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FRAUD IN MARKUPS: AN UNUSUAL SEC DECISION

Departing from long established precedents, the Commission rejects an NASD finding that a brokerage firm committed fraud by charging undisclosed markups far exceeding ten percent in riskless principal transactions not involving special circumstances.

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In *In the Matter of the Application of Dennis Todd Lloyd Gordon and Sterling Scott Lee* (“Gordon and Lee case”),¹ the Securities and Exchange Commission upheld NASD² findings of excessive markups in connection with the purchase and sale of low-priced securities. The Commission, however, did not uphold findings that such markups were fraudulent, despite their being undisclosed and exceeding 10 percent. This outcome is very surprising because the SEC consistently has held that markups exceeding 10% are fraudulent. The SEC’s holding suggests that the presence of certain facts or circumstances may lead the SEC to depart from its traditional view that undisclosed markups exceeding 10 percent are presumed fraudulent.

¹ Securities Exchange Act Release No. 57655 (April 11, 2008).

² In July 2007, the NASD changed its name to the Financial Industry Regulatory Authority (“FINRA”) in connection with the consolidation of the NASD and NYSE Regulation, Inc. Because the NASD disciplinary action occurred prior to that date, we refer to the self-regulatory organization as NASD.

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Facts

Dennis Todd Lloyd Gordon, the chairman and chief executive officer of former NASD member firm Lloyd Scott and Valenti (“LSVL”), and Sterling Scott Lee, LSVL’s president, appealed to the SEC from an NASD disciplinary action. The NASD had found that during a three-month period in 2002, Gordon and Lee, acting with scienter, caused LSVL to charge fraudulently excessive, undisclosed markups in 31 retail sales in violation of various NASD Conduct Rules,³ Section

³ The SEC upheld violations of NASD Conduct Rules 2110 (requiring adherence to high standards of commercial honor and just and equitable principles of trade), 2120 (prohibiting the use of manipulative, deceptive, or other fraudulent devices in connection with any transaction in, or purchase or sale of, any security), 2440 (requiring that securities transactions entered into between members and their customers occur at fair prices, taking into account all relevant circumstances), IM-2440 (which deems it a violation of NASD Conduct Rules 2110 and 2440 “for a member to enter into any transaction with a customer in any security at any price not reasonably related to the current

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10(b) of the Securities Exchange Act of 1934 and Rules 10b-5⁴ and 10b-10 thereunder.⁵ The transactions were in the shares of Pacific CMA, Inc. (“PCCM”), a thinly traded security quoted in the Over-the-Counter Bulletin Board (“OTCBB”).⁶

In a typical transaction, a registered representative of LSVL would identify a shareholder who owned and wanted to sell a large block of PCCM stock. The registered representative would then find potential buyers of the stock and call in the matched purchases and sales to Lee.⁷ LSVL would purchase PCCM from the seller at the inside bid price, charge the seller an additional five percent of the purchase price, and then

sell the stock to the previously identified buyers at the inside offer. LSVL kept as remuneration the difference between what it paid for the shares (*i.e.*, the inside bid price minus five percent) and the amount it was paid for the shares (*i.e.*, the inside offer price). This resulted in markups ranging from 12.9% to 54.55%, based on the difference between the sale and purchase price of the shares. The total firm profit from all the trades was \$32,301.

Regulatory Findings

NASD rules require that each securities transaction between a member and its customer be “at a price which is fair, taking into consideration all relevant circumstances.”⁸ NASD’s related mark-up policy states that a member firm that enters into a transaction with a customer “in any security at any price not reasonably related to the current market price” of the security violates applicable NASD rules.⁹ Where a broker-dealer is not a market maker, and LSVL was not, the best evidence of the current market price is the firm’s contemporaneous cost.¹⁰ This is particularly true in riskless principal transactions, where the contemporaneous cost must be used as the basis for calculating markups.¹¹ Both the SEC and NASD found that LSVL acted in a riskless capacity in the transactions in PCCM stock. Thus, LSVL’s markup on its sales transactions to customers should be the amount the sale price exceeded its contemporaneous price.

Absent a showing of genuinely unique circumstances, markups exceeding five percent are typically viewed as excessive, violating the NASD member’s obligations to

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market price of the security”), and 2230 (which sets forth disclosure and other requirements governing customer confirmations, including the requirement, when an NASD member is acting as agent for a customer to disclose “the source and amount of any commission or the remuneration received” in connection with the transaction reported in the confirmation).

⁴ Exchange Act Section 10(b) and Rule 10b-5 thereunder generally make it unlawful for any person to use any manipulative or fraudulent device in connection with the purchase or sale of any security.

⁵ Exchange Act Rule 10b-10 requires a non-market-maker broker-dealer, when effecting a riskless principal transaction for a customer, to disclose the difference between the price to the customer and the broker-dealer’s contemporaneous purchase price (for customer purchases) or sale price (for customer sales). 17 CFR § 240.10b-10(a)(2)(ii)(A).

⁶ Although LSVL effected each of those transactions as riskless principal, representing at least 65% of the total trading volume of PCCM shares during that period, LSVL was not a market maker in the stock. The SEC has defined a riskless principal transactions as one in which “after receiving an order to buy or sell from a customer, the broker-dealer purchases the security from another person to offset a contemporaneous purchase by the customer or sells the security to another person to offset a contemporaneous sale by the customer.” See Securities Exchange Act Release No. 34962 (November 10, 1994).

⁷ Lee executed all 31 transactions relating to this case, and Gordon reviewed each of the trades at the end of each month.

⁸ See NASD Conduct Rule 2440.

⁹ See IM-2440-1 (which states that entering into a transaction at a price not reasonably related to the current price of the security violated NASD Conduct Rules 2110 and 2440).

¹⁰ *First Independence Group*, 51 SEC 663, 664-65 (A993), *aff’d*, 37 F.3d 30 (2d Cir. 1994); *Adams Sec., Inc.*, 51 SEC 311, 312 (1993).

¹¹ *R.B. Webster Invs., Inc.*, 52 SEC 288, 291 n.18; *Kevin B. Waide*, 50 SEC 932, 934, 936-37 (1992).

adhere to just and equitable principles of trade and fair pricing.¹² In the Gordon and Lee Case, the appellants attempted to make such a showing, by describing the extra effort and expense they incurred in arranging the trades. Because Gordon and Lee failed to substantiate their extra effort and expense, particularly their lack of documentation and inability to describe the details of how the registered representative arranged the transactions, the NASD, and later the SEC, found the “extra effort” excuse unpersuasive. Accordingly, the SEC upheld the NASD’s charge that Gordon and Lee had violated applicable NASD Rules for charging excessive markups. The regulators also found that Lee (although not Gordon) violated Section 10(b) of Exchange Act and Rule 10b-10 thereunder, by failing to disclose the amounts of each markup on trade confirmations.¹³ Significantly, however, the SEC did *not* find that Gordon or Lee acted fraudulently in this case.

Previous SEC Action Regarding Excessive, Undisclosed Markups

The most significant aspect of the Gordon and Lee case was that the SEC did not find the brokerage firm’s pattern of behavior constituted fraud on the part of Gordon and Lee. Historically, the SEC has found that “at the least, markups on equity securities of more than 10% generally are fraudulent.”¹⁴ The SEC consistently has applied a 10% standard for when a markup will be deemed *per se* fraudulent. Broker-dealers have been sanctioned for fraudulently charging markups in excess of 10% in a variety of circumstances,¹⁵ including riskless principal trades in thinly traded stocks,¹⁶ penny

stock trades,¹⁷ and trades as market maker.¹⁸ The SEC has found that “markups of more than 10% are fraudulent even in the sale of low-priced securities,” ranging from 1 3/8 per share to 5 1/4 per share.¹⁹ A question arises as to whether the SEC’s failure to find fraud by Gordon and Lee in light of markups ranging from 12.9% to 54% signals a change in the SEC’s treatment of such behavior or is predicated on certain unusual aspects of this case.

The SEC’s explanation in the Gordon and Lee case as to why it did not uphold a fraud charge is sparse and unhelpful. The decision simply notes that “We do not, however, find fraud on this record.” This “finding” is particularly curious as it follows a lengthy explanation as to why the SEC will uphold the NASD’s charge of a violation of the NASD Mark-Up Policy. The SEC’s discussion about mark-up violations included a finding that the firm was not a market maker in the stock, so it was not entitled to capture the bid-ask spread in the security. The SEC further stated that, because the trades were riskless principal transactions, the firm’s contemporaneous cost must be used as the basis for determining its markup. Finally, the SEC found that the firm had failed to demonstrate that any special circumstances warranted markups above 5%.

Up until this point in the decision, it seemed inevitable that the SEC would find fraud involved. A non-market maker acting in a riskless principal capacity without any special mitigating circumstances charged markups well over 10%. Thus, the SEC determination not to sustain a fraud charge, particularly without any explanation, is baffling.

We believe that certain facts in the case might provide clues as to the SEC’s rationale. Specifically, the firm tried to determine an appropriate price by using the inside bid-ask quotes. It attempted to discern from the SEC whether its approach was valid by writing the SEC for clarification or a no-action letter regarding its cross-trading methodology. Its letter noted the NASD had questioned the firm’s ability to retain the bid-ask spread due to the fact that it exceeded the 5% guidelines. The SEC declined to provide the interpretive guidance or no-action relief because, as a matter of policy, such relief is

¹² See NASD Notice to Members 92-16 (April 1992).

¹³ The SEC found that Lee was responsible for the contents of the confirmations, but that the record did not demonstrate that Gordon knew or should have known of their contents.

¹⁴ See *In the Matter of Mark David Anderson*, Administrative Release No. ID-203 (April 30, 2002). See also *D.E. Wine Invs., Inc.*, 53 SEC 391, 394 (1998); *after remand*, 54 SEC 1213 (2001); *In the Matter of the Application of Crosby & Elkin, Inc.*, Exchange Act Release No. 17709 (April 13, 1981) (“we have consistently held that, *at the least*, markups of more than 10% are fraudulent in the sale of *equity securities* [italics in original; citations omitted]. And we have found markups in excess of 7% fraudulent in connection with such sales” (citing *Century Securities Company*, 43 SEC 371, 379 (1967))).

¹⁵ *Id.*

¹⁶ See *First Independence Group*, 37 F.3d at 31 (finding markups of 11.11% to 186.4% in 373 riskless principal transactions in thinly traded stocks excessive).

¹⁷ See, e.g., *Toney L. Reed*, 51 SEC 1009, 1012 (1994); *Great Lakes Equity Co.*, [1990-91 Decisions] Fed. Sec. L. Rep. (CCH) at 98,212; *Handley Inv. Co.*, 354 F.2d 64, 66th (10th Cir. 1965); and *Charles M. Weber*, 35 SEC 663 (1954).

¹⁸ *Jeffrey D. Field*, 51 SEC 1074, 1075 (1994).

¹⁹ *In the Matter of First Pittsburgh Securities Corporation*, Exchange Act Release No. 16897 (June 16, 1980).

given only prospectively, not retroactively, and the firm's request related to ongoing activity. As former SEC staffers, we find that result to be strange at best. If the firm's behavior was troublesome, then the SEC staff should have told that to the firm. On the other hand, if the firm's petition had some merit, then the staff should not have dismissed it on thin procedural grounds.

Although as a non-market maker the firm was not entitled to capture the inside spread, and it should have known that it could not base its markup off of the inside quotes rather than its contemporaneous cost, we surmise that its attempts to discern from the SEC if it could do so might have led the Commission to find that no fraud was involved. These facts might have led the SEC to rationalize that, while the principals involved should have known that their practices violated the NASD Mark-Up Policy, they did not intend to defraud their customers. Another possible explanation is that the SEC decided that, in the context of a contested proceeding, it only needed to uphold the absolutely clear violations of the NASD's Mark-Up Policy and the SEC's confirmation rule. Accordingly, it did not need to find a fraud charge, which might be more susceptible to

challenge if the decision were appealed. The paucity of a Commission explanation for not upholding the fraud charge tends to support this possible explanation.

Firms should not take the SEC's decision as a green light to charge markups greater than 10%. We believe that the SEC's decision was fact-specific and not of great precedential value. Moreover, the decision reinforces that high markups will still run afoul of the NASD Mark-Up Policy, even if not fraudulent. What the SEC decision does do, however, is provide some incentive for a party under investigation to consider whether to challenge a proposed fraud charge in a markup matter. This may particularly be the case where, as here, a defendant does not dominate or control the market for the stock or set the bid-ask quotes. Even if the SEC finds that a defendant did not calculate its markups properly in these circumstances, it may decline to uphold a fraud charge if contested. The lack of a clear explanation in the Gordon and Lee case as to why the SEC dismissed the fraud charge will keep defendants and regulators guessing about this in the future. ■