353 (quoting *Lawler v. Gilliam*, 569 F.2d 1283, 1287 (4th Cir. 1978)).

The Division contends that Anderson did not disclose the size of markups and markdowns in Treasury securities strips of 2.75% to 4.01%; CMO markups of 1.42% to 4.0%; and municipal bond markups or markdowns of 1.87% to 5.64%. It further contends that ninety-six total transactions by

Respondent resulted in deviations from industry practice and were excessive, and that Anderson aided and abetted Armscott's violations in many of these transactions.

The OIP also alleges that Anderson willfully aided and abetted and caused Armscott's violations of Sections 15(c)(1) and 15B(c)(1) of the Exchange Act and Rule 15c1-2 therunder, as well as MSRB Rules G-17 and G-30. Section 15(c)(1) of the Exchange Act prohibits any broker, dealer, municipal securities dealer, or government securities broker or dealer, from effecting any transaction in any security, municipal security, or government security by means of any manipulative, deceptive, or other fraudulent device or contrivance, as defined by Rule 15c1-2. Rule 15c1-2 of the Exchange Act defines the term to include any act, practice, or course of business, which operates or would operate as a fraud or deceit upon any person. It also includes any untrue statement of a material fact and any omission to state a material fact necessary to make statements made, in light of the circumstances under which they were made, not misleading. The elements of a cause of action under Section 15(c)(1) of the Exchange Act are the same as for Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5, except that Rule 15c1-2 of the Exchange Act requires that a statement or omission be made only with knowledge or reasonable grounds to believe that it is untrue and misleading. *See SEC v. Great Lakes Equities Co.*, [1990-91 Decisions] Fed. Sec. L. Rep. (CCH) 95,685, at 98,206 (E.D. Mich. 1990); *SEC v. Wexler*, [1993 Decisions] Fed. Sec. L. Rep. (CCH) 97,758, at 97,653 & nn.5-6 (S.D.N.Y. 1993).

Section 15B(c)(1) of the Exchange Act prohibits a broker-dealer from violating MSRB rules. MSRB Rule G-17 requires broker-dealers to deal fairly with others and not engage in deceptive, dishonest, or unfair practices. *See* MSRB Rule G-17, MSRB Manual (CCH) 3581. Section 15B(c)(1) of the Exchange Act and MSRB Rule G-17 requires a showing of at least negligence. *See SEC v. Dain Rauscher, Inc.*, 254 F.3d 852, 856 (9th Cir. 2001) (citing *Merrill Lynch, Pierce, Fenner & Smith Inc.*, 67 SEC Docket 1807 (Aug. 24, 1998)). A violation of MSRB Rule G-17 is not appreciably distinct from Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act, and will not be considered separately. *See SEC v. Fitzgerald*, 135 F. Supp. 2d 992, 1027 & nn.11-12 (N.D. Cal. 2001) (citations omitted). MSRB Rule G-30 requires broker-dealers to charge fair and reasonable prices for municipal securities. *See* MSRB Rule G-30, MSRB Manual (CCH) 3646.

For aiding and abetting liability under the federal securities laws, three elements must be established: (1) a primary or independent securities law violation committed by another party; (2) awareness or knowledge by the aider and abettor that his or her role was part of an overall activity that was improper; and (3) knowing and substantial assistance by the aider and abettor in the conduct that constitutes the violation. *See Graham v. SEC*, 222 F.3d 994, 1000 (D.C. Cir. 2000); *Woods v. Barnett Bank*, 765 F.2d 1004, 1009 (11th Cir. 1985); *Investors Research Corp. v. SEC*, 628 F.2d 168, 178 (D.C. Cir. 1980); *IIT v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980); *Woodward v. Metro Bank*, 522 F.2d 84, 94-97 (5th Cir. 1975); *SEC v. Coffey*, 493 F.2d 1304, 1316-17 (6th Cir. 1974); *Russo Sec. Inc.*, 53 S.E.C. 271, 278 & n.16 (1997); *Donald T. Sheldon*, 51 S.E.C. 59, 66 (1992), *aff'd*, 45 F.3d 1515 (11th Cir. 1995); *William R. Carter*, 47 S.E.C. 471, 502-03 (1981). A person cannot escape aiding and abetting liability by claiming ignorance of the securities laws. *See Sharon M. Graham*, 53 S.E.C. 1072, 1084 n.33 (1998), *aff'd*, 222 F.3d 994 (D.C. Cir. 2000).

Excessive Markups

> The essential objective of securities legislation is to protect those who do [not] know market conditions from the overreachings of

> those who do. Such protection will mean little if it stops short of the point of ultimate consequence, namely, the price charged for the securities. Indeed, it is the purpose of all legislation for the prevention of fraud in the sale of securities to preclude the sale of securities which are in fact worthless, or worth substantially less than the asking price.

Hughes v. SEC, 139 F.2d 434, 438 (2d Cir. 1943) (citations omitted).

Among the basic representations implied by a broker-dealer is that when it sells a security to a customer, the dealer will charge a price that is reasonably related to the current market price. The fiduciary duty that the broker-dealer owes to its customer demands this commitment to fair dealing. Charging customers prices that are not reasonably related to prevailing market prices, without disclosure, is a violation of the antifraud provisions. *See Assoc. Sec. Corp.*, 40 S.E.C. 10, 14 (1960), *aff'd*, 293 F.2d 738 (10th Cir. 1961). "Prevailing market price" is the price at which dealers are willing to, and do, buy and sell securities with one another. *See LSCO Sec., Inc.*, 49 S.E.C. 1126, 1127-28 (1989);*Alstead, Dempsey & Co.*, 47 S.E.C. 1034, 1035 (1984). Absent countervailing evidence, the best evidence of the prevailing market price at which dealers trade with one another is the dealer's contemporaneous cost. *See Barnett v. United States*, 319 F.2d 340 (8th Cir. 1963); *Nicholas Codispoti*, 48 S.E.C. 842, 844 (1987); *Alstead, Dempsey*, 47 S.E.C. at 1035; *Powell & Associates, Inc.*, 47 S.E.C. 746, 748 (1982). The Commission has specifically held that a dealer's contemporaneous cost of acquiring a security should be used as the basis for computing a dealer's markup for riskless principal transactions. *See First Independence Group Inc. v. SEC*, 51 S.E.C. 662, 664 nn.9 & 11 (1993) (citing *Kevin B. Waide*, 50 S.E.C. 932 (1992)), *aff'd*, 37 F.3d 30, 32 (2d Cir. 1994).

Since 1939, the Commission has found excessive markups violative of the antifraud provisions.

> It is well recognized that undisclosed markups on sales to retail customers can violate the antifraud provisions of the securities laws if they are not reasonably related to the prevailing market price and if such markups are charged with scienter. It also has been recognized that, at the least, markups on equity securities of more than 10% generally are fraudulent.

D.E. Wine Invs., Inc., 74 SEC Docket 2573, 2577 (Feb. 6, 2001) (citations and footnotes omitted).

Since 1943, pursuant to NASD Conduct Rules 2110 and 2440 and IM-2440, the NASD 5% policy has been the guideline for determining whether NASD members have complied with NASD markup and pricing rules. *See id.* at 2580-81. That guideline grew out of a survey that found 71% of the transactions were not over 5%. However, the Commission rejected an administrative law judge's application of the 5% guideline in determining markups were fraudulent. It reasoned that the policy is not applicable in the context of an OIP "where we must determine not whether the Respondent's pricing conformed to NASD rules but rather whether it violated the antifraud provisions of the securities laws." *Id.* at 2580-81. The Commission refused therefore to determine the prevailing marketplace price "mechanically," and found that a sale of 250 shares at $1.375 per share involving a 12.7% markup did not constitute excessive or fraudulent pricing because the transaction size was small and total compensation was thus comparable to a reasonable ticket charge. *See id.* at 2579, 2580 n.22 (citing *Century Capital Corp.*, 50 S.E.C. 1280, 1283 n.10 (1992), *aff'd*, 22 F.3d 1184 (D.C. Cir. 1994)). Finally, the Commission reversed the

administrative law judge's initial decision and dismissed the case. *See id.* at 2582.

However, brokers have been sanctioned for fraudulently charging excessive markups and markdowns when they traded stocks in a variety of circumstances. *See, e.g., David Disner*, 52 S.E.C. 1217, 1219, 1221-23 (1997) (finding 16% to 188% markups and markdowns in 359 penny sock transactions excessive); *First Independence Group*, 37 F.3d at 31 (finding 11.11% to 186.46% markups in 373 riskless principal transactions in thinly-traded stocks excessive); *Toney L. Reed*, 51 S.E.C. 1009, 1012 (1994) (finding markups of 19.05% to 58.74% in penny stocks excessive); *G.K. Scott & Co.*, 51 S.E.C. 961, 966 (1994) (finding 16% to 157% markups in common stock sales excessive), *aff'd*, 56 F.3d 1531 (D.C. Cir. 1995) (unpublished table decision); *Amato v. SEC*, 18 F.3d 1281, 1282 (5th Cir. 1994) (finding markups of 20%, or more, in 80% of transactions excessive); *Jeffery D. Field*, 51 S.E.C. 1074, 1075 (1994) (finding 5% to 50% markup in 274 transactions for market maker excessive); *Great Lakes Equity Co.*, [1990-91 Decisions] Fed. Sec. L. Rep. (CCH) at 98,212 (finding a 200% markup in 300 penny stock transactions excessive); *Handley Inv. Co.*, 354 F.2d 64, 66 (10th Cir. 1965) (finding 14% to 57.9% markup in fifty penny stock transactions excessive); *Merritt, Vickers, Inc.*, 42 S.E.C. 274 (1964) (finding markups of 10.5% to 125% for 120 stock sales excessive), *aff'd*, 353 F.2d 293 (2d Cir. 1965); *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 436 (2d Cir. 1943) (finding 25% markup on riskless stock trades excessive); *Charles M. Weber*, 35 S.E.C. 663 (1954) (finding 38.9% markup on penny stock excessive).

Of course, the instant case involves bonds, not equity securities. More specifically the transactions at issue are in U.S. Treasury notes, U.S. Treasury strips, mortgage-related specified pools, CMOs, and municipal bonds. Other sources may be helpful in a determination of excessive bond markups. The MSRB, the primary regulatory authority in the municipal securities market, is a self-regulating organization created by Congress in 1975, and supervised by the Commission. It is authorized to propose and adopt rules to effectuate the purposes of the Exchange Act with respect to transactions in municipal securities. *See* Section 15B(b); *Grandon v. Merrill Lynch Co.*, 147 F.3d 184, 191 (2d Cir. 1998).

The MSRB has expressly refused to adopt a specific percentage guideline for reasonable markups because of the heterogeneous nature of municipal securities transactions and municipal securities dealers. Specifically, the MSRB cited the following as factors that make a specific benchmark unfeasible: many differences in municipal securities transactions; size of the transactions; quality and maturities of municipal securities; nature of the services which municipal securities dealers provide; and varying pricing practices of municipal securities dealers in different areas. *See* Interpretive Notice to Rule G-30, "Report on Pricing" (Sept. 26, 1980), MSRB Manual (CCH) 3646, at 5159-60 (*Report on Pricing*). MSRB Rule G-30 requires that prices charged by a municipal securities dealer be "fair and reasonable, taking into account all relevant factors." MSRB Rule G-30; *see also Grandon*, 147 F.3d at 191. The MSRB enumerated the following "relevant factors" in the rule: (1) the best judgment of the broker, dealer or municipal securities dealer as to the fair market value of the securities at the time of the transaction and any securities exchanged or traded in connection with the transaction; (2) the expense involved in effecting the transaction; (3) the fact that the broker, dealer, or municipal securities dealer is entitled to a profit; (4) the total dollar amount of the transaction; (5) the availability of the security in the market; (6) the price or yield of the security; and (7) the nature of the professional's business. *See* MSRB Rule G-30; *Report on Pricing*, MSRB Manual (CCH) at 5160; *Grandon*, 147 F.3d at 190; *Press v. Chemical Servs. Corp.*, 166 F.3d 535, 529 (2d Cir. 1999).

The Commission has discussed disclosure requirements for corporate, municipal, and government debt securities. *See Zero-Coupon Securities*, 38 SEC Docket 234 (Apr. 21, 1987). The release states that markups of 10% on equity securities are fraudulent, and that 5.1% markups on debt securities may violate MSRB rules. *See id.* at 235. The Commission has stated that "common industry practice regarding markups is to charge a markup over the prevailing inter-dealer market price of between 1/32% and 3.5% (including minimum charges) for principal sales" on conventional treasuries, depending on maturity, order size, and availability. (Resp. Ex. 10 at 7-9.) *See id.* at 235. The Commission concluded that markups on debt securities are historically smaller than those on equity securities. However, a markup as low as 1% of the face amount of a zero-coupon bond, a debt security that does not pay interest to the holder periodically prior to maturity, trading at a deep discount may be excessive, because the bond may have a short maturity. *See id.* at 235. Although the release does not set a specific percent for bond markups, it makes clear that NASD and MSRB general rules and policies as to markups do apply to debt securities. (Resp. Ex. at 16.) *See id.* at 236.

The legal standard for determining when a markup is excessive has long been whether, based on all of the facts and circumstances in a given case, the price charged was reasonably related to the prevailing market price, which I conclude, here, was the price at which Anderson himself traded the bonds at issue. The reasonableness of the markup or markdown charged can be determined only on the basis of the individual facts of each case. In making this determination, the finder of fact must assess various factors, including, but not limited to, industry practice regarding the range of appropriate markups or markdowns on a particular security or similar type of security in comparable transactions. *See Grandon*, 147 F.3d at 190 (citing *Banca Cremi, S.A. v. Alex. Brown & Sons, Inc.*, 132 F.3d 1017, 1033 (4th Cir. 1997)); *SEC v. Feminella*, 947 F. Supp. 722, 729 (S.D.N.Y. 1996) (citations omitted). Thus, where a defendant "exacts unreasonable profits resulting from a price which bears no reasonable relation to the prevailing price" of the security, the antifraud provisions are violated. *See Grandon*, 147 F.3d at 190 (citing *Bank of Lexington & Trust Co. v. Vining-Sparks Sec. Inc.*, 959 F.2d 606, 613 (6th Cir. 1992)).

Anderson concedes that the Division's experts described industry practice for the markups and markdowns at issue here, and I have so found. However, deviation from industry practice constitutes only one factor that must be considered. Given the fact-specific nature of the inquiry, it is clear that there is no single, fixed percentage standard for what constitutes an excessive markup or markdown for all transactions. Rather, the fact finder must determine whether, under all the circumstances of the transaction, the price charged for the security was reasonably related to the prevailing market price.

With regard to scienter, in order to establish this element, the Commission must show that the respondent acted with actual intent to deceive, manipulate, or defraud, or severe recklessness, which is limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the respondent or is so obvious that the respondent must have been aware of it.

> In addition, while there is no fixed standard representing an appropriate markup for the transactions, at issue, there is regulatory guidance as to what is acceptable, which bears repeating: the price charged must be reasonably related to the prevailing market price of the security. Whether [respondent's] profit was unreasonable and whether [respondent] intended to

> deceive his client or acted with severe recklessness are questions of fact . . . .

Feminella, 947 F. Supp. at 731.

Sellers of bonds have been sanctioned in a variety of cases for excessive markups or markdowns. In *Thomas F. White & Co.*, the Commission reviewed and affirmed NASD sanctions. 51 S.E.C. 932 (1994), *aff'd*, 68 F.3d 482 (9th Cir. 1995) (unpublished table decision). The non-market maker firm had bought certain bonds and resold them to retail customers at "68.5", regardless of the price it had paid for them. The activity resulted in thirty-two retail sales with markups from 7.03% to 14.17%, which were "improper." *Id.* at 934. The NASD's order to return all commissions over 5% was affirmed with slight modification. *See id.* at 937. The Commission based its decision on the following NASD factors: characteristics of the debt securities sold; the fact that the firm was not a market maker; the rapid turnover to retail customers; and the nature of the market in the bonds. *See id.* at 936.

In *Investment Planning Inc.*, the Commission also affirmed NASD fines and suspensions for excessive markups. 51 S.E.C. 592 (1993). The firm and its executives routinely traveled to the homes of retired, conservative investors in rural areas. They sold the customers high-quality, zero-coupon municipal securities and interest-bearing bonds. The sales resulted in 4% to 7.26% markups for sixty-five corporate bond transactions, and 4% to 5.99% for sixty-seven municipal bond transactions, which were characterized as "extraordinary charges for ordinary transactions." *Inv. Planning Inc.*, 51 S.E.C. at 594. In *Donald T. Sheldon*, the Commission upheld an administrative law judge's sanction of a permanent bar for a variety of misconduct, including excessive markups. 51 S.E.C. at 59. The dealer's procedures manual described the markup policy in the municipal bond industry to be a quarter of 1% to 5% over the current market price for a bond. However, brokers engaged in 109 transactions in bonds where undisclosed markups of 6% to 15% were charged. *See Donald T. Sheldon*, 51 S.E.C. at 76-77. In *F.B. Horner & Associates, Inc.*, the Commission affirmed NASD sanctions against the brokerage firm and its president. 50 S.E.C. 1063 (1992), *aff'd*, 994 F.2d 61 (2d Cir. 1993) (per curiam). It agreed with the NASD that any markup in excess of 5% was unwarranted. *See F.B. Horner*, 50 S.E.C. at 1067. The Commission also rejected the expert's opinion that, because the trades were riskless, the appropriate markup was 1.8% to 2.9%. *See id.* at 1066. Instead, the Commission and the NASD based their decision on the time and effort that Horner had devoted to the client's portfolio and his expertise in locating and acquiring the unique product for his customers in deciding on a 5% markup threshold. *See id.* at 1067. The Commission imposed sanctions for markups of 8.09% and 6.9% on two purchases of principal-only CMOs that the client needed to balance the interest-only bonds in its portfolio. *See id.* at 1064-65.

In *First Honolulu Securities, Inc.*, the Commission reviewed an NASD matter and partially set aside findings of violation for markups. 51 S.E.C. 695 (1993). The Commission noted its opinions suggest that while markups of municipal bonds may reach 5%, that figure might be acceptable in only the most exceptional cases, and that it had long held that markups over 5% in municipal securities were excessive. *See First Honolulu*, 51 S.E.C. at 698-99, 701. Accordingly, the Commission sustained the findings of violation with respect to the markups at issue that exceeded 5%. The Commission also held that markups exceeding 4% on high-quality, zero-coupon municipal securities were excessive, but set aside the findings of violation for such markups between 4% and 5%, because "it may not have been clear to applicants in 1990 that markups on municipal securities of over four percent usually are unfair." *See id.* at 701. Finally, the Commission

commented that while it believed the markups below 4% on the municipal debt securities at issue were excessive, the NASD had introduced no evidence that would establish the unfairness of markups at those levels, and set aside those findings of violations. *See id.* at 701.

In *Banca Cremi, S.A. v. Alex Brown & Sons, Inc.*, a bank sued when it was left holding six CMOs after a market downturn in February 1994 and the price of the CMOs had dropped precipitously. 132 F.3d 1017, 1026 (4th Cir. 1997). The broker had charged: two markups of 5.25%; seven markups between 3.1% and 3.77%; seven markups of between 2.4% and 2.84%; and three markups of 2.06%, 1.78%, and 4.99% respectively, where it had sold over $100 million in CMOs to a bank and received over $2 million in commissions. *See Banca Cremi*, 132 F.3d at 1034. The court refused to shift the burden to the respondent to prove reasonableness after an expert opined that undisclosed markups over 1% on CMO sales were excessive. *See Banca Cremi*, 132 F.3d at 1034. Summary judgment for the broker was upheld because the court concluded from deposition testimony that the bank did not express any concern regarding the amount of any markups, and that the amount of the broker's markup was not a consideration in its decision to invest. *See id.* at 1036-37. The court also noted that the Commission does not generally require disclosure of sales fees as markups. "It is even more puzzling why the SEC, having once abandoned an effort to administratively require such disclosures, should now seek to judicially impose the identical requirements on dealers." *Id.* at 1035 (citations omitted). I conclude that the Division has not proved that Anderson charged excessive markups or markdowns, or that the prices he charged were not reasonably related to the prevailing market price. The Division's experts' opinions were not based on factors or data that could establish excessive markups and markdowns. They did not establish that the yield after Anderson's markups or markdowns was not "comparable to the yield on other securities of comparable quality, maturity, coupon rate, and block size then available in the market." *Report on Pricing*, MSRB Manual (CCH) at 5161. The MSRB singled out the resulting yield as the most important factor in determining the fairness and reasonableness of price in any given transaction. *See id.*

Robert M. MacLaverty expressed an expert opinion as to the pricing on the following transactions: twelve U.S. Treasury notes; four U.S. Treasury strips; twelve mortgage-related specified pools; and eight CMOs. MacLaverty concluded that the markups and markdowns on all of the above transactions should not have exceeded 1% of the purchase price, and the markups and markdowns charged on these transactions were inconsistent with industry standards and other relevant factors. (Div. Ex. 2 at 2.) MacLaverty determined the proper markup or markdown for each type of security by doubling the bid-ask spread at the time of the transaction: U.S. Treasury notes and strips had a bid-ask spread of 1/32; mortgaged-specified pools had a bid-ask spread of 1/8; and CMOs had a spread of 1/5. He asserted that this method took into account the necessary factors when charging a markup or markdown on a principal bond transaction, and concluded that Anderson, in charging different markups or markdowns, did not take into account such necessary factors. (Div. Ex. 2 at 4-8.) I do not agree that the bid-ask spread should be used as a basis for decision making here. Instead, prices paid pursuant to Anderson's trades, or contemporaneous cost, should be used. *See First Independence Group*, 51 S.E.C. at 664 nn.9 & 11. Peter C. McCabe also expressed an expert opinion on the markups and markdowns on certain municipal bond trades. (Div. Ex. 3 at 2.) McCabe alluded to several relevant factors in his opinion. However, in discussing the specific bonds at issue, he simply assigned a range of "appropriate" markups or markdowns. In most cases he did not compare the particular bond at issue with the price of other bonds with similar characteristics trading at the time as required by *Grandon*. McCabe went

through all sixty municipal bond trades and prepared charts that showed various characteristics of the bonds. He also provided what he believed to be an "appropriate" markup and markdown range. However, McCabe did not indicate the source for his "appropriate" markup and markdown ranges. (Tr. 257-71; Div. Ex. 3 at 20-23.) McCabe did not analyze similar bonds, available on those dates. (Tr. 318-19.) For sixty bond trades, Anderson's markups and markdowns exceeded industry standards by $68,386. (Div. Ex. 3 at 2-6, Div. Ex. 4.) McCabe also assigned no value to any special services Anderson provided his clients. (Div. Ex. 3 at 3.)

Careful analysis of the ninety-six bond trades in the instant case reveals that Anderson acted fairly based on the type of security. Anderson traded four times in U.S. Treasury securities where the markups ranged from 2.99% to 4.01%. He traded twelve times in U.S. Treasury securities where the markdowns ranged from 2.75% to 3.87% (with only two trades over 2.99%). He traded twenty times in government agency securities where the markdowns ranged from 1.42% to 4.07% (with only six trades over 4%). He traded fifty times in municipal securities where the markups ranged from 1.87% to 5.00% (with only twenty-six trades over 4%). And he traded ten times in municipal securities where the markdowns ranged from 3.02% to 5.64% (with only two trades over 4.99%). (Jt. Ex. 24 at 8-12.) Thus, for the type of security involved, I conclude that the pattern of trades shows commissions that are consistent with the standards described for pricing of bonds in the NASD Manual, MSRB Rules, and the Commission's own decisions and releases.

As for availability of the securities, several dozen primary dealers in the United States are required to make markets in U.S. Treasury notes and in U.S. Treasury strips daily. (Div. Ex. 2 at 3-4.) The CMOs that Anderson traded are more "back office intensive" to settle with a counter party and are not as liquid or as widely sold as treasuries. (Div. Ex. 2 at 7-9.) Municipal bonds likewise are not as widely available as U.S. Treasury notes; bond traders make markets in bond issues from most states in the secondary market. These municipal bond issues may also be underwritten by broker-dealers; there is no evidence that the municipal bond issues in the instant case were actively promoted at the time of the trades. (Div. Ex. 3 at 2-3.) Anderson's testimony that his trades were driven by the yield, tax consequences, portfolio, and special needs of each client was not contradicted. Thus, Anderson's trades in specialized securities justify the commissions he charged, and none of his clients were misled. (Tr. 484-89.) I disagree with the expert's opinion that Anderson ignored the call dates, and I credit Anderson's testimony, which was not contradicted, that he routinely discussed the issue of stated call dates with his customers and provided them with accurate yield figures that he had obtained from other brokers, along with his own estimate of what the call date might be. Investment advisers at AMM also assisted clients. (Tr. 426, 474-500; 524-34; Div. Ex. 3 at 2-4, Jt. Ex. 24 at 2.) Like the salesman in *F.B. Horner*, Anderson also used his expertise to locate securities that met the unique needs of the clients. (Tr. 462-63, 465.) *See* 50 S.E.C. at 1067. Thus he was entitled to higher markups.

The price of the security and the dollar amount of the trades are significant because broker profits and transaction costs can be spread over a larger number of bonds, lowering the charge per bond. (Div. Ex. 3 at 2.) Thus generally, the lower the price of the security or of the dollar amount of the trade, the higher the percent of reasonable markup. I disagree with the expert's characterization of the vast majority of the trades here as "institutional" in size and thus subject to lower markups. (Div. Ex. 3 at 2.) I credit Anderson's testimony to the effect that he had a continuing relationship with his clients, most of whom were wealthy individuals. His testimony is corroborated by the fact that the largest trade at issue was

only one for $375,000; the next was a single trade for $288,000, followed by six for $250,000. All the remaining trades were smaller. (Jt. Ex. 24.)

I conclude that the Division has failed to prove that the prices the clients paid were not reasonably related to the market price. Anderson's testimony that the clients were knowledgeable experienced investors who understood financial markets and interest rates is not contradicted by any evidence in the record. (Tr. 535, 540-51.) His testimony that he routinely informed his clients of the yield based on what he reasonably viewed as "the worst-case possible thing that could happen" was also not contradicted. (Tr. 592-94.) Most importantly, Anderson's description of the manner in which he used yield to calculate a reasonable commission as markup or markdown has not been characterized by the testifying experts or by the Division as highly unreasonable conduct involving not merely simple or inexcusable negligence or as an extreme departure from the standards of ordinary care. It has not even been described as inconsistent with industry practice or standards. Thus, higher markdowns were justified even though they may have resulted in figures that deviated from industry practice.

Industry practice as to markups on a particular security or similar type of security should be considered as a factor, of course. In the instant case, that practice would dictate that Anderson should have charged about half the amount he charged in markups and markdowns for municipal bond trades. (Div. Ex. 3 at 20-24.) It would also dictate the he should have charged less then one-third of the stated markups for U.S. Treasury notes and strips, specified pools, and CMOs. (Div. Ex. 2 at 18.) I have credited the testimony of the experts to that degree, although Anderson contends that other fixed fees usually charged by mutual funds should not be ignored. (Tr. 640-44.) I agree with that contention. I conclude that because industry practice is only one factor in the determination of whether the charges in the OIP have been established, it cannot be determinative here. Thus, I reject the conclusion of the Division experts that the departures from industry practice were extreme. Indeed, the Division's reliance on the figures that the experts suggest is not the approach taken by the courts or the Commission. See *Grandon*, 147 F.3d at 190; *Banca Cremi*, 132 F.3d at 1033; *Feminella*, 947 F. Supp. at 729; *D.E. Wine*, 74 SEC Docket at 2580-81; *Staten Sec. Corp.*, 25 SEC Docket 2006, 2007-09 (Apr. 9, 1982).

Anderson's testimony that he operated a small business with very few employees and that he earned a personal income well below $75,000 for the several years at issue here was not contradicted. (Tr. 648-49.) He is entitled to a profit and I conclude that the Division has failed to prove the prices that he charged his clients were not reasonably related to the prevailing market prices of the securities. He also attempted to cooperate with the NASD inquiry. I cannot take the settlements of other parties into account. Thus the case must be dismissed as to him. I must also conclude that since the markups and markdowns were not excessive, Armscott was not a primary or independent securities law violator. Therefore, Anderson did not aid or abet any Armscott violations. That section of the OIP must also be dismissed.

Record Certification

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), I certify that the record includes the items described in the record index issued by the Secretary of the Commission on October 7, 1999.

Order

IT IS ORDERED that the proceeding against Respondent Mark David Anderson be, and it hereby is, dismissed.

This Order shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that rule, a petition for review of this Initial Decision may be filed within twenty-one days after service of the decision. It shall become the final decision of the Commission as to each party who has not filed a petition for review pursuant to Rule 360(d)(1) within twenty-one days after service of the Initial Decision upon such party, unless the Commission, pursuant to Rule 360(b)(1), determines on its own initiative to review this Initial Decision as to any party. If a party timely files a petition for review, or the Commission acts to review as to a party, the Initial Decision shall not become final as to that party.

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Lillian A. McEwen
Administrative Law Judge

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1 Citations to the hearing transcript, and exhibits offered by the Division and Anderson will be noted as "Tr. __," "Div. Ex. __," and "Resp. Ex. __," respectively. Exhibits offered jointly by the parties will be noted as "Jt. Ex. __."

http://www.sec.gov/litigation/aljdec/id203lam.htm