MARK-UPS

Brandon Becker
Todd E. Wiench
WILMER, CUTLER & PICKERING[*/]
WASHINGTON, D.C.

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[*/] Brandon Becker is a partner and Todd Wiench is an associate in the law firm of Wilmer, Cutler & Pickering. This outline is for general information purposes only and does not represent Wilmer, Cutler & Pickering's legal advice as to any particular set of facts, nor does this outline represent any undertaking to keep recipients advised as to all relevant legal developments.

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I. FEDERAL SECURITIES LAWS

A. General

1. The difference between the price charged to a customer for a security and the prevailing market price for the security, when the seller of the security is acting as a principal, holding ownership of the security and selling it to the customer, is the mark-up. Press v. Chemical Investment Services Corp., 166 F.3d 529, 533 n.2 (2d Cir. 1999)[citing SEC v. First Jersey Securities, Inc., 101 F.3d 1450, 1469 (2d Cir. 1996), cert. denied, 118 S. Ct. 57 (1997)]. See also In re Lehman Brothers Inc., Securities Exchange Act Rel. No. 37673 (Sept. 12, 1996); 62 SEC Docket 2324 and Zero-Coupon Securities, Securities Exchange Act Rel. No. 24368 (Apr. 21, 1987), 38 SEC Docket 234.

2. On the other hand, if the seller of the security is acting as an agent, purchasing the security without actually taking ownership prior to transferring it to the customer, the renumeration would be referred to as a commission rather than a mark-up. Press v. Chemical Investment Services Corp., 166 F.3d 529, 533 n.2 (2d Cir. 1999).

3. The duty of fair dealing includes the implied representation that the price a firm charges bears a "reasonable relationship" to the prevailing market price. Charles Hughes & Co., Inc. v. SEC, 139 F.2d 434 (2d Cir.), cert. denied, 321 U.S. 786 (1943). "[A dealer] should disclose the market price if sales are to be made substantially above that level." Id. at 437.

B. Antifraud Provisions

1. Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") provides that:

   It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality or interstate commerce or of the mails, or of any facility of any national securities exchange—

   To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest for the protection of investors.

12 U.S.C. § 78j(b).

2. A securities fraud claim under Section 10(b) and Rule 10b-5 thereunder requires:

   a. a misstatement or omission of a material fact;

   b. in connection with the offer, sale or purchase of a security;

   c. made with scienter.

   In re Westinghouse Securities Litigation, 90 F.3d 696, 710 (3d Cir. 1996). See also, SEC v. Great Lakes Equities Co., [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,685, at 98,201, 98,211-12 (E.D. Mich. Sept. 4, 1990).

3. "A [dealer] . . . only has the duty to disclose the specifics of a mark-up--under the rubric of the obligation under Section 10(b) to disclose "material information"--when there is either a fiduciary relationship with the complaining party or when the mark-up is 'excessive.'" Press v. Chemical Investment Services Corp., 166 F.3d 529, 534 (2d Cir. 1999). See also, Grandon v. Merrill Lynch & Co., Inc., 147 F.3d 184, 190 (2d Cir. 1998) and SEC v. Feminella, 947 F. Supp. 722, 728-29 (S.D.N.Y. 1996).

4. If a dealer's price to a customer is "substantially different" from the prevailing market price, then, absent disclosure, the dealer has violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and possibly Section 17(a) of the Securities Act of 1933. Ryan v. SEC, Sec. Reg. & L. Rep. (BNA) No. 26 at 1273 (July 1, 1983) (9th Cir., May 23, 1983), aff'g, In re James E. Ryan, 47 S.E.C. 759 (1982). See also, Ettinger v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 835 F.2d 1031 (3d Cir. 1987); In re Crosby & Elkin, Inc., 47 S.E.C. 526 (1981); In re Alan Securities, Inc., 51 S.E.C. 1092 (1994).

5. Fraud occurs when "unreasonable prices are charged in individual transactions." In re Trost & Co., 12 S.E.C. 531, 535 (1942).

6. "[T]he failure to reveal the mark-up pocketed by the firm was both an omission to state a material fact and a fraudulent device." Charles Hughes

& Co., Inc. v. SEC, 139 F.2d 434, 437 (2d Cir.), cert. denied, 321 U.S. 786 (1943).

7. Courts consistently have held that a broker-dealer who charges excessive mark-ups on the sale of securities and fails to disclose this compensation violates the antifraud provisions of the federal securities laws. Banca Cremi S.A. v. Alex Brown & Sons, 132 F.3d 1017 (4th Cir. 1997); Ettinger v. Merrill Lynch Pierce, Fenner & Smith, Inc., 835 F.2d 1031 (3rd Cir. 1987); Barnett v. United States, 319 F.2d 340, 344 (8th Cir. 1963); Samuel B. Franklin & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944); SEC v. Rauscher Pierce Refsnes, Inc., 17 F. Supp.2d 985, 996 (D. Ariz. 1998); SEC v. Great Lakes Equities Co., [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) 95,685, at 98,201, 98,211 (E.D. Mich., Sept. 4, 1990); In re D.E. Wine Investments, Inc., Securities Exchange Act Rel. No. 39517 (Jan. 6, 1998); 66 SEC Docket 517.

8. Determinations of excessiveness are to be done on a case-by-case basis. Bank of Lexington & Trust Co. v. Vining-Sparks Securities, Inc., 959 F.2d 606, 613 (6th Cir. 1992). See also, Press v. Chemical Investment Services Corp., 166 F.3d 529, 535 (2d Cir. 1999); Grandon v. Merrill Lynch & Co., Inc., 147 F.3d 184, 190 (2d Cir. 1998); Banca Cremi, S.A. v. Alex. Brown & Sons, Inc., 132 F.3d 1017, 1033 (4th Cir. 1997); SEC v. Rauscher Pierce Refsnes, Inc., 17 F. Supp. 2d 985, 997 (D. Ariz. 1998); SEC v. Feminella, 947 F. Supp. 722, 729 (S.D.N.Y. 1996). Failure to perform a case-by-case analysis focusing on the particular facts of a situation can result in sanctions. See In re Lehman Brothers Inc., Securities Exchange Act Rel. No. 37673 (Sept. 12, 1996); 62 SEC Docket 2324. Some of the factors pertinent to this discussion can be found in NASD Mark-Up Policies, Section II infra and MSRB Mark-Up Policies, Section III, infra.

9. Arguments that mark-up practices are in line with industry practices and, therefore, could not have violated the law have been rejected by courts. SEC v. Rauscher Pierce Refsnes, Inc., 17 F. Supp.2d 985, 1001 (D. Ariz. 1998)[citing Newton v. Merrill, Lynch, Pierce, Fenner & Smith, 135 F.3d 266, 273-74 (3d Cir. 1998)], but see, District Business Conduct Committee For District No. 5 v. MMAR Group, Inc., 1996 NASD Discip. LEXIS 66 (Oct. 22, 1996), Complaint No. C0594001 ("We find . . . that evidence of industry practice is important, particularly in the evaluations of new and evolving markets . . . .").

C. Confirmation Disclosure of Mark-ups

1. Rule 10b-10 under the Exchange Act generally requires that broker-dealers provide customers with a written confirmation of a transaction disclosing certain information. Non-market makers in equity securities must disclose their mark-ups in riskless principal transactions. 17 C.F.R. § 240.10b-10(a)(ii)(A). In the case of any other transaction in a reported security, or an equity security that is quoted on NASDAQ or traded on a national securities exchange and subject to last sale reporting, the rule requires all broker-dealers to supply certain information designed to permit the customer to calculate the mark-up paid. 17 C.F.R. § 240.10b-10(a)(2)(ii)(B).

2. Rule 10b-10(a)(1) requires the disclosure of the net price of the security to the customer, but does not require disclosure of mark-ups.

3. Rule 10b-10(a)(5) requires that the customer's confirmation for transactions in debt securities effected exclusively on the basis of a dollar price show the dollar price at which the transaction was effected, and the yield to maturity calculated from the dollar price, but does not require that the mark-up be separately stated.

4. Rule 10b-10(a)(6) requires that the customer's confirmation for transactions in debt securities effected on the basis of yield to show the yield at which the transaction was effected, including the percentage amount and its characterization (<u>e.g.</u>, current yield, yield to maturity, or yield to call) and if effected at yield to call, the type of call, the call date and the call price, and the dollar price calculated from the yield at which the transaction was effected.

5. The SEC consistently has taken the position that Rule 10b-10 is not a safe harbor from Rule 10b-5 liability for failure to disclose excessive mark-ups. <u>See, e.g.</u>, Zero-Coupon Securities, Securities Exchange Act Rel. No. 24368 (April 27, 1987), 52 FR 15575. This position has received judicial support. "[A] broker-dealer's compliance with the disclosure requirements of Rule 10b-10 does not, as a matter of law, shield it from possible liability under Rule 10b-5." Ettinger v. Merrill Lynch, 835 F.2d 1031 (3d Cir. 1987). <u>See also</u>, Grandon v. Merrill Lynch, 147 F.3d 184 (2d Cir. 1998); Shivangi v. Dean Witter Reynolds, Inc., 107 F.R.D. 313 (S.D. Miss. 1985), <u>aff'd</u>, 825 F.2d (5th Cir. 1987); Krome v. Merrill Lynch, 637 F. Supp. 910 (S.D.N.Y. 1986) <u>and</u> <u>In re</u> Meyer Blinder, 50 S.E.C. 1215 (1992). In <u>Krome</u> the Court held that Rule 10b-10 was intended to provide additional protection to securities customers, and stated that it would "not interpret this rule to reduce the protection afforded purchasers under other provisions of the securities laws." 637 F. Supp. at 916.

6. In 1994, the SEC published for comment proposed amendments to Rules 10b-10 and 15c2-13 (governing municipal securities) with the intention of enhancing confirmation disclosure requirements for riskless principal transactions in debt securities. The proposed amendments would have required disclosure of mark-up information, and did not include an exception for market makers. The SEC reasoned that "investors in debt securities, like investors in equity securities, should be informed of the costs in riskless principal trades because, despite the legal distinctions, these trades are the functional equivalent of transactions effected on an agency basis." Securities Exchange Act Rel. No. 33743 (Mar. 9, 1994); 56 SEC Docket 558.

7. Ultimately later that same year, the SEC decided to defer the confirmation disclosure proposal, pending implementations of a proposal by the MSRB to make available price information on municipal securities on a next-day basis. The SEC reasoned that "the industry's efforts to improve transparency . . . ultimately will result in enhanced price disclosure for all transactions. Moreover, better dissemination of price information will benefit investors by providing them with useful information at the time they are making their investment decision, rather than after-the-fact when the confirmation is received." Confirmation of Transactions, Securities Exchange Act Rel. No. 34962 (Nov. 10, 1994), 57 SEC Docket 2674.

8. In response to the SEC's revisions to Rule 10b-10 and proposed Rule 15c2-13, the MSRB amended Rule G-15(a) governing confirmation disclosure in municipal securities. The changes to Rule G-15(a) were made for the purpose of clarifying the current customer confirmation requirements and incorporating previous Board interpretations into the language of the Rule to promote better compliance and provide more adequate disclosure. Order Approving Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Customer Confirmations, Securities Exchange Act Rel. No. 35953 (July 11, 1995), 59 SEC Docket 1914.

D. Penny Stock Rules

1. The SEC also has adopted special disclosure requirements in relation to penny stock transactions. Penny Stock Disclosure Rules, Securities Exchange Act Rel. No. 30608 (Apr. 20, 1992), 51 SEC Docket 415. Exchange Act Section 15(g) and the Rules promulgated thereunder provide the basis for the disclosure requirements applicable to low priced securities that have been the source of much fraudulent activity. Due to the complex

definition of penny stock and the numerous transaction exemptions, any questionable transaction needs to be evaluated to determine if such requirements are applicable.

2. Rule 15g-3 requires broker-dealers to disclose to each customer, prior to effecting any transaction in, and at the time of confirming any transaction regarding any penny stock:

   a. The inside bid quotation and the inside offer quotation for the penny stock appearing on a Qualifying Electronic Quotation System.

   b. If such inside quotation is not available, in a principal transaction the dealer is required to disclose its own bid and offer prices if, during the previous five business days, the dealer has effected at least three bona fide sales to, in the cases of its current offer quotation, or purchases from, in the case of its current bid quotation, other dealers consistently at these respective bid or offer quotations at the time of those transactions. The dealer also must reasonably believe in good faith at the time of the transaction with the customer that its bid and offer prices accurately reflect the price at which it is willing to sell to or buy from other dealers. The term consistently has been deemed to be 75% of the transactions at the time involved must be at that quotation, although if there are only three transactions, all three must be at the quotation. If the dealer's quotations cannot satisfy these requirements the dealer shall disclose that it has not consistently effected interdealer purchases or sales at its quotations, and the price at which the last bona fide inter-dealer purchase or sale occurred.

   c. In an agency transaction, or a transaction on a riskless principal basis, the broker-dealer must disclose the best inter-dealer bid and offer prices for the penny stock obtained through reasonable diligence. Reasonable diligence is at a minimum, presenting to the customer the best of three quotations obtained from market makers in the security.

   d. Regardless of whether the transaction is conducted on an agency or principal basis, the broker-dealer must disclose the number of shares to which the bid and offer prices apply.

3. Rule 15g-4 requires broker-dealers to disclose to each customer, both prior to effecting any transaction in, and at the time of confirming any

transaction with respect to, any penny stock, the aggregate amount of any compensation received by such broker-dealer in connection with such transaction.

a. If the transaction is an agency transaction, the broker must disclose any renumeration received or to be received by it from such customer in connection with such transaction.

b. If the transaction is conducted on a principal basis, or is a riskless principal transaction, disclosure must be made of the difference between the price to the customer and the prevailing market price. The standards for determining the prevailing market price are essentially the same standards used for almost all securities transactions. See Determining Prevailing Market Price, Section V, infra. The one notable distinction although, can be found within Rule 15g-4(d). This paragraph provides an alternative standard for use by market makers in calculating compensation by making available an "active and competitive market" standard in determining the prevailing market price if the aggregate number of transactions effected by such market maker in the penny stock in the last five business days preceding such transaction is less than 20% of the aggregate number of all transactions in the stock reported on a Qualifying Electronic Quotation System. There is no presumption the market is not active and competitive if a market maker does not qualify. See Active & Competitive, Section V.D.1, infra.

4. Rule 15g-5 requires that broker-dealers disclose the aggregate compensation of certain associated persons of such broker-dealer prior to effecting the trade and at the time of confirmation involving the sale of any penny stock.

II. NASD MARK-UP POLICIES

A. In 1943, the NASD announced that mark-ups should not normally exceed 5% of the prevailing market price. In a survey conducted by the NASD, it determined that 47% of transactions by members were made at mark-ups of 3% or less and 71% of the transactions were affected at mark-ups of 5% or less. As a result, the NASD adopted a 5% guideline to determine whether mark-ups were excessive. See NASD Mark-Up Policy, IM-2440 at 4351 (CCH). See also In re Thill Securities Corp., 42 S.E.C. 89, 92 n. 4 (1964); In re NASD, 17 S.E.C. 459 (1944).

B. Since 1943, the NASD has enforced an interpretation of its rules that deems it a violation of Rule 2110 and Rule 2440 for a member to enter into any transaction with a customer in any security at a price not reasonably related to the current market price of the security or to charge a commission which is not reasonable. Interpretation of the Board of Governors, NASD Mark-up Policy, NASD Manual IM-2440, at 4351 (CCH).

C. NASD Conduct Rule 2110

A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.

NASD Manual (CCH) at 4111.

D. NASD Conduct Rule 2440

In "over-the-counter" transactions, whether in "listed" or "unlisted" securities, if a member buys for his own account from his customer, or sells for his own account to his customer, he shall buy or sell at a price which is fair, taking into account all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense involved, and the fact that he is entitled to a profit; and if he acts as agent for his customer in any such transaction, he shall not charge his customer more than a fair commission or service charge, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense of executing the order and the value of any service he may have rendered by reason of his experience in and knowledge of such security and the market therefor.

NASD Manual (CCH) at 4351.

E. NASD Conduct Rule 2120

No member shall effect any transaction in, or induce the purchase of sale of, any security by means of any manipulative, deceptive or fraudulent device or contrivance.

NASD Manual (CCH) at 4141.

F. In IM-2440(a), the NASD has clarified that the 5% policy that has been adopted is a guide, not a rule, and that a mark-up pattern of 5% or even less may be considered unfair. NASD Manual (CCH) at 4351.

G. The NASD has determined that many of the factors considered, especially the 5% guideline, apply in both princial and agency transactions. Notice to Members 93-81, NASD Reminds Members of the Requirements for Fairness of Agency Commissions and Applicability of the 5% Policy, NASD Manual (CCH)(1993).

H. "Members must take steps to develop compliance procedures designed to guard against abusive mark-up/mark-down practices, and to ensure that critical issues such as prevailing market price, market-maker status, market environment for a security, and validation of quotations, among other, are routinely and consistently considered." Notice to Member 92-16, Mark-ups/Mark-downs in Equity Securities, NASD Manual (CCH)(1992).

I. The determination of fairness of a mark-up must be based on a consideration of all the relevant factors, of which the percentage of the mark-up is only one. NASD Mark-Up Policy, NASD Manual (CCH) at 4351.

J. The NASD identified several factors which may be relevant in determining the fairness of mark-ups in addition to the percentage of the mark-up. Under the NASD's Mark-Up Policy, IM-2440 at 4351-4353 (CCH), the factors to be considered in determining the fairness of mark-ups include:

1. The type of security involved, <u>i.e.</u>, stock vs. bond. For example, a higher percentage of mark-up customarily applies to a common stock transaction than to a bond transactions of the same size. <u>See e.g.</u>, <u>In re</u> Staten Securities Corp., 47 S.E.C. 766, 768 (1982).

2. The availability of the security in the market, <u>i.e.</u>, where the market is inactive, the dealer will usually spend more time and effort obtaining or selling the security, thus justifying a higher mark-up; conversely, where there is an active market and a minimum of time and effort is spent, a higher mark-up is not justified. <u>See</u> <u>In re</u> NASD, 17 S.E.C. 459, 466-67 (1944).

3. The price of the security, <u>i.e.</u>, lower priced securities may involve higher percentage mark-ups because of handling costs. <u>In re</u> Ross Securities, Inc., 40 S.E.C. 1064, 1066 (1962). Higher mark-ups, however, may not be justified where the amount of money in the transaction is relatively large, even if the securities have a low price. <u>See</u> <u>id</u>; <u>In re</u> Maryland Securities Co. Inc., 40 S.E.C. 443, 446 (1960).

4. The amount of money involved in the transaction, <u>i.e.</u>, a small amount may warrant a higher percentage mark-up; <u>see e.g.</u>, <u>In re</u> Lehman Brothers Inc., Securities Exchange Act Rel. No. 37673 (Sept. 12, 1996); 62 SEC Docket

2324, In re Greenberg, 40 S.E.C. 133, 136 (1960); In re Franklin, 38 S.E.C. 908, 911 (1959); In re NASD, 17 S.E.C. 459, 469 (1944).

5. Disclosure made to the customer. "Disclosure itself, however, does not justify a commission or mark-up which is unfair or excessive in the light of all other relevant circumstances." The fact that a client agrees to the compensation does not immunize the compensation from scrutiny. In re Hamilton Bohner, 50 S.E.C. 125, n.10 (1989). (quoting language presently found in Interpretation of the Board of Governors, NASD Mark-up Policy, NASD IM-2440 at 4351).

6. The patterns of mark-ups. Particular attention is given to the pattern of a member's mark-ups, but each transaction must meet the test of fairness.

7. The nature of the member's business. A dealer that provides services, such as research, advice, and financial planning and counseling to a customer may be justified in charging a higher mark-up. See F.B. Horner & Associates, Inc. v. SEC, 994 F.2d 61, 63 (2d Cir. 1993); In re Wheeler Municipal Corp., 50 S.E.C. 397 (1990); In re Midland Securities, 40 S.E.C. 333, 383 (1960).

K. The NASD Mark-up Policy historically always has applied to all over-the-counter transactions, whether in listed or unlisted equity and corporate debt, but not exempted securities which include government and municipal securities.

L. In December 1993, Congress enacted the Government Securities Act Amendments of 1993 (GSAA), which eliminated the statutory limitations on the NASD's authority to apply its sales practice rules to transactions in exempted securities, including government securities, but specifically excluding municipal securities.

M. The NASD published Notice to Member 94-62 to provide guidance in application of the mark-up policy to transactions in government and other debt securities, excluding municipal securities. Following a number of years and two amendments, the proposal is still pending, and is discussed in Section V.E., infra.

III. MSRB MARK-UP POLICIES

A. Excessive mark-ups on municipal securities violate MSRB Rule G-17, which requires dealers to deal fairly with their customers (MSRB Manual (CCH) ¶ 3581 at 4851-65), and MSRB Rule G-30, which requires dealers to sell municipal securities to customers at a price that is "fair and reasonable, taking into consideration all relevant factors." MSRB Manual (CCH) ¶ 3646, at 5159-65. These factors include:

1. the best judgment of the broker, dealer or municipal securities dealer as to the fair market value of those securities at the time of the transaction and of 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; and

4. the total dollar amount of the transaction.

B. The MSRB also has recognized other relevant factors, including:

1. the availability of the security in the market;

2. the price or yield of the security;

3. the nature of the professionals business;

4. the rating of the security;

5. the existence of an active sinking fund for the security;

6. the trading history of the securities, i.e. the degree of market activity and the existence of market makers in the security; and

7. the recovery of costs, including research and credits.

MSRB Interpretations of Rule G-30, "Report on Pricing," (Sept. 26, 1980), MSRB Manual (CCH) ¶ 3646, at 5160. <u>See also</u>, Grandon v. Merrill Lynch & Co., Inc., 147 F.3d 184, 190 (1998).

C. Among these numerous considerations, the MSRB has stated that the resulting yield to the customer is the "most important" factor in determining whether the price (including the mark-up) of a municipal security is fair and reasonable. The yield to the customer should be "comparable to the yield on other securities of comparable quality, maturity, coupon rate, and block size then available in the market." Grandon v. Merrill Lynch & Co., Inc., 147 F.3d 184, 190 (1998)(quoting MSRB Interpretations of Rule G-30, "Report on Pricing," (Sept. 26, 1980), MSRB Manual (CCH) ¶ 3646, at 5160).

D. Although the MSRB considered adopting mark-up "benchmarks," the MSRB expressly has refused to adopt a specific percentage guideline for a reasonable mark-up, "in view of the heterogeneous nature of municipal securities transactions and municipal securities dealer." See MSRB Interpretations of Rule G-30, "Report on Pricing," (Sept. 26, 1980), MSRB Manual (CCH) ¶ 3646, at 5158.

E. A specific benchmark was considered "unworkable" considering the: (1) many differences in municipal securities transactions; (2) size of the transactions; (3) quality and maturities of municipal securities; (4) nature of the services which municipal securities dealers provide; and (5) varying pricing practices of municipal securities dealers in different areas. Id. at 5159. See also, Grandon v. Merrill Lynch & Co., Inc., 147 F.3d 184, 190 (1998).

F. The Second Circuit recently evaluated the lack of statutory disclosure requirements for sales of municipal securities in Grandon v. Merrill Lynch & Co., Inc., 147 F.3d 184 (1998), where the court vacated a lower court dismissal of a private action on the grounds that no duty existed. While noting that no statutory disclosure requirement for mark-ups applies to the sale of municipal securities, the court unequivocally memorialized its application of the principals of an implied duty to disclose mark-ups on municipal securities when those mark-ups are excessive. Id. at 192-94 [referring to the absence of the requirement for a broker to disclose the amount of mark-up charged for a debt security in a riskless transaction. See 17 C.F.R. § 240.10b10(a)(2)(ii)(A) & (B)]. When a broker-dealer breaches this implied duty, a violation of Section 10(b) and Rule 10b-5 occurs. Id. at 193. The court also recognized a private action sustainable under the anti-fraud provisions of Section 10(b) and Rule 10b-5. Id.

Although the court further reasserted the reliance upon the relevant factors promulgated by the SEC and the MSRB, specifically noting that the "starting point" for each analysis should entail those factors contained within MSRB Rule G-30, the court does not provide an analytical application of these factors because the issue was not before it due to the lower court's dismissal on the grounds of lack of duty. Grandon v. Merrill Lynch & Co., Inc., 147 F.3d 184, 194 (1998).

G. Recently, on remand, the Southern District of New York again dismissed the complaint on the grounds that the plaintiffs failed to state a claim for fraudulent undisclosed mark-ups because they merely stated the name, amount, and price of the bonds, and claimed that the mark-ups charged were a stated percentage above the true market price. As such, by failing to address each of the MSRB factors, the complaint did not meet the sufficient particularity to survive the dismissal. Although, the plaintiffs were given an opportunity to correct the defects in the complaint by November 15, 1999. Grandon v. Merrill Lynch & Co., Inc., No. 95 Civ. 10742 SWK, slip op., 1999 WL 993653 (Nov. 1, 1999). See also, Lynn

Hume, Court Dismisses Case on Muni Markups, The Bond Buyer, 1999 WL 19927097 (Oct. 29, 1999).

IV. QUANTITATIVE STANDARDS

A. Equity Securities

1. The SEC consistently has held that, at the least, mark-ups in excess of 10% over the prevailing market price are, absent disclosure, fraudulent per se in the sale of equity securities. See SEC v. First Jersey Securities, Inc., 101 F.3d 1450, 1469 (2d. Cir. 1996), cert. denied, 118 S. Ct. 57 (1997); SEC v. Rauscher Pierce Refsnes, Inc., 17 F. Supp. 2d 985 (1998); SEC v. Great Lakes Equities Co., [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,685, at 98,201, 98,211-12 (E.D. Mich. Sept. 4, 1990); In re D.E. Wine Investments, Inc., Securities Exchange Act Rel. No. 39517 (Jan. 6, 1998), 66 SEC Docket 517; In re Richard R. Perkins, 51 S.E.C. 380 (1993); In re W.N. Whelen & Co., Inc.; 50 S.E.C. 282 (1990); In re Alstead Dempsey & Co., Inc., 47 S.E.C. 1034 (1984); In re Peter J. Kisch, 47 S.E.C. 802, 808 (1982); In re James Ryan, 47 S.E.C. 759 (1982); In re Powell & Associates, Inc., 47 S.E.C. 746, 748 (1982); In re J.A. Winston, 42 S.E.C. 62 (1964). See also Notice to Members 92-16, Mark-ups/Mark-downs in Equity Securities, NASD Manual (CCH) (1992).

2. Under the NASD's Mark-Up Policy, mark-ups for equity securities greater than 5% above the prevailing market price are presumed to be unreasonable and thus violative of NASD rules. Lehl v. SEC, 90 F.3d 1483, 1487 (10th Cir. 1996); Samuel B. Franklin & Co. v. SEC, 290 F.2d 719 (9th Cir. 1961); SEC v. Rauscher Pierce Refsnes, Inc., 17 F. Supp.2d 985, 996 (D. Ariz. 1998); In re Michael Alan Leeds, 51 S.E.C. 500 (1993); In re Voss & Co., Inc., 48 S.E.C. 39 (1984).

3. The SEC has held that mark-ups below 5% can be excessive. See In re Investment Planning, Inc., 51 S.E.C. 592 (1993) (holding mark-ups on municipal bonds between 4 and 5.99% excessive); and In re Lehman Brothers, Inc., Securities Exchange Act Rel. No. 37673 (Sept. 12, 1996), 62 SEC Docket 2324 (holding mark-ups of 3.5% to 4.7% excessive).

4. While the SEC and the NASD have been willing to set a ceiling for mark-ups, they have refused to set a floor, below which a mark-up can never be found excessive. SEC v. Rauscher Pierce Refsnes, Inc., 17 F. Supp.2d 985, 998 (D. Ariz. 1998).

5. Penny Stocks. The SEC previously has held that mark-up higher than 5% may be permissible in the sale of low priced securities, but mark-ups higher than 10% are unfair even in the sale of penny stocks. In re LSCO Securities, Inc., 50 S.E.C. 518 (1991); Cf. In re Gerald M. Greenberg, 40 S.E.C. 133 (1960); In re National Association of Securities Dealers, 17 S.E.C. 459 (1944).

B. Debt Securities-Generally

1. The SEC also consistently has found that mark-ups on debt securities, including municipal securities, generally are expected to be lower than mark-ups on equity securities. Grandon v. Merrill Lynch & Co., Inc., 147 F.3d 184, 191 (2d Cir. 1998); SEC v. Rauscher Pierce Refsnes, Inc., 17 F. Supp.2d 985, 998 (D. Ariz. 1998); SEC v. Feminella, 947 F. Supp. 722, 729 (S.D.N.Y. 1996); SEC v. Charles A. Morris & Associates, Inc., 786 F. Supp. 1327, 1334 n.5 (W.D. Tenn. 1973); In re Lehman Bros., Inc., Securities Exchange Act Rel. No. 37673 (Sept. 12, 1996); In re First Honolulu Securities, Inc., Securities Exchange Act Rel. No. 32933 (Sept. 21, 1993), 55 SEC Docket 63; In re Investment Planning, Inc., 51 S.E.C. 592 (1993); In re Donald T. Shelton, 51 S.E.C. 59 (1992); In re Codispoti, 48 S.E.C. 842, 843-44 (1987); In re Crosby & Elkin, Inc., 47 S.E.C. 526, 530 (1981); In re Edward J. Blumenfeld, 47 S.E.C. 189, 192 (1980).

2. The NASD's policy provides that mark-ups on debt securities usually will be smaller than those on equity securities. See Interpretation of the Board of Governors, NASD Mark-up Policy, NASD Manual IM-2440, at 4351 (CCH) ("[A] higher percentage of mark-up customarily applies to a common stock transaction than to a bond transaction of the same size."). See also Zero-Coupon Securities, Securities Exchange Act Rel. No. 24368 (Apr. 21, 1987), 52 FR 15575.

3. Although, particularly in debt securities, in appropriate circumstances mark-ups under 5% may be subject to sanction. In re Investment Planning, Inc., 51 S.E.C. 592 (1993) (determining that mark-ups of over 4% represented extraordinary charges for ordinary transactions); In re First Honolulu Securities, Inc., Securities Exchange Act Rel. No. 32933 (Sept. 21, 1993), 55 SEC Docket 63.

4. The Second Circuit in Press v. Merrill Lynch & Co., Inc., 166 F.3d 529 (2d Cir. 1999), recently affirmed a lower court summary judgment dismissal on the grounds that the mark-ups involved (1/6 of 1% on six-month straight Treasury bills) were not excessive as a matter of law. But see, SEC v. Rauscher Pierce Refsnes, Inc., 17 F. Supp.2d 985, 998 (D. Ariz.

1998)(denying a summary judgement motion and noting that Press was not controlling in the present case involving zero-coupon bonds); SEC v. Feminella, 947 F. Supp. 722, 729 (S.D.N.Y. 1996)("[T]he 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. This determination cannot reasonably be made upon a motion to dismiss.").

5. Investment firms are required to have procedures in place, even for securities that trade off computerized terminals, identifying personnel entrusted with determining the total mark-up charged the customer based upon prevailing market price, the appropriate range of mark-ups, and the facts to be weighed for each transaction. In re Lehman Brothers Inc., Securities Exchange Act Rel. No. 37673 (Sept. 12, 1996); 62 SEC Docket 2324.

C. Municipal Securities

1. The MSRB decided, after specifically requesting comment on the issue, not to establish pricing guidelines like the NASD's 5% policy. In its request for comments, however, the MSRB stated that:

   One suggestion that has been discussed would set the lower benchmark at one point and the upper benchmark at two and one-half points. In other words, compensation in the amount of $10 or less per $1000 par value of securities would be presumed to be fair; compensation in the amount of $25 or more per $1000 par value of securities would be given special scrutiny by the regulatory agencies. Compensation in the range between $10 and $25 per $1000 par value of securities would carry no presumption as to fairness, but might merit review depending on the surrounding circumstances. The Board emphasizes that these benchmarks are included in this notice for the purpose of eliciting and focusing comment.

   MSRB, Solicitation of Comments on Pricing Guidelines, at 2, dated January 4, 1980. The SEC, however, has upheld NASD decisions finding mark-ups as low as 4% to violate MSRB rules. <u>See</u> <u>In re</u> Investment Planning, Inc., 51 S.E.C. 592 (1993); <u>In re</u> First Honolulu Securities, Inc., Securities Exchange Act Rel. No. 32933 (Sept. 21, 1993), 55 SEC Docket 63.

2. “The SEC . . . has categorically stated that the NASD's 'five percent policy' does not apply to municipal securities.” Grandon v. Merrill Lynch & Co., Inc., 147 F.3d 184, 191 (2d Cir. 1998)[citing <u>In re</u> First Honolulu Securities, Inc., Securities Exchange Act Rel. No. 32933 (Sept. 21, 1993), 55 SEC Docket 63 <u>and</u> In re Staten Securities Corp., 47 S.E.C. 766 n.7 (1982), <u>but cf.</u>, In the Matter of Investment Planning, Inc., 51 S.E.C. 592 (1993)(“[I]t has long been recognized that debt securities mark-ups normally are lower than those for equities, and that, in appropriate circumstances, mark-ups under [five percent] may be subject to sanction.”)].

3. The SEC has noted that it is industry practice to charge mark-ups of between ¼% to 5% on transactions in municipal bonds. <u>See</u> SEC v. Charles A. Morris & Associates, Inc., 386 F. Supp. 1327 (W.D. Tenn. 1973); <u>In re</u> Donald T. Shelton, 51 S.E.C. 59 (1992); In re Nicholas A. Codispoti, 39 SEC Docket 312 (1987); <u>In re</u> Edward J. Blumenfeld, 18 SEC Docket 1379 (1979).

4. Although mark-ups on municipal bonds may reach 5%, that figure might be acceptable under only the most exceptional circumstances. In re Investment Planning, Inc., 51 S.E.C. 592 (1993)(rendering mark-ups of 4% to 5.99% violative of MSRB rules). See also, In re First Honolulu Securities, Inc., Securities Exchange Act Rel. No. 32933 (Sept. 21, 1993), 55 SEC Docket 63 (holding mark-ups in excess of 4% on municipal bonds excessive); In re Powell & Associates, Inc., 47 S.E.C. 746 (1982).

D. Zero-Coupon Securities

1. Zero-coupon securities are debt securities that do not pay interest to the holder periodically prior to maturity, and are sold, therefore, at a substantial discount from the face amount. These include: (1) original issue discount bonds; (2) stripped coupon bonds; and (3) interest coupons stripped from bonds and sold as separate instruments. While stripped United States Treasury securities initially were the most prevalent type of zero-coupon security, zero-coupon municipal securities also are now being issued. Zero-Coupon Securities, Securities Exchange Act Rel. No. 24368 (Apr. 21, 1987), 52 FR 15575.

2. In a release designed to remind broker-dealers that mark-up policy is applicable to zero-coupon securities, the SEC stated that: "As a result of the Commission's ongoing oversight of the secondary markets, the Commission believes that as a general matter, common industry practice regarding mark-ups is to charge a mark-up over the prevailing interdealer market price of between 1/32% and 3-1/ 2% . . . [on] conventional or "straight" Treasuries, depending on maturity, order size and availability. In light of this evidence, the Commission concludes that mark-ups on government securities, like mark-ups on corporate and municipal debt securities, usually are smaller than those on equity securities." The SEC implied that these standards would be equally applicable to government zero-coupon bonds, and that mark-ups above that range run the risk of being found excessive. Zero-Coupon Securities, Securities Exchange Act Rel. No. 24368 (Apr. 21, 1987), 52 FR 15575 at 15576.

3. The SEC found that, as a general matter, common industry practice was to charge a mark-up over the prevailing inter-dealer market price of between 1/32% and 3½% for principal sales of coupon bearing government bonds. Id. At the time, the SEC's concern was that, in situations when securities generally are based on their low dollar investment and an attractive yield, investors may not appreciate the significant mark-ups that might be charged, particularly given the limited market information available concerning the trading of zero-coupon securities. But see, Press v.

Chemical Investment Services, 988 F. Supp. 375 (S.D.N.Y. 1997).

For example, a 20-year Treasury zero would sell at 7, or $70 per $1,000 face value, to equal the current market yield of 13.75%. A two-point mark-up to 9. . . would be only $20 per $1,000 - but it would be 28.6% in percentage terms, and it would cut the yield to 12.41%.

Zigas, NASD Investigating Dealer Mark-Ups on Zero-Coupon Bonds, The Bond Buyer at 1, col. 3 (July 20, 1984). See also, Michael Siconolfi, Merrill Settles a Lawsuit Over Zero-Coupon-Bonds, Wall St. J. at B6 col. 6 (Feb. 20, 1991); Michael Siconolfi, Dean Witter Agrees to a Settlement of Zero Lawsuit, Wall St. J. at C8 col. 6 (Oct. 20, 1990); Smith, Zero-Coupon Bonds' Price Savings Jolt Investors Looking for Security, Wall St. J. at 36, col. 3 (June 18, 1984).

4. The SEC also questioned the practice of charging a percentage mark-up based on the face amount of a zero-coupon bond, a practice that it found could lead to excessive prices, particularly on deeply discounted bonds. For example, a 1% mark-up on a $1000 face amount bond would amount to a 10% mark-up if the bond were selling for $100. Mark-ups should therefore vary according to the length of the maturity of the security. Zero-Coupon Securities, Securities Exchange Act Rel. No. 24368 (Apr. 21, 1987), 52 FR 15575.

5. The SEC also has emphasized that the strip interest coupons and the bonds are separate securities and the mark-ups charged on these instruments must independently comply with the mark-up rules. Zero-Coupon Securities, Securities Exchange Act Rel. No. 24368 (Apr. 21 1987), 52 FR 15575 ("[B]ecause both the stripped interest coupons and the bond are separate securities, it is not sufficient for a broker-dealer to assure itself that the aggregate mark-up for the unstripped security taken as a whole is not excessive.").

6. In SEC v. Rauscher Pierce Refsnes, Inc., 17 F. Supp.2d 985 (D. Ariz. 1998), the court analyzed the mark-ups involving zero-coupon treasuries with mark-ups ranging from .0236% to .7333% in its denial of a motion to dismiss. While the court notes that "[t]he complex nature of a securities transaction generally makes it impossible in a motion to dismiss for a court to find a mark-up is or is not excessive as a matter of law," it rejects the notion that excessiveness can never be determined in such a motion. Id. at 997.

The court acknowledged the 3.5% ceiling proposed by the SEC in the

Zero-Coupon Release, but refused to create a judicially mandated safe harbor for a mark-up simply because it fell below a certain percentage without taking into consideration the circumstances surrounding the transaction. Id. at 998. "Under some circumstances mark-ups as high as 3½ % may not be excessive, but under other circumstances mark-ups above 1/32 of one percent may be excessive." Id. at 999. The court, citing the Zero-Coupon Release, notes that, "[the excessive percentage] may be as low as 1% of the face amount . . . because zero-coupon bonds trade at a deep discount." Id.

E. Treasuries

1. Recent significant developments in the Second Circuit may have the effect of altering the way mark-up cases, especially those involving treasuries, are evaluated. In Press v. Chemical Investment Services Corp., the plaintiff asserted that a mark-up of $158.86 on a transaction in a Treasury bill with a value of $99,329.56 was excessive due to the fact that the mark-up totaled more than 6% of the $2,511 yield realized on the transaction and 1/6 of a percent of the bill's overall price, a figure the plaintiff described as "approximately 5 times the industry standard of a spread of 1/32 of a percentage point." 988 F. Supp. 375, 380 (S.D.N.Y. 1997).

2. The court forcefully dismissed the argument about the mark-up totaling 6% of the yield in a footnote. The court stated that the comparison is "completely fallacious" because the mark-up, once assessed, never affected the investment return of the plaintiff, a return the plaintiff had clear knowledge of before the transaction was consummated. The court further notes that "[i]n these types of Treasury bill transactions, where the expected rate of return is so small to begin with, such comparisons are inherently misleading. Here, for example, even a nominal processing fee of $50 would constitute approximately 2% of Press's return. . . . [T]he SEC has made clear that the amount of a mark-up is determined by the "prevailing market price" of the security, the best evidence of which is the 'dealer's contemporaneous cost' . . . . In other words, generally speaking, the mark-up is the amount charged over and above a security's wholesale price; in no way does it relate to the security's expected or eventual return." Id. at 385 n.13.

3. The plaintiff's were required to fall back to their arguments based upon what they asserted as common industry practice. The court was not persuaded. Citing the guidelines in the Zero Coupon Release of 1/32% to 3½% and noting the other factors to be taken into consideration, the court wrote:

> Simply put, the markup is indisputably at the extreme low end of what the SEC considers to be acceptable, and Press provides absolutely no authority for his contention of [the standard industry spread.] More specifically, no authority of which this Court has been advised involves a markup even remotely as small as the 1/6 of a percent markup at issue in this case; indeed, from the Court's review, “excessiveness” appears not even to become a consideration in debt-security cases until markups reach the three to three and one-half percent range.

Id. at 385-86.

4. The result of the Southern District's conclusion was that the mark-ups involved in the case were not excessive as a matter of law.

5. Upon appeal, the Second Circuit, in affirming the Southern District's decision, upheld the decision that the mark-ups were not excessive as a matter of law.

6. In addition, much more subtly the Second Circuit expanded the purview of factors to be considered in determining when a mark-up is excessive, in the specific case of a T-bill, but also alluded to more general application by suggesting that the factors were proper in all mark-up determinations. The factors it articulated in the opinion were the same factors used by the Grandon court, but removed the constraints of a municipal security forum. Thus, in actuality, beyond the well-entrenched factors contained within the NASD Mark-Up guidelines of IM-2440, more factors become relevant to any determination. Specifically, the court noted that consideration should be taken of :

    a. The expense associated with effectuating the transaction;

    b. The reasonable profit earned by the broker or dealer;

    c. The expertise provided by the broker or dealer;

    d. The total dollar amount of the transaction;

    e. The availability of the financial product in the market;

    f. The price or yield of the instrument;

g. The resulting yield after the subtraction of the mark-up compared to the yield on the other securities of comparable quality, maturity, availability, and risk; and

h. The role played by the broker or dealer.

Press v. Chemical Investment Services Corp., 166 F.3d 529 (2d Cir. 1999).

7. The Second Circuit also affirmed the lower court's analysis of the proper emphasis to be placed upon the percentage of the yield. “In calculating the mark-ups based upon a percentage of the yield, the fact remains that the comparison between the mark-up is not determinative.” Press v. Chemical Investment Services Corp., 166 F.3d 529 (2d Cir. 1999).

8. Regarding GNMA securities, the SEC in In re Lehman Brothers Inc., Securities Exchange Act Rel. No. 37673 (Sept. 12, 1996), 62 SEC Docket 2324, issued a settlement order that determined mark-ups ranging from 3.5% to 4.7% were “excessive.” Specifically, a registered representative who charged large across-the-board sales credits in the context of these transactions negated the notion that the mark-ups charged were based on the particular facts and circumstances of each securities transaction. In the case the representative had agreed when he joined the firm that he could charge a 3-point sales credit on all GNMA securities regardless of the market conditions at the time or the dollar amount or complexity of any particular transaction. Id.

9. The SEC in Lehman focused on the “starting point” for any analysis: the securities industry experience and practice regarding the range of appropriate markups on the particular securities or similar types of securities. In re Lehman Brothers Inc., Securities Exchange Act Rel. No. 37673 (Sept. 12, 1996), 62 SEC Docket 2324 [citing F.B. Horner & Associates v. SEC, 994 F.2d 61 (2d Cir. 1993); In re Sheldon, Reid, and Pattison, Securities Exchange Act Rel. No. 31475 (Nov. 18, 1992), 52 SEC Docket 3826]. [Note that the SEC asserts it can use industry practice against a alleged violator, but defenses based upon compliance with industry practices have been rejected in some instances. See Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266 (3d Cir. 1996).] Citing the Zero Coupon Release industry practices of 1/32% to 3½ %, the SEC found excessive mark-ups in the transactions primarily due to the fact that the mark-ups never bore any rational relationship to any single securities transaction.

F. Other Debt Securities

1. In Banca Cremi, S.A. v. Alex. Brown & Sons, Inc., 132 F.3d 1017 (4th Cir. 1997), the court affirmed a dismissal relating to CMO's purchased by a foreign financial institution. Among the numerous claims pleaded was an excessive mark-up claim based on mark-ups ranging from 5.25% in two transactions to 1.78%. The court spent a significant amount of time, albeit in dictum, on the criteria to be evaluated in the excessiveness determination, and as such provides helpful insight into mark-up analysis. The factors the court illustrates as relevant in determining the reasonableness of a mark-up include: (1) the type of security involved; (2) the availability of the security in the market; (3) the price of the security; (4) the amount of money involved in a transaction; (5) disclosure; (6) the pattern of mark-ups or mark-downs; and (7) the nature of the nature of the member's business. Id. [citing 3C Harold S. Bloomenthal, Securities and Federal Corporate Law, App. 12.13 (Apr. 1, 1992)]. Notwithstanding the factors to be utilized in the analysis, the court illustrated that an independent analysis must afforded to each mark-up case. The court also provided the grounds for fraud claims in instances involving excessive mark-ups, including the requirements for a private cause of action. The court laid the groundwork for an analysis of the excessiveness of the mark-ups, an analysis that ultimately was not performed.

   The outcome of the case turned on an alternate issue: the failure of the plaintiff to plead the facts of the fraud claim with particularity, thus failing to meet the burden of resisting a summary judgement motion. The Bank alleged that the mark-ups involved in the case were undisclosed and excessive, making the omissions necessarily material. Further, the Bank asserted that because the case involved an omission rather than a misstatement, reliance can be presumed. To that end, the only evidence presented by the plaintiffs was an expert who testified that, in his opinion, the mark-ups were excessive. Plaintiffs rested on the assumption that the burden of proof shifted to the defendants to prove that they did not commit the alleged fraud. Following the argument to its logical conclusion, the court notes that it is “acutely uncomfortable” with the proposition that an unhappy investor could produce a witness to present evidence of excessiveness, effectively shifting the burden of proof to the defendant to prove that no fraud was committed as the Bank and the SEC allege. The court, in fact, rejected the shift of the burden of proof in the case, because the requirement of pleading with particularity in such a fraud case had not been satisfied.

Specifically, the reliance element was determined to be absent. While reliance can often be inferred in a failure-to-disclose case, the defendant was successfully able to rebut such an inference of reliance through testimony illustrating the fact that the Bank did not, in fact, rely on "any shinglecreated presumption that the defendants were charging an undefined 'fair' rate of mark-up." Id. at 1038.

2. In District Business Conduct Committee For District No. 5 v. MMAR Group, Inc., 1996 NASD Discip. LEXIS 66 (Oct. 22, 1996), Complaint No. C0594001, the National Business Conduct Committee of the NASD reversed and dismissed the District Business Conduct Committee's decision finding excessive and fraudulent mark-ups and mark-downs in government (specifically CMOs) and corporate securities. The mark-ups/mark-downs ranged from 1.54% to 4.56% in the government securities and 1.75% to 3.63% with one mark-up of 4.7% on corporate debt securities. Id. The National Committee found merit in the argument that "the NASD and SEC releases provided insufficient notice that percentage mark-ups in this range would be deemed excessive and fraudulent for sales of CMO-derivative products in the early 1990s." Id.

During the time at issue, the Committee noted that the SEC had not found mark-downs less than 4% to be excessive in litigated cases, and had not found mark-ups or mark-downs in debt securities or securities with new and evolving markets to be excessive in the absence of evidence that such mark-ups/mark-downs exceeded those customarily charged by other broker-dealers for similar products. Id. The Committee noted that these factors should be taken into account in light of the lack of notice argument espoused.

The Committee "clarifies" its opinion by noting it does not want to hold that the NASD policies or guidelines are ambiguous, but rather that, "during the period at issue, the [NASD] and the [SEC] had not promulgated interpretations and other releases sufficient to place respondents on notice that percentage mark-ups and mark-downs similar to those at issue in this case for CMO-derivative at issue in this case were excessive and/fraudulent." But see, In re Investment Planning, Inc., 51 S.E.C. 592 (1993)[rejecting a similar argument of lack of notice on more "ordinary" investments].

"In the absence of any case law or rules providing clear guidance regarding the appropriateness of the mark-ups and mark-downs that respondent charged for these products in the new and evolving market that existed during the relevant period, we must look to industry practice in transactions of similar size and involving similar products." In District Business Conduct Committee For District No. 5 v. MMAR Group, Inc., 1996 NASD Discip. LEXIS 66 (Oct. 22, 1996), Complaint No. C0594001. The case ultimately was resolved based on the fact that the respondents presented evidence of industry practice and the staff failed to introduce any such evidence to counter or rebut the respondent's evidence.

3. In 1992, the SEC issued its decision in F.B. Horner & Associates, 50 S.E.C. 1063 (1992) <u>aff'd</u>, 994 F.2d 61 (2d Cir. 1993), affirming the NASD's findings that mark-ups in excess of 5% on two sales of principal only collateralized mortgage obligations were excessive. In its brief on appeal, the SEC argued that industry practice in sales of these type of CMOs is to charge mark-ups substantially below 5%, and only allowed the 5% mark-up due to the time and effort expended by Horner, the respondent in the case.

4. In Elysian Federal Savings Bank v. First Interregional Equity Corp., 713 F. Supp. 737 (D.N.J. 1989), the SEC submitted an amicus curiae brief in which it asserted that the mark-ups charged for certain principal only trust certificates ("POs") were patently excessive. The SEC determined that the undisclosed mark-ups in these PO transactions, which ranged from 17.84% to 21.27% and involved large amounts of money ($1.3 million to $7.4 million) were fraudulent.

5. In a supplemental amicus curiae brief in the same case, the SEC argued that the mark-ups on certain collateralized mortgage obligations ("CMOs") were also excessive under all the relevant criteria. Although the mark-ups ranged from 5.3% to 7.39%, or under 10%, this was nearly double the standard industry practice identified for comparable Treasury bonds.

G. Yield Burning Issues

1. The SEC has been focused on the practice of "yield burning." "Yield burning" refers to a variety of practices, but generally is thought to include selling Treasury securities to municipal bond issuers with high mark-ups in connection with advance refunding transactions. Jeffrey J. Wick, Yield Burning and Municipal Finance: A Primer, 18 <u>Ann. Rev. Banking L.</u> 533 (Mar. 1999).

2. In one of the first cases to address the issue of yield burning, the court in SEC v. Rauscher Pierce Refsnes, Inc., 17 F. Supp. 2d 985 (D. Ariz. 1998), denied a motion to dismiss relating to an advance refunding COPs for the State of Arizona. Rauscher was the state's financial advisor and handled the

refunding. In analyzing the plaintiff's claim of excessive mark-ups, the court focused on the nature of the alleged violation, an omission rather than a fraudulent statement. Due to the well established requirement that broker-dealers have a duty to disclose excessive mark-ups, the court became involved in a factual analysis of the mark-ups themselves, and concluded that it was not ultimately willing to make such a determination "as a matter of law," the applicable standard. While acknowledging the defendants presentation focusing on the 5% guideline contained in the NASD Mark-Up Policy and Zero Coupon Release, the court rejected the proposition that the mark-ups at issue (.55% average), while being at the low end of the range, were so low as to not raise a fact issue for a jury. The case, decided post-Press (but prior to the Second Circuit's affirmance) specifically refused to expand the scope of that holding to the case at issue. See generally, SEC Charges Rauscher with Yield Burning in Arizona COPs Offering, 3 No. 10 Andrews Sec. & Commodities Litig. Rep. 13 (Jan. 28, 1998).

3. In light of the opinion, and the potentially troubling statements therein, many municipal securities firms began negotiating a global settlement. Recently, Dain Rauscher, Inc., the successor to Rauscher Pierce, along with 15 other municipal securities firms, have tentatively agreed to a settlement which would cover all federal yield-burning charges in connection with hundreds of advance refundings done in the early 1990's. The settlement, expected to exceed $100 million, originally expected to be finalized as early as October or as late as December, is now not likely to occur until next year. Some of the delay is due to the numerous calculations on hundreds of advance refundings, as well as regional firms balking at signing onto the agreement. The regional firms are trying to make the case that they should be treated more leniently and accorded higher mark-up levels than the major firms because they were involved in fewer, smaller transactions with similar costs. Lynn Hume, Yield-Burning Deal Delayed Until 2000, The Bond Buyer, 1999 WL 19927315 (Nov. 5, 1999); Lynn Hume, Yield-Burning Markup Level Reached, The Bond Buyer, 1999 WL 19925061 (Aug. 25, 1999). See also, Lynn Hume, Yield Burning Deal Proposed; Rauscher Case to go Forward, The Bond Buyer, 1998 WL 13144397 (Aug. 14, 1998).

4. Pursuant to the settlement, firms would contribute based on the extent to which the mark-ups on the escrow securities they sold to municipal issuers exceeded 40 to 55 basis points of their costs. Whether a firm would fall within that range would depend on several factors, including whether the firm served as underwriter or financial advisor as well as the escrow provider in a refunding. The markup threshold in the tentative settlement,

which at 40 basis points would be the equivalent of 4/10 of 1%, is lower than the 1% floor that had been set by the firms, but higher than the 2/32 of 1% level that the SEC had said was reasonable in <u>Rauscher Pierce</u>. <u>See</u> Lynn Hume, Yield-Burning Markup Level Reached, <u>The Bond Buyer</u>, 1999 WL 19925061 (Aug. 25, 1999). Many of the firms viewed the SEC as attempting to rewrite mark-up law through "ad hoc adjudication." Lynn Hume, Enforcement: Dain Rauscher Faults SEC for Imposing New Markup Standards, <u>The Bond Buyer</u>, 1998 WL 13142785 (June 29, 1998). <u>See also</u>, Craig T. Ferris, Markup Standards and Yield Burning: A Time for Compromise, <u>The Bond Buyer</u>, 1998 WL 5278541 (June 8, 1998); Lynn Hume, Yield Burning: Firms, Agencies Disagree on Markups But May Keep Talking, <u>The Bond Buyer</u>, 1998 WL 5278445 (June 3, 1998); Lynn Hume, Firms Meet With Agencies to Blast Yield-Burning Approach, <u>The Bond Buyer</u>, 1998 WL 5278296 (May 29, 1998); Lynn Hume, Rauscher: SEC Would Impose New Rules In Yield-Burning Case, <u>The Bond Buyer</u>, 1998 WL 5276588 (Apr. 2, 1998); <u>and</u> Lynn Hume, Stage Set for Yield-Burning Battle By Former SEC Enforcement Chief, <u>The Bond Buyer</u>, 1997 WL 15596369 (Sept. 16, 1997).

5. The SEC settled the first case involving yield burning with its order in <u>In re</u> Meridian Securities, Inc., Securities Exchange Act Rel. No. 39905, (Apr. 23 1998), 66 SEC Docket 2327. <u>Meridian</u> involved the charging of excessive, undisclosed mark-ups on U.S. Treasuries to school districts and other municipalities in Pennsylvania and West Virginia. Acting as underwriter and escrow provider in many instances, Meridian "calculated the mark-ups on a portfolio basis and, as a result, charged excessive mark-ups on individual Treasury securities ranging as high a 13.78 percent in connection with various advance refunding transactions and as high as 46.29 percent in two other cases involving another type of refinancing." <u>Id</u>. None of the mark-ups involved were disclosed to the school districts and municipalities, but <u>Meridian</u> did provide documents that certified that the prices charged were fair market value and established without an intent to reduce yield. Also, as underwriter, the offering documents were deficient due to these excessive mark-ups. Such misrepresentation and non-disclosure of excessive mark-ups resulted in a fraud violation by <u>Meridian</u>. The SEC also alleged that in three transactions, Meridian shared its profits on the sale of the escrow securities with outside "consultants" in order to obtain the escrow business. According to the SEC, these payments also should have been, but were not disclosed to the issuers.

6. Recently, Lazard Freres settled a yield burning case with the SEC for $11 million. In <u>In re</u> Lazard Freres & Co., LLC, Securities Exchange Act Rel. No. 41318 (Apr. 21, 1999), 1999 SEC LEXIS 813. Whereas in <u>Meridian</u>

some limited advisory service was performed, Lazard involved a signed financial advisory contract. The SEC determined that Lazard breached its fiduciary duties of good faith and fair dealing by failing to disclose its excessive mark-ups to its financial advisory client, Passaic Valley Sewage Commission. Passaic, also the purchaser of the bonds that had been excessively marked-up, relied heavily upon the expertise of Lazard because they had no prior experience with refunding or purchasing Treasury notes or bonds. Lazard allegedly did not disclose that it acted as principal in the escrow sale transaction until several weeks after the sales date. The SEC found the non-disclosure of the fact that the transactions were performed on a principal basis, as well as the failure to disclose the actual and apparent conflicts of interest, material omissions. Id.

7. Additionally, the mark-ups in Lazard were approximately ½ of 1%, while, at the time, other dealers generally charged "materially lower markups on escrow securities when the prices were determined through competition or a bona fide arm's length negotiation." The SEC determined that these transactions were not conducted at prices reasonably related to the current wholesale market prices for the securities under the particular facts and circumstances. Because the escrow yield was so far beneath the tax limitation, Passaic was deprived of the money that it could have retained as the difference between the mark-up charged by Lazard and what the SEC believes a reasonable mark-up would be. "All profit made by Lazard on the escrow securities reduced dollar-for-dollar Passaic Valley's debt service savings on the refunding." Additionally, Lazard collected fees pursuant to its financial advisory contract with Passaic. As such, the excessive mark-ups resulted in a fraud on Passaic. Id. See also, Lazard Freres Settles SEC, IRS "Yield Burning" Suits For $11 Million, 5 No. 5 Andrews Derivatives Litig. Rep. 8 (May 6, 1999).

8. Prudential Securities Inc. and Everen Securities Inc. are the targets of a recently filed lawsuit on behalf of Chicago alleging they were engaged in yield burning on dozens of advance refundings during the early 1990s in two Chicago deals. The plaintiff's expert consultant based his finding on a formula that asserts mark-ups above 1/64th of 1% as excessive, but the legal brief filed does not clearly spell out how that formula was developed. This past summer, Chicago signed a settlement agreement with Merrill Lynch & Co., after the city was notified that a lawsuit was pending by the same law firm. Within the past month, eight more issuers have entered into settlement agreements with the firms that underwrote the deals, many of them mirroring the one entered into between Merrill Lynch and Chicago. Under the Merrill Lynch settlement, Merrill maintains that it did nothing wrong, but it agrees to hold the city harmless from any liability, loss, cost

or damage should the Internal Revenue Service determine the bonds taxable. Yvette Shields, Dozens of Issuers Burned on Refundings, Lawsuit Alleges, The Bond Buyer, 1999 WL 19927240 (Nov. 3, 1999); Yvette Shields, More Potential Illinois Yield-Burning Lawsuits Settled, The Bond Buyer, 1999 WL 19926814 (Oct. 21, 1999).

H. These standards are only presumptions of unreasonableness. The circumstances surrounding trading in a security may suggest that mark-ups less than 10% or 5% are unreasonable [e.g., In re Staten Securities Corporation, 47 S.E.C. 766 (1982)] or that mark-ups greater than these figures may be reasonable (e.g., a minimum ticket charge on a $200 transaction).

I. Unreasonable mark-ups cannot be justified by excessive expenses. NASD Mark-Up Policy, IM-2440, NASD Manual (CCH) at 4351.

J. In calculating the mark-ups relating to a single customer, the individual transactions are probative of the mark-ups, not the average mark-up per customer. See F.B. Horner & Associates, Inc. v. SEC, 994 F.2d 61, 63 (2d Cir. 1993); In re W.N. Whelen & Co., Inc., 50 S.E.C. 282 (1990).

K. A dealer who has a position in the securities is not entitled to a higher mark-up to compensate for the risk. White v. SEC, 68 F.3d 482 (9th Cir. 1995); In re Investment Planning, Inc., 51 S.E.C. 592 (1993); In re Richard R. Perkins, 51 S.E.C. 380 (1993); In re Century Capital Corp. of South Carolina, 52 SEC Docket 1467, 1992 WL 258851, *3 (SEC)(1992), aff'd, 22 F.3d 1184 (D.C. Cir. 1994); In re First Pittsburgh Securities Corp., 47 S.E.C. 299, 306 (1980); In re Financial Estate Planning, Securities Exchange Act Rel. No. 14984 (July 21, 1978), 15 SEC Docket 352; In re Waldron & Co., 46 S.E.C. 697, 700 (1976).

L. “Extraordinary retail sales efforts” and high marketing expenses do not justify retail prices higher than those at which the same securities are generally available to investors through other dealers who operate in the same market. In re Investment Planning, Inc., 51 S.E.C. 592 (1993)[citing In re General Investing Corp., 41 S.E.C. 952, 957 (1964)].

M. The fact that a broker-dealer lost money on other transactions for the same clients or that some of the mark-ups paid the firm's costs in other transactions does not justify an excessive mark-up in any one transaction. F.B. Horner & Associates, Inc. v. SEC, 994 F.2d 61, 63 (2d Cir. 1993); In re Investment Planning, Inc., 51 S.E.C. 592 (1993).

N. Similarly, where a dealer sells short, he cannot pass on that risk to the investor in the guise of excessive mark-ups. In re Meyer Blinder, 50 S.E.C. 1215 (1992); In re Investment Service Co., 41 S.E.C. 188, 196 (1962). The SEC, in applying its mark-up policy, does not penalize dealers for their inventory profit, nor does it compensate them for the risk they assume when they sell short. See Supplemental Amicus Curiae Brief of the Securities and Exchange Commission in Elysian Federal Savings Bank v. First Interregional Equity Corp., 713 F. Supp. 737 (D.N.J. 1989)(No. 88-3528) at 9-12.

O. A broker-dealer always has the right to produce evidence to demonstrate that unusual circumstances may justify mark-ups that are higher than ordinarily accepted, i.e., countervailing evidence. See e.g., In re Strathmore Securities, Inc., 42 S.E.C. 993 (1966).

P. Markdowns

While mark-downs are calculated in the same manner as mark-ups, lower percentage mark-downs have been determined to be in violation of the NASD Rules. See In re Hamilton Bohner, 50 S.E.C. 125 (1989) (mark-downs ranging from 5.3% to 10.2% far in excessive of permissible levels and NASD's findings of violation upheld); In re Thill Corp., 42 S.E.C. 89, 92-95 (1964) (mark-downs ranging from 2% to 6% determined to violate NASD's Rules). See also, In re D.E. Wine Investments, Inc., Securities Exchange Act Rel. No. 39517 (Jan. 6, 1998), 66 SEC Docket 517; In re LSCO Securities, Inc., 50 S.E.C. 518 (1991); In re Clarence Earl Thorton, 42 S.E.C. 751, 752 n.2 (1965). For particularly dramatic conduct, see In re Orion Securities, Inc., Securities Exchange Act Rel. No. 34-35001 (Nov. 23, 1994), 58 SEC Docket 140 (examining transactions involving mark-downs well in excess of 1000%).

V. DETERMINING PREVAILING MARKET PRICE

A. General Rules

1. The determination of the prevailing market price has often been the “key” component in the evaluation of excessive mark-ups. Grandon v. Merrill Lynch & Co., Inc., 147 F.3d 184, 189 (2d Cir. 1998). See also, Gerard S. Citera, Equity Trading Issues, SD44 ALI/ABA 43, 54 (Jan. 14, 1999), Joseph I. Goldstein & L. Delane Cox, Penny Stock Markups And Markdowns, 85 Nw. U. L. Rev. 676 (1991).

2. Generally, the “prevailing market price” is the price at which dealers are willing to, and do, buy and sell securities. In re D.E. Wine Investments, Inc., Securities Exchange Act Rel. No. 39517 (Jan. 6, 1998), 66 SEC Docket 517; In re Meyer Blinder, 50 S.E.C. 1215 (1992)[citing In re Alstead, Dempsey & Co., Inc., 47 S.E.C. 1034 (1984)]. There are

exceptions to this general rule, however. In reviewing possible mark-up violations, the SEC or NASD will examine all available information on a security to determine the best indicator of the prevailing market price.

3. Moreover, a broker-dealer always has the right to produce evidence to show that some indicia of the prevailing market price other than that which the SEC ordinarily looks to would be a better measure of the prevailing market under the circumstances. See, In re Hibbard, Brown & Co., Inc., Securities Exchange Act Rel. No. 35476 (Mar. 13, 1995), 58 SEC Docket 2561; In re G.K. Scott & Co., Inc., Securities Exchange Act Rel. No. 33485 (Jan. 14, 1994), 55 SEC Docket 2887; In re Richard R. Perkins, Securities Exchange Act Rel. No. 32188 (Apr. 21, 1993), 53 SEC Docket 3944; In re Meyer Blinder, 50 S.E.C. 1215 (1992).

4. Historically, the SEC has examined all of the available information concerning a security to select the best evidence of the prevailing market price. Factors considered include the trading characteristics of a particular security, the information available with respect to trading in that security, and the parties to a particular transaction. Different measures of the prevailing market price have been considered dispositive based on the facts of each case. Gerard S. Citera, Equity Trading Issues, SD44 ALI/ABA 43, 54 (Jan. 14, 1999).

5. Generally, the appropriate measure of the prevailing market price will depend on the type of broker-dealer involved, as well as the competitiveness of the market for the security involved.

B. Retail Dealers

1. The SEC, NASD, and the courts consistently have held that, absent countervailing evidence, a retail dealer's contemporaneous cost of acquiring a security provides the best evidence of the prevailing market price for the security, and thus should be used as the basis for computing a dealer's mark-ups. See Grandon v. Merrill Lynch & Co., Inc., 147 F.3d 184, 187 (2d Cir. 1998); SEC v. First Jersey Securities, Inc., 101 F.3d 1450, 1469 (2d. Cir. 1996), cert. denied, 118 S. Ct. 57 (1997); First Independence Group, Inc. v. SEC, 37 F.3d 30, 32 (2d Cir. 1994); Orkin v. S.E.C., 31 F.3d 1056, 1063-64 (11th Cir. 1994); F.B. Horner & Associates, Inc., v. S.E.C., 994 F.2d 61, 63 (2d Cir. 1993); Ettinger v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 835 F.2d 1031 (3d Cir. 1987); Barnett v. United States, 319 F.2d 340, 344 (8th Cir. 1963); SEC v. Thomas James Associates, 738 F. Supp. 88 (W.D.N.Y. 1990); SEC v. Great Lakes Equities Co., [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH)

¶ 95,685, at 98,201, 98,211-12 (E.D. Mich. Sept. 4, 1990); SEC v. Seaboard Corp., [1964-661 Fed. Sec. L. Rep. (CCH) ¶ 91,697 (S.D.N.Y. 1966); In re D.E. Wine Investments, Inc., Securities Exchange Act Rel. No. 39517 (Jan. 6, 1998), 66 SEC Docket 517; In re David Disner, Securities Exchange Act Rel. No. 34-38234 (Feb. 4, 1997), 63 SEC Docket 1934; In District Business Conduct Committee For District No. 5 v. MMAR Group, Inc., 1996 NASD Discip. LEXIS 66 (Oct. 22, 1996), Complaint No. C0594001; In re Lehman Brothers Inc., Securities Exchange Act Rel. No. 37673 (Sept. 12, 1996), 62 SEC Docket 2324; In re George Salloum, Securities Exchange Act Rel. No. 35563 (Apr. 5, 1995), 59 SEC Docket 39; In re R.B. Webster Investments, Inc., Securities Exchange Act Rel. No. 35754 (May 23, 1995), 59 SEC Docket 880; In re Hibbard, Brown & Co., Inc., Securities Exchange Act Rel. No. 35476 (Mar. 13, 1995), 58 SEC Docket 2769; In re Alan Securities, Inc., 51 S.E.C. 1092 (1994); In re Thomas F. White & Co., Inc., 51 S.E.C. 932 (1994); In re Sherman, Fitzpatrick & Co., Inc., Securities Exchange Act Rel. No. 33923 (Apr. 19, 1994), 56 SEC Docket 1493; In re Michael Alan Leeds, 51 S.E.C. 500 (1993); In re Richard R. Perkins, 51 S.E.C. 380 (1993); In re Meyer Blinder, 50 S.E.C. 1215 (1992); In re Kevin B. Waide, 50 S.E.C. 932 (1992); In re LSCO Securities, Inc., Securities Exchange Act Release No. 28944 (Mar. 21, 1991), 48 SEC Docket 759; In re Rooney, Pace, Securities Exchange Act Rel. No. 25125 (Nov. 13, 1987), 39 SEC Docket 844; In re James E. Ryan, 47 S.E.C. 759 (1982); In re Powell & Associates, Inc., 47 S.E.C. 746 (1982); In re Codispoti, 48 S.E.C. 530 (1981); In re First Pittsburgh Securities Corp., 47 S.E.C. 299, 306 (1980); In re Gateway Stock & Bond, Inc., 43 S.E.C. 191 (1966); In re Kenneth B. Stucker Investment Securities, 42 S.E.C. 910 (1966); and In re Naftalin & Co., 41 S.E.C. 823 (1964). See also, Interpretation of the Board, Mark-Up Policy, IM-2440 NASD Manual (CCH) at 4351; Zero-Coupon Securities, Securities Exchange Act Rel. No. 24368 (Apr. 21, 1987), 52 FR 15575; and Penny Stock Disclosure Rules, Securities Exchange Act Rel. No. 30608 (Apr. 20, 1992), 51 SEC Docket 415. But see, In re Bennett Johnson, 45 S.E.C. 278 (1973)(holding that dealer's contemporaneous cost was not representative of the prevailing market sales in certain circumstances, i.e., distress sales or block purchases).

2. If there are no contemporaneous purchases by the dealer, other contemporaneous inter-dealer transactions are examined as evidence of the prevailing market price. SEC v. First Jersey Securities, Inc., 101 F.3d 1450, 1469 (2d. Cir. 1996), cert. denied, 118 S. Ct. 57 (1997); First Independence Group v. SEC, 37 F.3d 30 (2d Cir. 1994); SEC v. Great Lakes Equities Co., [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,685, at 98,201, 98,211-12 (E.D. Mich. Sept. 4, 1990); In re Adams

Securities, Inc., 51 S.E.C. 1092 (1994); In re Alstead, Dempsey & Co., Inc., 47 S.E.C. 1034 (1984); In re Kenneth B. Stucker Investment Securities, 42 S.E.C. 910 (1966); In re Naftalin & Co., 41 S.E.C. 823 (1964).

3. When evaluating inter-dealer transactions, however, especially in the event the information is proffered to provide countervailing evidence of the prevailing market price, the SEC has stated that it is essential to examine the nature of the inter-dealer market to determine the extent they are valid. A market where inter-dealer prices are not determined by the unimpeded interaction of supply and demand representing the collective judgments of the marketplace does not provide evidence of prevailing market price. In re Hibbard, Brown & Co., Inc., Securities Exchange Act Rel. No. 35476 (Mar. 13, 1995), 58 SEC Docket 2561 (determining the inter-dealer transactions at issue were the result of a "'staged-managed' performance" which produced wholly illusory prices). See also, In re Robert B. Orkin, Securities Exchange Act Rel. No. 32035 (Mar. 23, 1993), 53 SEC Docket 2903, aff'd 31 F.3d 1056 (11th Cir. 1994); In re Pagel, Inc., 48 S.E.C. 223 (1985), aff'd, 803 F.2d 942 (5th Cir. 1986); In re Alstead, Dempsey & Co., Inc., 47 S.E.C. 1034 (1984); In re Edward J. Mawod & Co., 46 S.E.C. 865 (1977), aff'd, 591 F.2d 588 (10th Cir. 1979).

4. The SEC traditionally has disfavored the use of quotations in determining the prevailing market price. For certain securities, often only if there are no contemporaneous inter-dealer transactions may validated quotations used. See Merritt, Vickers, Inc. v. SEC, 353 F.2d 293 (2d Cir. 1984); SEC v. Great Lakes Equities Co., [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,685, at 98,201, 98,211-12 (E.D. Mich. Sept. 4, 1990); In re LSCO Securities, Inc., Securities Exchange Act Rel. No. 28944 (Mar. 21, 1991), 48 SEC Docket 789; In re Alstead, Dempsey & Co., Inc., 47 S.E.C. 1034 (1984); and In re Gateway Stock & Bond, Inc., 43 S.E.C. 191 (1966).

   a. Quotations only are considered reliable evidence of the prevailing market price when the validity of those quotations can be shown by comparing them with actual inter-dealer transactions during the period in question and by showing that actual inter-dealer trades are occurring at the quotations. See SEC v. Great Lakes Equities Co., [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,685, at 98,201, 98,211-12 (E.D. Mich. Sept. 4, 1990); In re Orion Securities, Inc., Securities Exchange Act Rel. No. 34-35001 (Nov. 23, 1994), 58 SEC Docket 140; In re Bison Securities, Inc., Securities Exchange Act Rel. No., 32034 (Mar. 23, 1993), 53 SEC

Docket 2892; In re Adams Securities, Inc., 51 S.E.C. 1092 (1994); In re Richard R. Perkins, 51 S.E.C. 380 (1993); In re LSCO Securities, Inc., 50 S.E.C. 518 (1991); In re Sherman Gleason & Co., 15 S.E.C. 639, 651- 53 (1944) (falling within the range of quotations does not make mark-up reasonable if the industry's practice itself is not reasonably related to the market price).

b. The NASD has stated that because NASDAQ/NMS and some regular NASDAQ securities being sold by a market maker to retail customers trade in an active competitive market, inside quotations (high bid/low ask) are usually sufficiently valid and reliable as evidence of the prevailing market price for mark-up and markdown purposes. The integrity of these quotations is a function of the real-time trade reporting system for these securities. Specifically, NASDAQ tests the validity of NASDAQ/NMS securities' quotations against actual transactions reported on a real-time basis throughout the trading day. Similarly, an active, competitive market in a regular NASDAQ security allows market makers executing frequent interdealer trades to use actual trades to validate the inside quotations displayed on NASDAQ. Notice to Member 92-16, Mark-ups/Mark-downs in Equity Securities, NASD Manual (CCH)(1992).

c. Quotations in more obscure securities (i.e. "pink sheets", Non-NASDAQ OTC) with limited inter-dealer activity often show wide spreads between the bid and ask prices and are likely subject to negotiation, rendering the quotes unreliable for mark-up determinations. In re David Disner, Securities Exchange Act Rel. No. 34-38234 (Feb. 4, 1997), 63 SEC Docket 1934; In re George Salloum, Securities Exchange Act Rel. No. 35563 (Apr. 5, 1995), 59 SEC Docket 39; In re LSCO Securities, Inc., 47 S.E.C. 759 (1982); In re Alstead, Dempsey & Co., Inc., 47 S.E.C. 1034, 1036 (1984); In re James E. Ryan, 47 S.E.C. 759 (1982); In re Charles Michael West, 47 S.E.C. 39, 42 (1979); and In re Gateway Stock & Bond, Inc., 43 S.E.C. 191 (1966). See also, Penny Stock Disclosure Rules, Securities Exchange Act Rel. No. 30608 (Apr. 20, 1992), 51 SEC Docket 415 ("The Commission believes that outside of an electronic quotation environment with multiple displayed quotations, quotations in non-NASDAQ OTC market are not sufficiently reliable to require broker-dealers to give them to customers without a validation process.").

d. Quotations are not validated merely by participation in SOES, because even in a competitive market, SOES is solely a means for automatically handling retail order flow without negotiation among dealers. In re George Salloum, Securities Exchange Act Rel. No. 35563 (Apr. 5, 1995), 59 SEC Docket 39; In re Frank L. Palumbo, Securities Exchange Act Rel. No. 36427 (1995), 60 SEC Docket 1473.

e. Using quotations unsubstantiated by a dealer's own sales to calculate mark-ups may constitute reckless indifference to the duty owed to customers. In re R.B. Webster Investments, Inc., Securities Exchange Act Rel. No. 35754 (May 23, 1995), 59 SEC Docket 880. See also, Orkin v. SEC, 31 F.3d 1056 (11th Cir. 1994); In re First Independence Group, Inc., Securities Exchange Rel. No. 32817 (Aug. 27, 1993), 54 SEC Docket 1866; In re Meyer Blinder, 50 S.E.C. 1215 (1992); and In re Osborne Stern & Co., 50 S.E.C. 1295 (1992).

5. In riskless principal transactions, fairness requires a broker-dealer that is not a market maker to base its mark-up on contemporaneous cost; countervailing evidence of the market is irrelevant. In re Kevin B. Waide, 50 S.E.C. 932 (1992).

6. What is contemporaneous?

a. Contemporaneous cost is the dealer's purchase price for a security in a purchase that is closely related to a sale of that security to a retail customer. In re LSCO Securities, Inc., 50 S.E.C. 518 (1991); In re Costello, Russotto & Co., 42 S.E.C. 798, 799 (1965); In re Shearson, Hammill & Co., 42 S.E.C. 811, 837 (1965); In re Maryland Securities Co., 40 S.E.C. 443, 446 (1960); In re Managed Investment Programs, 37 S.E.C. 783, 786 (1957).

b. When more than one purchase has occurred during the day of sale to a customer, the purchase closest in time, to the sale will be used as the contemporaneous cost, regardless of whether the trade occurred before or after the retail sale. In re D.E. Wine Investments, Inc., Securities Exchange Act Rel. No. 39517 (Jan. 6, 1998), 66 SEC Docket 517 (holding an Administrative Law Judge erred in rejecting the relevance of interdealer trades occurring after retail trades). The average purchase price during the day is not used. In re Century Securities Co., 43 S.E.C. 371, 378 (1967), aff'd sub nom., Nees v. SEC, 414 F.2d 211 (9th Cir. 1969).

Likewise, it is inappropriate to look to the average of mark-ups or mark-downs to justify excessive mark-ups/mark-downs in individual transactions. See In re Hamilton Bohner, 50 S.E.C. 1225 (1989); In re Williams H. Keller, Jr., 38 S.E.C. 900, 906 (1959).

c. Although same-day purchases are preferred for contemporaneous cost, if no such purchases have occurred, prices paid within five or fewer business days prior to the day of sale have been used. See In re D.E. Wine Investments, Inc., Securities Exchange Act Rel. No. 39517 (Jan. 6, 1998); In re LSCO Securities, Inc., 50 S.E.C. 125 (1989); In re Codispoti 48 S.E.C. 842, 843 (1987); In re Linder, Billotti & Co., Inc., 42 S.E.C. 807 (1965); In re Advanced Research Associates, Inc., 41 S.E.C. 579 (1963); In re William H. Keller, Jr., 38 S.E.C. 900, 904 (1959).

d. While prices paid within a few days of the trade may be relevant to some extent, in a very active market, with rapid price fluctuation, it may be necessary to undertake an hour-by-hour or minute-by-minute analysis of interdealer trading to gauge accurately the prevailing market price at a particular point in time. In re D.E. Wine Investments, Inc., Securities Exchange Act Rel. No. 39517 (Jan. 6, 1998)[citing In re George Salloum, Securities Exchange Act Rel. No. 35563 (Apr. 5, 1995), 59 SEC Docket 43].

e. Within the Proposed Debt Mark-Up Release, the SEC states that "[a] transaction is 'contemporaneous' if it occurs close enough in time to a later transaction that it would [reasonably be expected to reflect the current market price for the security. A transaction would] (sic) not be contemporaneous if it is followed by intervening changes in interest rates or other market events that reasonable (sic) would be expected to affect the market price." Notice of Filing of Proposed Rule Change and Amendments Nos. 1 and 2 by the National Association of Securities Dealers, Inc., Relating to the Application of NASD's Mark-Up Policy to Transactions in Government And Other Debt Securities, Release No. 34-40511 (Sept. 30, 1998), File No. SR-NASD-97-61.

C. Integrated Dealers

1. Background

a. The contemporaneous cost standard may not be appropriate for integrated dealers, i.e., dealers who both make a market in a security and sell it to retail customers. Such a result would deter market-makers from taking the risk of maintaining a market or a position in a security and, consequently, would impair market liquidity. See, In re Peter J. Kisch, Securities Exchange Act Rel. No. 19005 (Aug. 24, 1982), 25 SEC Docket 1243, 1246.

b. Section 3(a)(38) of the Securities Exchange Act of 1934 defines the term market maker as "any specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular and continuous basis." 15 U.S.C. § 78c(a)(38). See In re LSCO Securities, Inc., Securities Exchange Act Rel. No. 26779, (May 3, 1989), 43 SEC Docket 1354, 1356-57. The SEC concluded that LSCO was not acting as a market maker on the days in question. While LSCO entered its name as a market maker in the "pink sheets," it did not enter into interdealer sales, or provide quotations to other dealers but merely acquired stock for resale to retail customers. See also SEC v. Great Lakes Equities Co., [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,685, at 98,201, 98,211-12 (E.D. Mich. Sept. 4, 1990); In re LSCO Securities, Inc., 50 S.E.C. 518 (1991).

c. A special study of the Securities Market recognized the inherent dilemma over 35 years ago, stating that:

> An integrated firm making a market in a security by placing two way quotations in the sheets ordinarily will purchase stock at its inside bid. If the fairness of the mark-up is based on the integrated firm's contemporaneous cost, the mark-up would be computed on the basis of its bid price. In the case of many low priced securities, where the spread between the inside bid and offer may be considerably more than 5 percent, the integrated firm might then have to sell to its customers at a price less than its inside offer, i.e. the price at which it stands ready to sell to other broker dealers. On the other hand, if the mark-up is computed on the basis of a representative offer appearing in the sheets, sales will be made at a price considerably in excess of 5 percent of the integrated firm's contemporaneous cost.

Report of the Special Study of the Securities Markets of the SEC, H.R. Doc. No. 95, Pt. 2, 88th Cong., 1st Sess. 649 (1963).

d. Because such integrated dealers often purchase stock from other dealers at or around their bid price and sell to other dealers at or around their ask price, the SEC in <u>In re</u> Peter J. Kisch, Securities Exchange Act Rel. No. 19005 (Aug. 24, 1982), 25 SEC Docket 1242, reasoned that applying a contemporaneous cost standard to the retail transactions of such dealers could deprive them of the opportunity to earn a so-called "dealer's turn" by buying at their bid and selling at their ask (i.e., their spread). The SEC stated that, for market makers, contemporaneous sales to other broker-dealers or contemporaneous offering prices may be used to determine mark-ups. The SEC also stated that, because the broker-dealer in the case dominated the market, its own inside offer quotation could not be used to compute mark-ups. <u>Id</u>.

e. In <u>In re</u> Alstead, Dempsey & Co., Inc., 47 S.E.C. 1034 (1984), the SEC reaffirmed the <u>Kisch</u> rationale, recognizing that "application of the 'contemporaneous cost' rule (in effect using a dealer's bid as the basis for computing retail mark-ups) may not be appropriate" when dealing with integrated market makers. However, the SEC questioned the use of offering quotations for computing mark-ups in obscure securities with limited inter-dealer activity or where one market maker dominates the market. The SEC noted that "quotations for obscure securities with limited interdealer trading activity may have little value as evidence of the current market." The SEC held that a dealer that dominated and controlled the market for a particular stock was required to rely on contemporaneous cost to compute its mark-ups.

2. The SEC's position, as articulated in <u>Kisch</u> and <u>Alstead, Dempsey</u> was summarized in the Zero-Coupon Release. The SEC wrote that "[a]s a general matter, the best evidence of the prevailing market price for a broker-dealer who is not making a market in the security is that dealer's contemporaneous cost of acquiring a security." Zero-Coupon Securities, Securities Exchange Act Rel. No. 24368 (Apr. 21, 1987), 52 FR 15575. Nevertheless, in the case of integrated market makers, the SEC stated that "the best evidence of the prevailing market generally is contemporaneous sales by the firm (or by other market makers) to other dealers." <u>Id.</u>

3. The House Report of the Penny Stock Reform Act of 1990 discussed the continuing validity of <u>Alstead</u>. The Report acknowledged that there is a

well-developed body of law on how to calculate mark-ups and that the "leading case in this area, Alstead, Strangis & Dempsey, Inc., 47 S.E.C. 1034 (1984), clearly establishes the standards to be used to evaluate whether a customer was excessive mark-ups by a dealer that both makes a market in the security and sells the security to retail customers." House Comm. on Energy and Commerce, Report to accompany the Penny Stock Reform Act of 1990, H.R. Rep. No. 617, 101st Cong. 2d Sess. (July 23, 1990) (reporting H.R. 4497).

4. A market maker may buy or sell a security at a time when it holds the opposite order from a customer and may offset that customer's order. Although such a transaction could be characterized as riskless, it is part of a market maker's normal function and the mark-up should likely be computed on the basis of contemporaneous prices. In applying mark-up analysis, a broker-dealer cannot be considered a market maker for some trades but not for others. In re Strategic Resource Management, Inc., Securities Exchange Act Rel. No. 36618 (Dec. 21, 1995); 60 SEC Docket 2493.

D. Alstead, Dempsey

In In re Alstead, Dempsey & Co., Inc. 47 S.E.C. 1034 (1984), the SEC clarified the appropriate mark-up guidelines for integrated dealers depending upon the type of market trading in the security involved occurs.

1. Active/Competitive Markets.

a. If the market for a security is both active and competitive, and an integrated dealer's quotes can be validated, the dealer may use its own contemporaneous inter-dealer sale price or the lowest, independent offer quotation as the base for computing its mark-ups. See, e.g., SEC v. First Jersey Securities, Inc., 101 F.3d 1450, 1469 (2d. Cir. 1996), cert. denied, 118 S. Ct. 57 (1997); Penny Stock Disclosure Rules, Securities Exchange Act Rel. No. 30608 (Apr. 20, 1992), 51 SEC Docket 415; In re Alstead, Dempsey & Co., Inc., 43 S.E.C. 1034 (1984).

b. An active, competitive market for a security generally exists where more than one market maker has daily or frequent interdealer trades at competitive prices and no market maker dominates and controls that trading activity by accounting for a large portion of the wholesale/retail volume. Notice to Member 92-16, Mark-ups/Mark-downs in Equity Securities, NASD Manual (CCH)(1992).

c. The NASD Board has stated that a competitive market is characterized by three features:

i. the regular publication of quotations with relatively narrow spreads;

ii. frequent interdealer transactions consistently effected at or near the quoted prices so as to validate the reliability of quotations; and

iii. the absence of dominations by a single firm.

In re Hampton Securities, Inc., NASD, ATL-992 (June 1, 1989)

d. NASDAQ/NMS and some regular NASDAQ securities being sold by a market maker to retail customers in an active competitive market such that inside quotations (high bid/low ask) are usually sufficiently valid and reliable as evidence of the prevailing market price for mark-up and mark-down purposes. Notice to Member 92-16, Mark-ups/Mark-downs in Equity Securities, NASD Manual (CCH)(1992).

e. As the SEC stated in Alstead: "Where there is an active, independent market for a security, and the reliability of quoted offers can be tested by comparing them with actual inter-dealer transactions during the period in question, the quotations may provide a proper basis for computing mark-ups. Thus, if inter-dealer sales occur with some frequency, and on the days when they occur they are consistently effected at prices at or around the quoted offers, it may properly be inferred that on other days such offers provide an accurate indication of the prevailing market." In re Alstead, Dempsey & Co., Inc., 47 S.E.C. 1034 (1984).

f. The Alstead decision did not define what level of trading volume constitutes an "active," much less competitive, market for a security. In its amicus memorandum, however, the SEC suggested that, at least, those NASDAQ securities that have been designated as tier one national market system securities, and thereby subjected to last-sale reporting on a real-time basis, generally should be treated as trading in an active, competitive market.

g. At that time, the standards for what constituted tier one securities were: a bid price of $10 or more; average monthly trading volume over 6 months of 6,000,000 shares; net tangible assets of $2,000,000 and capital and surplus of $1,000,000; at least 1200 holders of record of 100 shares or more and at least 500,000 publicly held shares; market value of the publicly held shares of $5,000,000; and four NASDAQ market makers for at least 90% of the business days of the last six months. Rule 11Aa2-1(b)(4)(i), 17 C.F.R. § 240.11Aa2-1(b)(4)(i) (1986).

h. The SEC has promulgated Rule 15g-4(d) solely pertaining to penny stocks which deems a market “active and competitive” in determining the prevailing market price with respect to a transaction by a market maker in a penny stock if the aggregate number of transaction effected by such market maker in the penny stock in the five business days preceding such transaction is less than 20% of the aggregate number of all transactions in the penny stock reported on a Qualified Electronic Quotation System as defined in Rule 15g-3(c)(5). While this numerical value is probative as to the SEC's perception of the issue, it is still only limited to transactions in penny stocks. Penny Stock Disclosure Rules, Securities Exchange Act Rel. No. 30608 (Apr. 20, 1992), 51 SEC Docket 415.

2. Inactive/Competitive Markets.

a. If the market for a security is inactive (i.e., the stock is thinly traded) but competitive, then an integrated dealer may use its own contemporaneous inter-dealer sale price, or in their absence, the lowest offer quotation, if previous inter-dealer sales have occurred consistently at or around the quoted offer price sufficient to validate the quote. Notice to Member 92-16, Mark-ups/Mark-downs in Equity Securities, NASD Manual (CCH)(1992).

b. In an in active/competitive market where a market maker seeks to purchase a security from its retail customers, the best evidence of the prevailing market price for mark-down purposes would be the market maker's actual contemporaneous purchases from other broker-dealers, then validated high bid quotation, and finally its contemporaneous sales. Notice to Member 92-16, Mark-ups/Mark-downs in Equity Securities, NASD Manual (CCH)(1992).

c. As the SEC stated in Alstead: "Except for one day during the period in question, registrant's offering price for Bliss [a "Pink sheet" security] was 4. But it never effected any sales at that figure. The two sales it made to another dealer were at prices of 3-7/16 and 3-1/2, and even its sales to retail customers were consistently below its published wholesale offering price. Moreover, on several occasions when registrant was short and purchased Bliss stock from another dealer, a strong indication that registrant initiated the transactions and thus paid the other dealer's offering price, registrant paid prices ranging from about 2-3/4 to 3-3/8." "In view of the foregoing, it is clear that registrant's offering price was wholly illusory, and cannot be accepted as evidence of the prevailing market. Since there is no indication that registrant controlled the market for Bliss, the prices it charged the other dealer in two transactions may properly be used as a basis for computing mark-ups. In all other instances during the period in question, the best evidence of the prevailing market is the price registrant paid for Bliss in contemporaneous transactions." In re Alstead, Dempsey & Co., Inc., 47 S.E.C. 1034, 1038 (1984).

3. Dominated/Controlled Markets.

a. If the market for a security is "dominate[d]" by an integrated dealer "to such a degree that it control[s the] wholesale prices" for the security, then the dealer should use its contemporaneous purchase price as the basis for computing its mark-ups. SEC v. First Jersey Securities, Inc., 101 F.3d 1450, 1469 (2d. Cir. 1996), cert. denied, 118 S. Ct. 57 (1997); In re C. James Padgett, Securities Exchange Act Rel. No. 38423 (Mar. 20, 1997), 64 SEC Docket 272; In re George Salloum, Securities Exchange Act Rel. No. 35563 (Apr. 5, 1995), 59 SEC Docket 39; In re Hibbard, Brown & Co., Inc., Securities Exchange Act Rel. No. 35476 (Mar. 13, 1995), 58 SEC Docket 2561; In re Michael Alan Leeds, 51 S.E.C. 500 (1993); In re Meyer Blinder, 50 S.E.C. 1215 (1992); In re Rooney, Pace Inc., Securities Exchange Act Rel. No. 25125 (Nov. 13, 1987), 39 SEC Docket 844; In re Alstead, Dempsey & Co., Inc., 47 S.E.C. 1034 (1984). See also Notice to Member 92-16, Mark-ups/Markdowns in Equity Securities, NASD Manual (CCH)(1992).

b. If an integrated dealer dominates the market to the extent that there is no independent, competitive market, then the firm is presumed to control the market, absent evidence to the contrary. In re Meyer Blinder, 50 S.E.C. 1215 (1992) [clarifying In re Alstead, Dempsey

& Co., Inc., 47 S.E.C. 1034 (1984)].

c. There is no "bright line" test for domination and control and that the facts and circumstances of each case must be carefully weighed. Therefore, a member should monitor the nature and volume of its activity in a particular security to determine whether it is in a dominant and controlling position that would require the use of cost to arrive at prevailing market price. Notice to Member 92-16, Mark-ups/Mark-downs in Equity Securities, NASD Manual (CCH)(1992).

d. While the issue of whether a firm dominates the market for a particular security must be decided on the facts and circumstances of each case, some of the factors the SEC has found to be probative include: (1) whether the firm was an underwriter of the initial public offering of the stock and sold a substantial percentage of the offering to its own customers; (2) whether the firm was a market maker in a secondary market for the stock and traded a significant amount of the total aftermarket volume; and (3) the number of other market makers in the stock and their percent of total trading volume as compared to the trading volume of the firm in question. <u>In re</u> Meyer Blinder, 50 S.E.C. 1215, 1218 n.14 (1992)(citing Penny Stock Disclosure Rules, Securities Exchange Act Rel. No. 30608 (Apr. 20, 1992), 51 SEC Docket 415). <u>See also</u>, SEC v. First Jersey Securities, Inc., 101 F.3d 1450, 1469 (2d. Cir. 1996), <u>cert. denied</u>, 118 S. Ct. 57 (1997); <u>In re</u> First Island Securities, Inc., 51 S.E.C. 1086 (1994).

e. The NASD, in the Proposed Debt Mark-Up Policy, while specifically noting that the interpretation does not address the application of the Proposed Policy to transactions involving the domination and control of the market for a security, states that the analysis of whether the market for any particular security is dominated and controlled should take into account the extent to which the particular security is fungible with other similar securities. Notice of Filing of Proposed Rule Change and Amendments Nos. 1 and 2 by the National Association of Securities Dealers, Inc., Relating to the Application of NASD's Mark-Up Policy to Transactions in Government And Other Debt Securities, Release No. 34-40511 (Sept. 30, 1998), File No. SR-NASD-97-61.

f. Although a number of factors have been identified as being important in the domination and control equation, the regulatory decisions have concentrated on two essential statistics: percentage of total volume of transactions in the security the alleged dominator and controller has done during the applicable period, and the percentage of the total float of the security held by the firm's customers. Dan Brecher & Jeffrey S. Rosen, Securities Arbitration of Customer Claims Alleging Unsuitability, Improper Mark-ups/Markdowns or Breach of Fiduciary Duties, 950 PLI/Corp. 469, 488-89 (July-August 1996).

g. The SEC has "repeatedly and consistently" found domination where a firm sells all or a substantial percentage of an IPO to retail customers and then as a market maker in the secondary market, trades a significant amount of the total aftermarket volume. In re C. James Padgett, Securities Exchange Act Rel. No. 38423 (Mar. 20, 1997), 64 SEC Docket 27. See also, In re Paul C. Kettler, Securities Exchange Act Rel. No. ID-66 (June 27, 1995), 59 SEC Docket 1755; In re Rita H. Malm, Securities Exchange Act Rel. No. 35000 (Nov. 23, 1994), 58 SEC Docket 131; In re R.B. Webster Investments, Inc., 51 S.E.C. 1269 (1994).

h. In Padgett, the firm was responsible for well over 90% of the combined retail and wholesale trades for each security. Other cases in which domination and control has been found include In re Frank L. Palumbo, Securities Exchange Act Rel. No. 36427 (Oct. 26, 1995), 60 SEC Docket 1473, in which the firm dominated the purchase volume in three securities by 91.75%, 80.32% and 91.8%, and the total purchase transactions by 83.64%, 78.07% and 93.6%. The firm dominated the sales side to much the same extent. Similarly, in Malm the firm executed 96.3% of the total volume. In In re Universal Heritage Investment Corp., 47 S.E.C. 839 (1982), the SEC found that a broker-dealer that was the only market maker to submit quotation prices on 109 of 189 days in question, and on 52 of the other days its bids were equal to or higher than the highest bid for the stock, controlled the market for the security to such a degree that the use of quotations as the basis for computing its mark-ups was inappropriate. The court upheld an SEC finding of domination where the firm in question accounted for 75% of the trading in Norris & Hirshberg, Inc. v. SEC, 177 F.2d 228 (D.C. Cir.1949). See also, In re G.K. Scott & Co., Inc., 51 S.E.C. 961 (1994); In re First Island Securities, Inc., 51 S.E.C. 1086 (1994); In re Richfield Securities, Inc., 51 S.E.C. 797 (1993); In re Meyer Blinder, 50 S.E.C. 1215 (1992); In re Rooney, Pace Inc., Securities Exchange Act Rel. No. 25125 (Nov. 13, 1987), 39 SEC Docket

844; In re Codispoti, 48 S.E.C. 842 (1987); In re Alstead, Dempsey & Co., Inc., 47 S.E.C. 1034 (1984). In contrast, the SEC did not find such domination and control in In re Peter J. Kisch, Securities Exchange Act Rel. No. 19005 (Aug. 24, 1982), 25 SEC Docket 1242, in which the dominant dealer was but one of 14 dealers for a security and accounted for less than half of the trading volume.

i. "It seems clear that, when an underwriter . . . sells 90% of an offering to its own customers and the remainder is fragmented among a number of other dealers, trading in the aftermarket is necessarily contingent on the underwriter's customers furnishing the supply. Because the identity of those customers is known only to the underwriter, tapping that supply for resale lies uniquely within the underwriter's control. The fact that such an underwriter is in a position to dominate and control the trading market . . . enable[s] the underwriter to control wholesale pricing to such an extent as to preclude an independent, competitive market from arising, notwithstanding the presence of other dealers who may be entering quotations. The price leadership resulting from its almost exclusive control of the source of supply empowers the underwriter to set prices arbitrarily." In re Michael Alan Leeds, 51 S.E.C. 500 (1993) [quoting In re Pagel, Inc., 48 S.E.C. 223, 226 (1985), aff'd 803 F. 2d 942 (8th Cir. 1986)(finding it sufficient that the ability to control the market existed, rather than requiring actual proof)]. See also, In re George Salloum, Securities Exchange Act Rel. No. 35563 (Apr. 5, 1995), 59 SEC Docket 39; In re Robert B. Orkin, 51 S.E.C. 336, 337 (1993), aff'd, 31 F.3d 1056 (11th Cir. 1994); In re Steven B. Theys, Securities Exchange Act Rel. No. 32358 (May 24, 1993), 54 SEC Docket 446.

j. The SEC determined that there was no domination and control in a situation where a firm controlled no more than 25% of the public float, in the absence of any other indicia of control. In re Hibbard, Brown & Co., Inc., Securities Exchange Act Rel. No. 35476 (Mar. 13, 1995), 58 SEC Docket 2561 (but noting in a footnote that the SEC is not making the determination that a broker-dealer which only has a small part of the float could not be deemed to control the market for a security).

k. In the Alstead decision, the SEC distinguished between a firm that merely dominated the market and a firm that dominated and controlled a market. In the case where the firm did not dominate and control the market "the prices [the firm] charged the other dealer in two transactions may properly be used as a basis for computing mark-ups." In re Alstead, Dempsey & Co., Inc., 47 S.E.C. 1034, 1038 (1984).

l. A firm that controls a market exercises a substantial influence over the price of the stock such that, as a practical matter, the firm, and not the competitive market factors, determines the price of the stock. In re Meyer Blinder, 50 S.E.C. 1215, 1218 n.15 (1992).

m. The lack of dominance of a market may be shown by "frequent interdealer transactions consistently effected at or near the quoted prices so as to validate the reliability of quotations." Dan Brecher & Jeffrey S. Rosen, Securities Arbitration of Customer Claims Alleging Unsuitability, Improper Mark-ups/Mark-downs or Breach of Fiduciary Duties, 950 PLI/Corp. 469, 488 (July-August 1996).

n. Generally, a dominant market maker who controls the wholesale prices should use its contemporaneous purchase price from other dealers as the basis for calculating mark-ups. If, however, the market maker has no contemporaneous purchases from other dealers, the market maker's contemporaneous purchase price from retail customers, adjusted for the mark-down inherent in that purchase may be the best evidence of the prevailing market. "An integrated dealer may establish by countervailing evidence, however, that some other measure is better evidence of the prevailing market price from which mark-ups should be calculated." In re Meyer Blinder, 50 S.E.C. 1215 (1992).

o. An exception to using the contemporaneous purchase price may arise in situations where a dealer has only a few contemporaneous purchases from other dealers but many contemporaneous purchases from customers in a dominated and controlled market. In this situation, it may be far more appropriate to use the retail purchase prices as the prevailing market price in lieu of its wholesale cost. This is especially relevant where the isolated wholesale transactions could be called into question due to size, frequency, price, or other features that suggest that these are not bona fide trades, but rather designed to artificially establish a particular prevailing market price. Notice to Member 92-16, Mark-ups/Markdowns in Equity Securities, NASD Manual (CCH)(1992).

4. The Alstead decision, in particular its application to integrated dealers, has, and continues to generate significant commentary. Brandon Becker, Soo J.

Yim, Mark S. Shelton & Daniel Gallagher, The Duty of Best Execution, SD44 ALI-ABA 9 at 7-9 (Jan.14, 1999); Gerald S. Citera, Equity Trading Issues, SD44 ALI-ABA 43 at 11 (Jan. 14, 1999); Becker & Kramer, SEC Plays Proper Role in OTC Pricing Regulation, Legal Times at 14 (Nov. 26, 1984); Pickard & Djinis, SEC Cracks Down on Inflated Broker-Dealer Mark-ups, Legal Times at 15 (June 14, 1984); Bloomenthal, "Recent Cases," 6 Secs. Fed. Corp. L. Rep. 124 (May 1984); Ingersoll, SEC Stiffens Penalty for Minnesota Broker Accused of Overcharges in Sales of Stock, Wall St. J. at 8, col. 1 (Apr.18, 1984); and Bloomenthal, Broker-Dealer Compliance: Some Problem Areas, 5 Secs. & Fed. Corp. L. Rep. (pts. 1 & 2) 73 & 81 (Nov. 1983 and Dec.1983).

E. Prevailing Market Price -- Debt Securities Generally

1. As a practical matter, despite various criticisms, regulators have used a substantially similar analytical framework for computing mark-ups charged for corporate, municipal and government debt securities, and for making determinations of excessiveness as for equity securities.

2. Proposed NASD Debt Mark-up Release

The NASD has sought to clarify the calculation of the prevailing market price in debt securities for many years now. Pursuant to the expanded authority granted the NASD by the Government Securities Act Amendment, the NASD in August of 1994 published for member comment Notice to Members No. 94-62. Because of the convergence of multiple issues in NTM 94-62, the NASD deferred action on the proposal until 1997, when it published the Debt Mark-up Interpretation Amendment No. 1. Due to another lapse of time, the NASD subsequently has substituted Amendment No. 2 for the proposed language of the Debt Mark-Up Interpretation. Notice of Filing of Proposed Rule Change and Amendments Nos. 1 and 2 by the National Association of Securities Dealers, Inc., Relating to the Application of NASD's Mark-Up Policy to Transactions in Government And Other Debt Securities, Rel. No. 34-40511 (Sept. 30, 1998), File No. SR-NASD-97-61.

3. According to the Proposed Debt Mark-Up Release, when inter-dealer transactions are not available, a dealer that effects a transaction in government or other debt securities with a customer and determines the mark-up or mark-down on a basis other than its own contemporaneous cost must be prepared to overcome the presumption that the contemporaneous cost provides the best measure of the prevailing market price. Factors that the NASD believes may be taken into consideration

include, but are not limited to:

a. Prices of any dealer transactions in the security in question with institutional accounts with which any dealer regularly effects transactions in the same or a similar security;

b. Contemporaneous inter-dealer quotations in the security in question made through an inter-dealer quotation mechanism through which transactions do in fact occur in that security at prices that are reasonably related to the displayed quotations;

c. Yields calculated from prices of inter-dealer transactions in "similar" securities, as defined below;

d. Yields calculated from prices of transactions with institutional accounts in "similar" securities; and

e. Yields calculated from validated inter-dealer quotations in "similar" securities.

4. In considering yields of "similar" securities, members may not rely on a limited number of transactions that are not fairly representative of the yields of transactions of "similar" securities taken as a whole.

5. The NASD Mark-up Release explains that for a security to be considered "similar" for these purposes, it "should be sufficiently similar to the security under review that it would serve as a reasonable alternative to an investor seeking the risk profile of an investment in the security under review. At a minimum, the security or securities should be sufficiently similar that a market yield for the security under review can be fairly estimated by interpolation or extrapolation from the yields of the 'similar' security or securities." Where a security has several components, appropriate consideration may also be given to the prices or yields of the various components of the security.

6. The degree to which a "security is similar" as that term is used in Section V.E.3.c, V.E.3.d and V.E.3.e supra, may be determined by factors that include, but are not limited to:

a. Credit quality considerations, such as whether the security issued by the same or similar entity, bears the same or similar credit rating, or is supported by a similarly strong guarantee or collateral;

b. The extent to which the security trades at a comparable spread over Treasuries of similar duration;

c. General structural characteristics of the issue, such as coupon, maturity, duration, complexity or uniqueness of the structure, callability, the likelihood that the security will be called, tendered or exchanged, and other embedded options; and

d. Technical factors such as the size of the issue, the size of the transactions or quotations being compared, the float and recent turnover of the issue and legal restrictions on transferability.

7. The Proposed Interpretation acknowledges the difficult questions posed with respect to mark-ups of debt securities that are relatively illiquid or that are designed for a particular type of customer or type of customer. While the Interpretation presumes that a comparison to “similar” securities may be helpful in establishing the prevailing market price of such a security, the default standard of contemporaneous cost remains in effect unless the dealer can show that this measure is not indicative of the prevailing market price.

8. If the debt security at issue trades with significant equity like characteristics (that is, where the value of the security is highly dependent on the circumstances of the issuer rather than responding to changes in interest rates in a manner typical of most other debt securities) the use of comparisons with similar securities of unrelated companies will generally not be relevant.

9. If contemporaneous cost is the appropriate measure for a market maker trading illiquid securities, the market maker’s entitlement to a spread should nonetheless be a factor in determining the reasonableness of the mark-up.

10. A number of comment letters have been written by industry associations, including both the Bond Market Association (“BMA”) and the Securities Industry Association (“SIA”). While generally supportive of the NASD's efforts to provide further guidance and clarification to the application of the existing NASD mark-up policy to debt securities, the BMA and the SIA both propose significant changes that would have to be made prior to the supporting the Proposed Interpretation. <u>See</u>, Letter from Paul Saltzman & George P. Miller, Bond Market Association (Dec. 16, 1998); Letter from Lee B. Spencer, Jr. & R. Gerald Baker, Securities Industry Association (Dec. 14, 1998). <u>See also</u>, Letter from Betsy Dotson,

Government Finance Officers Association (Dec. 7, 1998); Letter from James F. Smith, Freeman Securities Co., Inc. (Dec. 16, 1998); and Letter from Marjorie E. Gross, Chase Manhattan Bank (Dec. 15, 1998).

11. The BMA, while supportive of the NASD's efforts to provide guidance, disagrees with a number of premises within the Proposed Interpretation. Specifically, strong objections were raised concerning the assertion that the NASD and the SEC have made clear the appropriate mark-up or mark-down is “substantially less that 5 percent,” as it argues that that is not the current state of the law. As such, the BMA is concerned with establishment of a new, substantive mark-up policy in that respect. Additionally, the BMA disagrees with the premise that the best evidence of the prevailing market price is the dealer's contemporaneous cost of acquiring the securities over concerns that such a default standard would establish a costly, unfair and largely unworkable evidentiary burden for dealers to overcome. General concerns are expressed over the applicability of the concepts of “market maker” and “domination and control” in debt markets, as well as the need for clarification of the definition of “riskless principal.” <u>See</u>, Letter from Paul Saltzman & George P. Miller, Bond Market Association (Dec. 16, 1998).

12. The SIA, while also supportive of the NASD's efforts, illustrate some “important modifications” that are necessary in order to provide adequate interpretative guidance, the benefit of which may not be particularly helpful in the concept of certain debt markets. Concerns are expressed that the Proposed Interpretation “relies too heavily on equity-based characteristics of mark-up doctrine that does not adequately reflect fundamental differences in the roles of dealers in equity and fixed income markets.” As with the BMA, concerns are also expressed about the creation of a new mark-up policy for covered debt securities that is “substantially less that 5 percent,” far beyond that of the unreasonableness of the mark-ups “in excess of 5%” in NASD Rule IM-2440. The SIA also illustrates that the definition of “market-making” needs expanding, and the severe concerns that arise with the presumptive favoritism of contemporaneous cost. The SIA is of the opinion that contemporaneous cost should be “de-emphasized” as an indicator of prevailing market price, and while the other factors listed may provide helpful guidance, that guidance would prove helpful only to the extent such a list is not viewed as exhaustive. <u>See</u>, Letter from Lee B. Spencer, Jr. & R. Gerald Baker, Securities Industry Association (Dec. 14, 1998).

F. Prevailing Market Price -- Corporate Debt Securities

1. Early SEC decisions often involved mark-ups on corporate debt securities. See, e.g., Charles Hughes & Co., Inc. v. SEC, 139 F.2d 434 (2d Cir.), cert. denied, 321 U.S. 786 (1943); In re Scott McIntyre & Co., 11 S.E.C. 442 (1942); In re Allender Co., 9 S.E.C. 1043 (1941); and In re Duker & Duker, 6 S.E.C. 386 (1939).

2. Two SEC decisions involving corporate debt securities reaffirmed the applicability of the traditional mark-up analysis in the context of reviewing two NASD disciplinary decisions. In re DMR Securities, Inc., 47 S.E.C. 180 (1979) ("DMR I"); In re DMR Securities, Inc., 47 S.E.C. 350 (1980) ("DMR II"). See also, In re Thomas White & Co., Inc., 51 S.E.C. 932 (1994). Read together, DMR I and DMR II reaffirmed for corporate debt securities that:

   a. "[I]n the absence of countervailing evidence, a dealer's contemporaneous cost is the best evidence of current market price . .." DMR I, 47 S.E.C. at 182 (footnote omitted).

   b. A transaction will be treated as contemporaneous, for purposes of computing a firm's mark-ups if it is closely related in time to the retail sales in question, which generally requires that the base transactions occur on the same day as, or prior day to, the retail transaction in question. See, DMR I, 47 S.E.C. at 182 and DMR II, 47 S.E.C. at 351.

G. Prevailing Market Price -- Municipal Securities

1. In Grandon v. Merrill Lynch & Co., 147 F.3d 184 (2d Cir. 1998), the Second Circuit ruled that "there exists an implied duty to disclose mark-ups on municipal securities when those mark-ups are excessive." The court stated, as a general rule, the prevailing market price of bonds is the contemporaneous cost paid by the broker-dealer. The court determined that, like broker-dealers selling OTC securities (as in First Jersey), broker-dealers selling municipal securities implicitly represent to their customers that the prices charged are reasonable related to the prices charged in an open and competitive market. Id. at 192-93.

2. There has been more active scrutiny of mark-ups involving municipal securities than of mark-ups on corporate debt securities. See e.g., SEC v. Charles A. Morris & Associates, Inc., 786 F. Supp. 1327 (W.D. Tenn. 1973); In re Marion Bass Secs. Corp., Securities Exchange Act Rel. No. 39170 (Sept. 30, 1997), 65 SEC Docket 1214; In re Staten Securities, 47 S.E.C. 766 (1982); In re Crosby & Elkin, Inc., 47 S.E.C. 526 (1981); In re

DMR Securities, Inc., 47 S.E.C. 350 (1980); In re Edward J. Blumenfeld, 47 S.E.C. 189 (1980); and In re Charles Michael West, 47 S.E.C. 39 (1979).

3. In large part, the mark-up analysis used in these cases is similar to the traditional analysis of equity security mark-ups. Indeed, the SEC specifically has rejected the argument that "expert testimony" was necessary "to establish prevailing market prices and excessive mark-ups based thereon" for municipal securities. Rather, the SEC reaffirmed the contemporaneous cost standard and held that "[T]he burden is on the dealer to establish the contrary." In re Charles Michael West, 47 S.E.C. 39 (1979) (footnote omitted).

4. Because there is generally very limited trading activity for any particular issue of municipal securities, the SEC has questioned the probative value of quotations for such securities as establishing the prevailing market price. In re Powell & Associates, Inc., 47 S.E.C. 746, 747-48 (1982); In re Charles Michael West, 47 S.E.C. 39, 42 (1979). Although, since 1995, MSRB Rule G-14(a) has required brokers, dealers, and municipal securities dealers to report interdealer municipal securities transactions to the MSRB by submitting to the National Securities Clearing Corporation information required to produce a compared trade for the transaction on the night of the trade. Additionally, since March 1, 1998, every broker, dealer and municipal securities dealer is required to report to the MSRB all customer transaction by midnight of the day of the trade. The information gathered by the MSRB is published in daily reports which include the high, low, and average prices of municipal securities that are traded four or more times on a given day.

5. The NASD has considered the issue of excessive mark-ups of municipal securities in In re International Trading Group, Complaint No. C07950058 (July 2, 1998). Drawing upon prior decisions, the NASDR reaffirmed the viability of the current inter-dealer price as the prevailing market price.

H. Prevailing Market Price -- Zero-Coupon Securities

1. "[W]here the inter-dealer market is dominated by a single market maker (which may be the case where a zero-coupon security is a proprietary product of a broker-dealer), the best evidence of the prevailing market generally will be the broker-dealer's contemporaneous retail purchases, adjusted to reflect the markdown inherent in such customer transactions." Zero-Coupon Securities, Securities Exchange Act Rel. No. 24368 (Apr. 21, 1987), 52 FR 15575, 15577.

2. In one zero-coupon securities case, SEC v. MV Securities, Inc., (S.D.N.Y. No. 84 Civ. 1164), Lit. Rel. No. 10289 (Feb. 21, 1984), 29 SEC Docket 1454; and Lit. Rel. No. 10303 (Mar. 5, 1984), 29 SEC Docket 1591 (describing the consent order), the SEC's memorandum requesting a temporary restraining order stated that: "The zero coupon bonds examined . . . consistently showed mark-ups in excess of 15%, and sometimes as much as 149% over the contemporaneous cost for those bonds paid by MVS. Contemporaneous cost has been recognized as an accurate indication of the relevant market price of a bond." Memorandum in Support of Application for an Order to Show Cause, Temporary Restraining Order, and Motion for a Preliminary Injunction, Expedited Discovery and Other Equitable Relief, at 23, <u>in</u> SEC v. MV Securities Inc. The SEC used a "same-day and next-day" standard to compute the firm's mark-ups. <u>See</u> Affidavit of Paul Bodor, at 7, dated February 7, 1984, in SEC v. MV Securities, Inc. ("With respect to [zero-coupon] securities, WS records show that MVS generally purchased a quantity of the zero coupon bonds wholesale from another broker-dealer and then sold them retail to the firm's customers.").

3. The SEC has negotiated settlements in a number of zero-coupon securities cases. <u>See</u> <u>In re</u> David B. Harberson, Securities Exchange Act Rel. No. 26312 (Dec. 2, 1988), 42 SEC Docket 409; <u>In re</u> Scott M. Flanagan, Securities Exchange Act Rel. No. 26313 (Dec. 2, 1988) 42 SEC Docket 410; <u>In re</u> Alan Charles Refkin, Securities Exchange Act Rel. No. 26311 (Nov. 25, 1988); <u>In re</u> PaineWebber, Inc., Securities Exchange Act Rel. No. 26418 (Mar. 4, 1988), 40 SEC Docket 693; <u>and</u> <u>In re</u> Sutro & Co., Inc., Securities Exchange Act Rel. No. 23663 (Sept. 30, 1986), 36 SEC Docket 1199.

VI. SCIENTER IN CASES ALLEGING EXCESSIVE MARK-UPS.

A. A plaintiff is required to prove that a defendant acted with scienter to recover under Section 10(b) and Rule 10b-5. <u>In re</u> D.E. Wine Investments, Inc., Rel. No. ID-134 (June 9, 1999), 1999 WL 373279 (S.E.C.)[citing Aaron v. SEC, 446 U.S. 680 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976)]. Scienter is established by showing that the defendant acted intentionally, willfully, or recklessly. <u>In re</u> Leslie Fay Companies, Inc., 871 F. Supp. 686, 691-94 (S.D.N.Y. 1995); Coleco Industries v. Berman, 567 F.2d 569, 574 (3d Cir. 1977), <u>cert. denied</u>, 439 U.S. 830 (1978). Reckless conduct, has been defined for Section 10(b) purposes, as "'highly unreasonable [conduct], involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must be aware of it.'" In re Silicon Graphics Inc. Securities Litigation 183 F.3d 970 (9th Cir. 1999)[quoting Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990)]. See also, In re Phillips Petroleum Securities Litigation, 881 F.2d 1236 (3d Cir. 1989); Van Dyke v. Coburn Enter. Inc., 873 F.2d 1094 (8th Cir. 1989); Hackbart v. Holmes, 675 F.2d 1114 (10th Cir. 1982); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir. 1978) and Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1045 (7th Cir. 1977).

B. Every court of appeals that had considered the question prior to the passage of the Private Securities Litigation Reform Act held that recklessness satisfied the scienter requirement. Bryant v. Avado Brands, Inc., ___ F.3d ___, 1999 WL 688050 (11th Cir. 1999) (citations omitted). In passing the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Congress has upheld the standard of recklessness as sufficient for the scienter requirement under Rule 10b-5. See U.S.C. § 78u-5(c) (Supp. II 1996), and § 78u-4(g).

C. Following the passage of the PSLRA, the issue causing judicial uncertainty is the pleading standard required for scienter. The Second and Third Circuits have held that a strong inference of scienter can be alleged by showing a motive and opportunity to commit fraud or by showing circumstantial evidence denoting either recklessness or conscious misbehavior. See In re Advanta Corp. Securities Litigation, 180 F.3d 525 (3d Cir. 1999) and Press v. Chemical Investment Services Corp., 166 F.3d 529 (2d Cir. 1999). The Sixth and Eleventh Circuits have held that scienter could be alleged by pleading facts that give rise to a strong inference of recklessness, but refused to accept the proposition that allegations of motive and opportunity to commit fraud were sufficient to plead scienter, unless the facts demonstrate the required state of mind, namely that the defendant acted recklessly or knowingly. See Bryant v. Avado Brands, Inc., ___ F.3d ___, 1999 WL 688050 (11th Cir. 1999), and In re Comshare Securities Litigation, 183 F.3d 542 (6th Cir. 1999). Finally, the Ninth Circuit has reached the conclusion that PSLRA substantively raised the required level of scienter, that allegations showing motive and opportunity to commit fraud are not sufficient to allege the necessary state of mind, and that conscious recklessness is required to raise a strong inference of scienter under PSLRA. See In re Silicon Graphics Securities Litigation, 183 F.3d 542 (9th Cir. 1999).

D. Circumstantial evidence is often the only means of establishing scienter; direct evidence is not necessary. See Gray v. First Winthrop Corp., 82 F.3d 877, 844 (9th Cir. 1996); United States v. Ruggiero, 56 F.3d 647, 655 (5th Cir. 1995); Herman & McLean v. Huddleston, 459 U.S. 375, 390 n.30 (1983).

E. The scienter of a broker-dealer's officials may be imputed to the broker-dealer itself. In re D.E. Wine Investments, Inc., Rel. No. ID-134 (June 9, 1999), 1999 WL 373279 (S.E.C.) [citing SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1089 n.3 (2d Cir. 1972)].

F. A dealer has a duty to learn the prevailing inter-dealer market price of the securities it sells, to assure its retail customers that the prices it charges them are reasonably related to the prevailing market prices and do not include excessive mark-ups. In re Meyer Blinder, 50 S.E.C. 1215 (1992)[citing In re Powell & Associates, Inc., 47 S.E.C. 746 (1982)].

G. In the SEC's brief in Elysian Federal Savings Bank v. First Interregional Equity Corp., 713 F. Supp 737 (D.N.J. 1989), the SEC argued that the scienter issue in mark-up cases is not often addressed because the facts relevant to this issue usually are not in dispute and the scienter determination is usually straightforward. The SEC stated that the dealer knows the prevailing inter-dealer market price for the securities, knows the retail price that it is charging the customer, and is aware that its mark-up exceeds industry norms, but nonetheless charges the customer the retail price without disclosure. In such circumstances, the dealer's knowing conduct satisfies the scienter requirement, and it is not necessary to determine if the dealer acted recklessly by failing to make a proper inquiry. See Supplemental Amicus Curiae Brief of the Securities and Exchange Commission in Elysian Federal Savings Bank v. First Interregional Equity Corp., 713 F. Supp. 737 (D.N.J. 1989)(No. 88-3528) at 23. See also, In re Powell & Associates, Inc., 47 S.E.C. 746, 748 (1982); In re James Ryan, 47 S.E.C. 759, 763 (1982); In re Crosby & Elkin, Inc., 47 S.E.C. 526, 531 (1981).

H. Under the NASD's antifraud provision, presently found in Conduct Rule 2120, the SEC has held that a finding of scienter is also required to sustain a violation. See In re Meyer Blinder, 50 S.E.C. 1215 (1992); In re Walter T. Black, Securities Exchange Act Rel. No. 28630 (Nov. 20, 1990), 46 SEC Docket 1414; and In re Universal Heritage Investments Corp., 47 S.E.C. 839 (1982). Reckless conduct satisfies the scienter requirement in the NASD Rule. In re Meyer Blinder, 50 S.E.C. 1215 (1992) "Where a dealer knows the circumstances indicating the prevailing interdealer market price for the securities, knows the retail price that it is charging the customer, and knows or *recklessly* disregards the fact that its mark-up is excessive, but nonetheless charges the customer the retail price, the scienter requirement is satisfied." Id. (emphasis added)[citing In re Powell & Associates, 47 S.E.C. 746, 748 (1982)].

VII. MARK-UP GUIDELINES AND THE ANTITRUST LAWS.

A. No challenge to the SEC's or the NASD's mark-up policies has been sustained under the federal antitrust laws, because the policies do not establish any schedule of fixed rate of compensation. See National Association of Securities Dealers, Inc., 17 S.E.C. 459 (1944).

B. Various courts have concluded that the antitrust laws do not control in the limited area where they must be deemed to have been impliedly repealed if the Securities Exchange Act is to work. See United States v. National Association of Securities Dealers, Inc., 422 U.S. 694 (1975); Gordon v. New York Stock Exchange, 422 U.S. 659 (1975); Silver v. New York Stock Exchange, 373 U.S. 341, 357 (1963); Austin Municipal Securities, Inc. v. NASD, 757 F.2d 676 (5th Cir. 1985); Thill Securities Corp. v. New York Stock Exchange, 633 F.2d 65 (7th Cir. 1980), cert. denied, 450 U.S. 998 (1981); Hardin v. American Stock Exchange, 527 F.2d 1366 (5th Cir. 1976); In re Richfield Securities, Inc., 51 S.E.C. 797 (1993); In re Richard R. Perkins, 51 S.E.C. 380 (1993); In re Meyer Blinder, 50 S.E.C. 1215 (1992).

C. Antitrust laws were not designed to protect persons who commit fraud; the fraud provision under Rule 10b-5 is a proscription against a dealer charging undisclosed excessive mark-ups, not a proscription against the mark-up itself. The SEC's purpose in insisting on disclosure of excessive mark-ups is to prevent the deception of investors regarding their transaction charges, and not to set rates for those charges. See Supplemental Amicus Curiae Brief of the Securities and Exchange Commission in Elysian Federal Savings Bank v. First Interregional Equity Corp., 713 F. Supp. 737 (D.N.J. 1989)(No. 88-3528) at 31.

D. In a concurrence vacating and remanding a disciplinary action taken by the NASD, SEC Commissioner Wallman noted a concern regarding the NASD's requirement that its members engage in securities transactions at fair prices. Wallman noted that:

> [W]hile the NASD's “5%” mark-up policy is just a guideline, and was and is undoubtedly well intentioned, my strong concern is that such guidelines have the potential to set floors for pricing or to preclude or otherwise limit competition or innovation, thereby disadvantaging investors. For those reasons, in other industries, similar maximum price guidelines have been held to represent per se violations of the antitrust laws. . . . This issue is even more pointed here where the policy was established by an informal survey of industry participants over five decades ago without any rate-making or other analysis. Therefore . . . I believe the NASD and the Commission must revisit the broader, competitive implications of the 5% policy, and other similar policies as soon as possible.

In re Raymond James & Associates, Inc., Securities Exchange Act Rel. No. 38893 (Aug. 1, 1997); 65 SEC Docket 212 [referring to the Letter from Department of

Justice to John R. Ferguson re: Pharmaceutical Manufacturers Association (Oct. 1, 1993)].

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