92-4131

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

F.B. HORNER & ASSOCIATES, INC., *et al.*,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Petition for Review of an Order of the
Securities and Exchange Commission

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, RESPONDENT

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

ERIC SUMMERGRAD
Principal Assistant General Counsel

SUSAN S. MCDONALD
Special Counsel

Securities and Exchange Commission
Washington, D.C. 20549

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BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, RESPONDENT

COUNTERSTATEMENT OF THE ISSUES PRESENTED

1. Whether the Securities and Exchange Commission properly found that petitioners, a securities firm and its president, charged excessive price mark-ups in two securities sales, in violation of the Rules of Fair Practice of the National Association of Securities Dealers, Inc. ("NASD").

2. Whether the Commission abused its discretion in affirming a fine imposed on petitioners by the NASD in an amount equal to the amount of their excessive mark-ups, plus $5,000 for each of the two violative trades, for a total of $99,201.20.

PRELIMINARY STATEMENT

The petitioners in this case are F.B. Horner & Associates, Inc. ("FBH"), a securities firm which was a member of the NASD, and its president, Fred B. Horner. In 1988 Horner arranged for one of FBH's largest customers, a savings bank, to buy two lots

of bonds. FBH effected the sales in two transactions in which it acted as a principal; that is, FBH acquired the bonds from another securities firm and then resold them to the bank. The Commission held that the petitioners charged excessive prices on the transactions, in violation of the NASD's Rules of Fair Practice.

When a securities firm engages in transactions with a customer as a principal, it makes a profit on the transaction by marking up the price of the security by some percentage over the prevailing inter-dealer price (i.e., the wholesale price at which dealers buy from market makers in the securities). The NASD rules prohibit its members from charging a mark-up in retail sales that is in excess of an amount reasonably related to the prevailing wholesale inter-dealer price.

In the circumstances here, where FBH was not a market maker maintaining a trading market in the security, the prevailing inter-dealer price is determined, absent countervailing evidence, by looking at the firm's contemporaneous cost in acquiring the security. The petitioners provided no countervailing evidence of trading in this security that would show that FBH's contemporaneous cost did not reflect the prevailing inter-dealer market, and the Commission properly relied on that cost as the measure of the wholesale price. Indeed, petitioners' principal argument is not that the prevailing wholesale price was different from FBH's cost, but that the Commission should have disregarded the wholesale price altogether and used the actual retail price

charged by FBH to the bank as the proper retail price, since that is what petitioners claim the customer believed the security was worth. This tautology, however, would render every retail price fair.

Applying the firm's contemporaneous cost, FBH charged their bank customer mark-ups of 8.09% on the first sale of bonds and 6.91% on the second sale, realizing a total dollar mark-up of over $270,000. This, the Commission held, was excessive, in violation of the NASD's rules. The Commission has long applied the NASD's policy that generally a mark-up of more than 5% in the sale of equity securities is excessive, and that the mark-up on debt securities, such as those sold here, generally is far lower than 5%.

The Commission did recognize that these are not *per se* limitations, and that certain circumstances can justify a higher than usual mark-up. Accordingly, it took into account the services that FBH had provided in restructuring this customer's portfolio, and the effort involved in finding appropriate bonds, and allowed the firm a 5% mark-up on these sales, a very generous mark-up for a debt security. It held, however, that the amounts over 5% were excessive.

Petitioners contend, however, that a variety of circumstances justified a mark-up of more than 5%. They note that FBH did not keep the entire mark-up, but shared 25% of it with another firm. But the other firm, Bear Stearns & Co., received that cut as compensation for taking care of clearing the

transaction and providing other important services. FBH could not pass along such costs of doing business by increasing its mark-up.

Petitioners also argue that these two transactions should not be viewed in isolation and that instead all of FBH's transactions with this customer should be averaged, and the average mark-up considered. But the NASD's rules require that each transaction be fair; the averaging rule petitioners propose would be unworkable, requiring an assessment of the circumstances of all transactions with the customer, and would make customer and regulatory monitoring of mark-ups very difficult. The NASD acted rationally in not electing that approach. Likewise, the amount of appropriate mark-up does not turn, as petitioners suggest, on whether the securities firm is overall profitable. The rules do recognize a dealer's right to a reasonable profit on each transaction, but FBH would have realized that here with a 5% mark-up.

Petitioners also urge that the appropriate mark-up is whatever a securities firm and a "sophisticated" customer agree to. The NASD, however, did not opt for this approach. The rules require that the mark-up be objectively justified in relation to the circumstances of the transaction. This may not be the rule petitioners believe is best, but it is a rational rule, is of longstanding application, and is what petitioners understood they were bound by. Their policy arguments belong in a different forum.

Finally, petitioners contest the amount of the fine imposed on them, and Horner objects because it was made joint and several on the firm and him. The fine was equal to the amount of excess profit on the transactions, plus $5,000 per transaction. This was a reasonable amount, and left the firm with a healthy profit on the transactions. Petitioners' argument that the fine should be based on the firm's modest net capital would allow firms to reap exorbitant illegal profits and still pay only a small fine. Joint and several liability was also appropriate, since Horner was directly responsible for the violations and since he owned 75% of the firm's stock and his wife owned the rest, and he thus benefitted from these violations. The Commission acted within its discretion in sustaining the fine.

COUNTERSTATEMENT OF THE CASE

A. The Order Under Review

On July 2, 1992, the Securities and Exchange Commission issued an opinion in which it reviewed *de novo* a disciplinary decision of the NASD, and held that FBH and Fred B. Horner, the president of FBH, had charged unfair price mark-ups to a customer in two sales of securities, in violation of the Rules of Fair Practice of the NASD, which implement Section 15A of the Securities Exchange Act, 15 U.S.C. 78o-3 (A. 463). 1/ Based on that opinion, the Commission issued an order affirming the

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1/ "A." refers to the joint appendix. "R." refers to the administrative record. "Br." refers to petitioners' brief.

sanctions imposed on FBH and Horner by the NASD -- a censure and a joint and several fine of $99,201.20 (A. 472).

B. The Statutory Scheme Involved

The NASD is a national securities association registered with the Commission under Section 15A of the Securities Exchange Act, 15 U.S.C. 78o-3, and has primary responsibility under the Act, subject to comprehensive oversight by the Commission, for regulation of those who sell securities in the over-the-counter market. The Act requires associations such as the NASD 2/ to adopt rules to regulate the conduct of their member brokerage firms and associated persons, 3/ and authorizes the NASD to enforce its rules through the imposition of disciplinary sanctions on its member firms and associated persons. 4/ Pursuant to the statute, the NASD has promulgated Rules of Fair Practice which require adherence to the federal securities laws and to specified standards of professional conduct.

In accordance with the statutory scheme, disciplinary action taken by the NASD is subject to review by the Commission on

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2/ The NASD is in fact the only national securities association registered under Section 15A.

3/ Section 15A(b)(6), 15 U.S.C. 78o-3(b)(6).

4/ Section 15A(b)(7) and (8), and 15A(h), 15 U.S.C. 78o-3(b)(7) and (8), and (h). The Securities Exchange Act specifies that the rules of a national securities association be designed, among other things, "to promote just and equitable principles of trade * * * and, in general, to protect investors and the public interest * * * ." Section 15A(b)(6), 15 U.S.C. 78o-3(b)(6).

application of the aggrieved party. 5/ In reviewing disciplinary action taken by the NASD, the Commission is required to conduct a de novo review of the record and make its own findings on whether the conduct in question violated the NASD rule charged. 6/ In addition, if the Commission finds that the sanctions imposed are "excessive or oppressive," the Commission may modify or cancel these sanctions. 7/ Under this statutory scheme, it is the Commission's order, not the order of the NASD, that is the subject of the review proceeding in this Court. 8/

C. Facts

FBH was a "$5,000 broker-dealer" 9/ and NASD member that specialized in government securities and other fixed income obligations (A. 191). As a $5,000 broker-dealer, FBH "introduce[ed] and forward[ed]" customer transactions to another broker-dealer that carried the customer accounts and executed the

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5/ Sections 19(d)(2) and (e)(1) of the Securities Exchange Act, 15 U.S.C. 78s(d)(2), (e)(1).

6/ See Nassau Securities Service v. SEC, 348 F.2d 133, 135 (2d Cir. 1965); Sorrell v. SEC, 679 F.2d 1323, 1326, n.2 (9th Cir. 1982).

7/ Section 19(e)(2) of the Securities Exchange Act, 15 U.S.C. 78s(e)(2).

8/ See Section 25(a) of the Securities Exchange Act, 15 U.S.C. 78y(a); Nassau Securities Service v. SEC, 348 F.2d 133, 135 (2d Cir. 1965); R.H. Johnson & Co. v. SEC, 198 F.2d 690, 694-95 (2d Cir.), cert. denied, 344 U.S. 855 (1952); Shultz v. SEC, 614 F.2d 561, 568 (7th Cir. 1980).

9/ A $5,000 broker-dealer is one whose minimum required net capital is $5,000, instead of the $25,000 required of securities firms in general.

transactions. See 17 C.F.R. 240.15c3-1(a)(2)(i), (vi). 10/ The firm was required to execute principal transactions -- those where it was buying for or selling from its own account -- on a riskless basis; that is, it could not execute a customer buy or sell order as a principal until it had effected a transaction to, respectively, acquire the security from another firm or dispose of it to another firm. See 17 C.F.R. 15c3-1(a)(2)(vi). 11/ For example, where as here FBH executed a customer buy order by selling securities to the customer as a principal, it first had to acquire the security from another firm. The firm also was required to clear its orders through another broker-dealer. Id.

Consistent with these restrictions, FBH cleared its transactions through Bear, Stearns & Co. (A. 309). It also had an arrangement with Bear Stearns, pursuant to which FBH was authorized to sell its customers any securities held by Bear Stearns in inventory, and FBH was connected to Bear Stearns' internal broadcast system which transmitted updated inventory information throughout the day (A. 304, 313). Bear Stearns was

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10/ In addition, a $5,000 broker-dealer could not hold or owe customer funds or securities. Id.

11/ Securities firms, in general, may effect securities transactions in two capacities. A firm may act as a "broker", where it is "engaged in the business of effecting transactions in securities for the account of others," 15 U.S.C. 78c(a)(4), that is, as an agent effecting transactions with a third party for a customer. Alternatively, it may act as a "dealer," where it "engage[s] in the business of buying and selling securities for [its] own account," id., 15 U.S.C. 78c(a)(5), that is, as a principal selling to or buying from a customer.

entitled to receive 25% of FBH's mark-ups on all bond transactions executed by Bear Stearns (A. 312- 14).

One of FBH's main customers was Cayuga Savings Bank, a small upstate New York community bank (A. 219). FBH believed that Cayuga's portfolio should be restructured to lower the bank's interest rate risk (A. 304). The bank accounted for 35% of FBH's business, and FBH did substantial work in restructuring its portfolio (R. 16). In connection with this work, the firm passed on to Cayuga routine information, such as a breakdown of Cayuga's portfolio and daily quotation rates on mortgage-backed securities which FBH needed in order to conduct its business (A. 221-25). An NASD witness testified that some of this information was "basic information * * * available to anyone * * * from any one of a number of vendors" (A. 225). Other materials prepared by FBH for Cayuga were, this witness testified, "standard items * * * available to any bank, any individual, [and] any brokerage firm at a fraction of the mark-up" charged by FBH here (A. 248).

Both of the transactions at issue in this case occurred within a period of about 45 minutes on September 9, 1988 (A. 332). That morning, Horner heard over the Bear Stearns inter-firm broadcast system that the firm had just purchased some principal only, collateralized mortgage obligation ("CMO") bonds of a type Horner had previously discussed with Cayuga and knew Cayuga was seeking to buy (A. 304-07, 319). These were PaineWebber CMO Trust Series L, Class L-1, zero coupon bonds

(A. 18, 195). 12/ This lot of bonds had a current face value of $4,753,800 (A. 80).

Upon hearing about the bonds, Horner immediately contacted a Bear Stearns' trader, who offered him the bonds at a price of $34 per bond, a total price of $1,616,292 (A. 109, 304-05). 13/ Based on FBH's expression of interest on behalf of Cayuga, the trader "circled" the bonds for FBH (A. 304). This meant that Bear Stearns would not sell the bonds to anyone else at the price the trader had quoted to FBH, but if someone else bid a higher price for them, Bear Stearns would sell to the higher bidder (A. 332-33). However, FBH was not obligated to purchase the bonds and so was not at risk of financial loss if Cayuga had declined to purchase the bonds (A. 404).

Horner decided to charge, and Cayuga agreed to pay, $36 3/4 per bond, 2 3/4 points above what FBH was paying for the bonds, for a total price of $1,747,022 (A. 109). The price FBH charged Cayuga represented an 8.09% mark-up over the price FBH had paid

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12/ "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. * * * [T]he discount from face value in effect represents the aggregate interest the holder receives if he holds the security to its stated term of maturity." Zero Coupon Securities, Sec. Exch. Act Rel. No. 24368 (Apr. 21, 1987). Horner also refers to these bonds in his brief as "Super PO's".

13/ Bear Stearns had purchased the bonds for $32 3/4 per bond from PaineWebber on the previous day, September 8. Thus, it sold them to FBH at 3.8% over its contemporaneous cost.

to Bear Stearns, or a total dollar mark-up of $130,729 (A. 109).

At the time it agreed to the purchase, Cayuga asked Horner to try to obtain more of the same bond (A. 338). Horner immediately contacted Bear Stearns, purchased the first lot of bonds, and ascertained that another lot of bonds, with a current face value of $5,986,484, could be purchased at $34 3/4, a total of $2,057,854 (A. 109). 14/ He called Cayuga back and offered the bonds at $36 3/4, the same price he had charged for the first lot of bonds and 2 points above what FBH was paying for the second lot (A. 339). Cayuga agreed to the transaction, which was for a total purchase price of $2,200,033 (A. 109). The percentage mark-up over FBH's purchase price was 6.91%, and the total dollar mark-up was $142,178 (id.). The total combined mark-up in dollars on the two trades was $272,908 (id.).

D. Proceedings Before the NASD

On August 23, 1989, the District Business Conduct Committee for District No. 12 of the NASD ("DBCC") commenced disciplinary proceedings against FBH and Horner by filing a complaint alleging violations of Article III, Sections 1 and 4 of the NASD's Rules

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14/ PaineWebber had purchased the bonds from one of its customers, also on September 9, 1988, for a price of $32 1/2. It sold the bonds to Bear Stearns at 33 1/4, which was 2.3% over its same-day cost. Bear Stearns then sold the bonds to FBH at 34 3/8, 3.4% over its same-day cost.

of Fair Practice 15/ (A. 9-11). The complaint alleged that the mark-ups on the two bond sales to Cayuga were "not fair, considering all relevant circumstances including, but not limited to, the type of security involved and the risk to [FBH and Horner]" (A.10).

On February 14, 1990, the DBCC held an evidentiary hearing on the complaint. In a decision dated March 28, 1990, the DBCC determined that the mark-ups were unfair in that they exceeded the maximum fair mark-up, which it determined was 5% for these transactions (A. 351-59). The DBCC ordered that Horner and the firm be censured, fined $30,000 and required to disgorge $89,201.20 -- the amount of their mark-ups above 5% (A. 359).

15/ Article III, Section 1 of the rules, NASD Rules of Fair Practice, Article III, Section 1, NASD Manual (CCH) ¶2151 at 2014, states:

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

Article III, Section 4, NASD Rules of Fair Practice, Article III, Section 4, NASD Manual (CCH) ¶2154 at 2054, states in relevant part:

> In "over-the-counter" transactions, whether in "listed" or "unlisted" securities, if a member * * * sells for his own account to his customer, he shall * * * sell at a price which is fair, taking into consideration 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 * * *.

Section 4 and related interpretations are appended to petitioners' brief.

FBH and Horner appealed the DBCC decision to the NASD Board of Governors. The Board conducted a hearing on August 8, 1990, at which FBH and Horner appeared with counsel. On November 28, 1990, the Board of Governors issued a decision affirming the findings of the DBCC (A. 453). However, the Board modified the sanctions imposed by the DBCC (A.462). It dismissed the order requiring disgorgement of the excessive mark-ups of $89,201.20 (id.). Instead it increased the fine from $30,000 to $99,201.20, an amount equalling the excessive mark-ups above 5%, plus $5,000 per transaction (id.). The net effect was to reduce FBH and Horner's total monetary sanction by $20,000. The Board also affirmed the censure imposed on FBH and Horner (id.).

E. The Commission Proceeding

FBH and Horner appealed the NASD's decision to the Commission (R. 35). On July 2, 1992, the Commission, upon an independent review of the record, issued an opinion and order affirming the NASD's disciplinary action (A. 463).

The Commission concluded that FBH and Horner charged Cayuga an excessive and unfair mark-up over the "prevailing market price" on the two bond sales (A. 469). It held that, under longstanding Commission and judicial precedent, the best evidence of the prevailing market price was the firm's contemporaneous cost in acquiring the security (A. 466), and found that FBH's mark-up over that price was 8.09% and 6.91%, respectively, on the two sales (A. 465). It rejected FBH and Horner's contentions that the true market price was higher, as represented by either

the price Cayuga agreed to pay FBH or, alternatively, a higher price Salomon Brothers allegedly bid just before FBH sold the bonds to Cayuga (A. 466, 467-68).

The Commission further held that a mark-up over 5% on these sales was excessive. It noted the NASD's longstanding policy that a mark-up of more than 5% on equity securities is excessive, and the NASD's and Commission's longstanding position that where (as here) debt securities are sold, a smaller mark-up usually will be charged (A. 465). The Commission rejected FBH and Horner's contention that the industry practice with respect to the securities sold here is to charge mark-ups over 5%. In so finding, it reviewed other transactions in the securities sold here, as well as the testimony of an expert witness presented by the NASD staff (A. 467) -- who testified that a dealer who engages in a riskless transaction in this type of bond would charge a mark-up of only 5/8 to 1 point, which would have produced mark-ups of only 1.8% to 2.9% here (A. 218).

The Commission also rejected FBH and Horner's contentions that the firm's mark-ups were appropriate compensation for various services provided to Cayuga. It noted that certain of these services, specifically the provision of computerized portfolio analyses, were routine services that other firms provided at a fraction of the mark-up here (A. 468). It recognized that FBH had devoted time and effort to restructuring Cayuga's portfolio, but that the NASD took the value of those services into account in allowing a "very generous" 5% mark-up, a

mark-up far above the usual for this type of security (id.). Likewise, the Commission rejected the contention that the high mark-up charged was justified by Bear Stearns' receipt of 25% of the mark-up, noting that a firm cannot pass along its costs in that fashion (A. 469).

The Commission also held that Cayuga's after-the-act ratification of the mark-ups did not demonstrate that they were reasonable when made (A. 468-69). And it rejected FBH and Horner's contentions that the mark-ups charged on these two transactions should not be considered separately, but as part of the overall pattern of mark-ups charged to Cayuga (A. 469). The Commission noted that the NASD rules require a fair mark-up on each transaction (id.).

Finally, the Commission rejected FBH and Horner's contention that, even if he had charged unfair mark-ups, the violations were merely "technical" and thus the fine assessed by the NASD was excessive and unreasonable, particularly in view of the fact that FBH was a $5,000 broker-dealer with net capital of only $150,000 as of November 30, 1989 (A. 470). The Commission noted that under its prior decisions the amount of a fine is not related to a firm's net capital and found that the fine here -- $5,000 per infraction, plus the portion of mark-up over the allowed 5% -- was "fully warranted in light of the serious misconduct we have found" (id.). 16/

16/ The Commission noted that the Board of Governors had reduced the sanctions ordered by the district committee, by (continued...)

FBH and Horner moved the Commission to stay its order pending this petition for review. On August 12, 1992, the Commission granted the stay (A. 473).

ARGUMENT

I. FBH AND ITS PRESIDENT CHARGED EXCESSIVE MARK-UPS IN THE SALE OF DEBT SECURITIES, IN VIOLATION OF THE RULES OF FAIR PRACTICE OF THE NATIONAL ASSOCIATION OF SECURITIES DEALERS.

The Commission properly found that the FBH firm and its president charged mark-ups of 8.09% and 6.91% when it twice sold debt securities to Cayuga. 17/ It correctly concluded that these mark-ups were excessive, in violation of the NASD's Rules of Fair Practice, in that an appropriate mark-up, taking into account all the circumstances, including the nature of the security, the risk borne by FBH, and the services provided by FBH to Cayuga, was at most no more than 5%.

Securities firms that sell securities to retail customers generally earn money on the transaction in one of two ways. If the firm engages in the sale as a broker, that is as an agent that arranges a sale from a third party to the customer, the firm charges a commission. If the firm acts as a dealer, as was the

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16/(...continued)
eliminating the disgorgement requirement and increasing the fine (A. 470 n.19). The Commission did observe that normally disgorgement of wrongly obtained profits, and restitution of those amounts to the customer, should be ordered in NASD proceedings.

17/ The Commission's findings of fact are conclusive and must be accepted by the Court if they are supported by substantial evidence. Section 25(a) of the Securities Exchange Act, 15 U.S.C. 78y(a)(4); Higgins v. SEC, 866 F.2d 47, 49 (2d Cir. 1989).

case here, and sells the security to the customer for its own account, it charges a mark-up on the sale.

The NASD's Rules of Fair Practice have long required members to charge fair prices in transactions with their retail customers. Article III, Section 4 of the Rules states that in selling securities in the over-the-counter market, "if a member * * * sells for his own account to his customer, he shall * * * sell at a price which is fair, taking into account all relevant circumstances * * *." NASD Rules of Fair Practice, Article III, Section 4, NASD Manual (CCH) ¶2154 at 2054. 18/ Interpreting this section, as well as Section 1 -- which requires adherence to just and equitable principles of trade -- the NASD has stated:

> It shall be deemed conduct inconsistent with just and equitable principles of trade 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 for the security * * *.

Id., Interpretation of the Board of Governors, NASD Manual (CCH) ¶2154 at 2056. 19/

18/ Other portions of the rule require the setting of fair commissions or service charges when acting as an agent.

19/ The rule is not an antifraud provision, and thus is distinct from the well recognized doctrine under antifraud provisions of the securities laws that a securities dealer impliedly represents that its prices are reasonably related to the prevailing market price of the security, and that failure to disclose excessive prices can constitute fraud. Charles Hughes & Co. v. SEC, 139 F.2d 434, 436-37 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944). The NASD's rules flatly prohibit excessive markups regardless of whether disclosure is made. See In re Amsbray, Allen & Morton, Inc., 42 S.E.C. 919, 922 (1966); In re Thill Securities Corporation, 42 S.E.C. 89, 95 (1964); Rules of Fair Practice, Article III, (continued...)

The fairness of prices charged by dealers to their retail customers is measured by determining the appropriate mark-up a dealer may charge over the prevailing inter-dealer, or wholesale price. This requires two steps. First, the prevailing inter-dealer market price for the security must be determined. Second, it must be determined whether the mark-up over that price charged to the retail customer was, under the circumstances, excessive.

Determining the prevailing market price in this case is simple. As a general rule, the best evidence of the prevailing inter-dealer market price for a security, absent countervailing evidence, is a dealer's contemporaneous cost in acquiring the security, unless the firm is acting as a market maker in the security (and there is no dispute that FBH was not) 20/. See

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19/(...continued)
Section 4, Interpretation of the Board of Governors, NASD Manual (CCH) ¶2154 at 2057 ("Disclosure * * * does not justify a commission or mark-up which is unfair or excessive in the light of all other relevant circumstances.").

20/ A market maker, in general, maintains a wholesale market in a security by buying from and selling to other dealers. For a discussion of when a broker-dealer is a market maker in this context, see generally In re Adams Securities, Inc., Securities Exchange Act Release No. 34-31971 (March 9, 1993). Although petitioners concede that FBH was not a market maker, they argue (Br. 19-21) that because of FBH's arrangement with Bear Stearns -- which they term a joint venture -- FBH "should have been entitled to set mark-ups as if [it] were a market maker" (Br. 19). That argument was not raised before the Commission, and thus may not be raised in this Court. See Section 25(c)(1) of the Securities Exchange Act, 15 U.S.C. 78y(c)(1). Nassau Securities Service v. SEC, 348 F.2d 133, 135 (2d Cir. 1965); Lowell H. Listrom & Co. v. SEC, 803 F.2d 938 (8th Cir. 1986).

It is, in any event, incorrect. Bear Stearns was a market maker in this security, but FBH's arrangement had nothing to
(continued...)

Barnett v. United States, 319 F.2d 340, 344 (8th Cir. 1963); In re Alstead, Dempsey & Co., 47 S.E.C. 1035 (1984); In re First Pittsburgh Securities Corp., 47 S.E.C. 299, 306 (1980); In re West, 47 S.E.C. 39, 41-42 (1979). Cf. Report to Accompany the Penny Stock Reform Act of 1990, 101st Cong., 2d Sess., H.R. Rep. No. 101-617 30 (1990) (noting "the well-developed body of law on how to calculate excessive markups").

FBH's acquisition of these securities was plainly contemporaneous with the sales to Cayuga; it was virtually simultaneous. See In re LSCO Securities, Inc., 48 SEC Dkt. 759, 761 (March 21, 1991) (absent showing of change in the market, dealer cost can be used for up to five business days); In re Nicholas A. Codispoti, 48 S.E.C. 842, 843 (1987) (same). The Commission properly relied on FBH's acquisition cost as the measure of prevailing market price.

20/(...continued)
do with that wholesale function. FBH's role was limited to directing retail customers to Bear Stearns and, in exchange for services provided, giving Bear Stearns a portion of its profits. Nor was FBH standing in Bear Stearns' market maker shoes by acquiring these bonds. Bear Stearns bought these bonds from one dealer (PaineWebber) and sold them at a higher price to FBH, realizing a profit on the spread between the purchase and sale prices. FBH acquired these securities from Bear Stearns on the same basis as any wholly unrelated dealer would have, and its cost provides the proper basis for calculating its mark-up. Finally, even if FBH were treated as standing in Bear Stearns' shoes as a market maker, the result would be the same. Bear Stearns would have been entitled to sell this security at retail at a mark-up over the price at which it sold at wholesale (i.e., to other dealers). But the price at which Bear Stearns sold to other dealers is identical to the price at which FBH bought, the price on which FBH's mark-up is based.

FBH and Horner offered no evidence that would support any other measure of the prevailing inter-dealer price. 21/ They argue (Br. 22-23), rather, that the true measure of the market price was the retail price Cayuga agreed to pay; that price, they claim, represents what the bonds were "worth" (Br. 22). This novel contention is without merit. To use the retail price actually paid as the measure of the proper retail price would be a tautology. Under that principle, Horner could have charged whatever price Cayuga would agree to, and would be deemed to have charged a fair mark-up, no matter how large. There is no authority for such an absurd result.

Using FBH's contemporaneous cost as the prevailing market price, its mark-up was, on the two trades, 8.09% and 6.91%. The next question is whether this was excessive.

The NASD has long adhered to what is known as the "5% policy." Under that policy, a mark-up of more than 5% is

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21/ Petitioners did argue below that the current market price at the time of the transactions was actually $37 1/4, a price based on a bid Horner testified he received from Salomon Brothers just before he set the price FBH would charge Cayuga. The Commission did not credit this testimony, which was inconsistent with other evidence in the record, and petitioners no longer press this argument on appeal. In any event, the asserted bid would not constitute evidence of market price here. Quotations merely propose a transaction and do not reflect the actual result of a sale. For this reason quotations for obscure securities such as those at issue here, with little inter-dealer trading activity, have little value as evidence of the current market, especially in the face of evidence of lower prices in actual transactions. In re LSCO Securities, Inc., 48 SEC Dkt. 759, 761 (March 21, 1991).

generally considered excessive. See Rules of Fair Practice, Article III, Section 4, Interpretation of the Board of Governors, NASD Manual (CCH) ¶ 2154 at 2056. 22/ The 5% policy, however, is not a per se rule, and the appropriate mark-up must be judged by the circumstances in each case. The circumstances may indicate that a higher or lower mark-up is proper. See In re Staten Securities Corp., 47 S.E.C. 766, 767 (1982); In re J.S. Winston & Co., 42 S.E.C. 62, 69-70.

One factor that the NASD and the Commission have stressed is that the fair mark-up with respect to debt securities generally is considerably lower than for equity securities, and generally is well below 5%. In re Staten Securities Corp., supra; In re DMR Securities Inc., 47 S.E.C. 350, 353 (1980); In re Edward J. Blumenfeld, 47 S.E.C. 189, 192 (1979). As the Commission has stated, "percentage mark-ups on zero-coupon securities, as with other debt securities, usually will be smaller than those on equity securities." Zero-Coupon Securities, Sec. Exch. Act Rel. No. 24368, 38 SEC Dkt. 234, 236 (April 21, 1987).

The evidence in this case showed that the industry practice with respect to zero-coupon bonds of this type -- collateralized mortgage obligations -- was to charge mark-ups substantially lower than the NASD 5% guideline for equity securities. The Commission credited the testimony of an NASD expert witness, with

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22/ See also In re Meyer Blinder, 52 SEC Dkt. 1436 n.11 (Aug. 26, 1992), appeal docketed sub nom. Gorden v. SEC, No. 92-1554 (D.C. Cir.); In re Thill Securities Corp., 42 S.E.C. 89, 92 n.4; In re National Association of Securities Dealers, Inc., 17 S.E.C. 459 (1944).

considerable experience in the trading and mark-up of CMO's, who reviewed transactions in this security (see nn. 13, 14) and testified that an appropriate mark-up for a dealer such as FBH, which was not at risk in the transactions, 23/ would be 5/8 to 1 point, which applied to these trades, would result in mark-ups of only 1.8% to 2.9%. 24/ The sole countervailing evidence proffered by petitioners (Br. 21) was evidence that Bear Stearns had charged a 7% mark-up 25/ on a transaction that occurred the same day as those at issue here, in which it sold PaineWebber CMO Series M bonds. However, as the Commission noted (A. 468 n.12), the series M bonds were not the same security as the series L

23/ Petitioners do claim in passing (Br. 24) that FBH was at risk because Cayuga had 30 days to settle the trade, and had it reneged FBH would have been left holding the bonds. Transactions in these types of bonds generally settle once a month, and there could have been a lag of up to thirty days prior to settlement. But the risk of non-settlement is a risk present in every retail transaction, and does not justify an unusually high mark-up.

24/ Petitioners attack the Commission's reliance on this witness's testimony (Br. 22), contending generally that he was "clearly lacking in expertise." But they offer no specific basis for disputing the Commission's finding that the witness had considerable relevant expertise. As the Commission noted (A. 467 n.10), "[t]he witness was executive vice president of a brokerage firm that dealt primarily in fixed income securities. He was also principal financial officer of that firm's subsidiary which issued and structured CMO's, and supervised the firm's fixed income trading desk, reviewing markups on all CMO transactions."

25/ Petitioners erroneously state (Br. 21) that Bear Stearns charged an 8% mark-up on this trade. The evidence was that the mark-up was only 6.67% (A. 109). The Commission decision referred to it as a 7% mark-up (A. 468 n.12).

bonds involved here, and the record contained no evidence as to the circumstances of that trade. 26/

As justification for the mark-ups, petitioners point to the various services FBH provided to Cayuga (Br. 13-14, 16-18), including market and portfolio analyses, and the time assertedly spent in finding suitable securities for Cayuga, such as those here. It is appropriate to consider a firm's services in determining a fair mark-up, and both the NASD and the Commission gave considerable weight to the time and effort Horner spent in restructuring Cayuga's portfolio and in locating and acquiring the securities involved here for Cayuga (A. 468). For this reason, the Commission allowed FBH a 5% mark-up on each of the transactions, significantly above the customary industry practice. However, the Commission concluded, based on the testimony of the NASD's expert witness (see A. 221-25, 248), that certain other of the services petitioners cite, specifically market and portfolio analyses FBH provided to Cayuga (R. 22a), were routine services that could not justify even higher mark-ups.

Petitioners further contend (Br. 19) that the Commission erred in refusing "to consider the obviously unusual profit-

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26/ Petitioners contend (Br. 21) that the burden was on the NASD, and not on them, to adduce evidence of the circumstances of this transaction. This transaction was, however, one which petitioners raised and one whose relevance to these transactions it was their burden to show. But even if the circumstances were identical to those here, it would not outweigh the extensive evidence showing that the usual mark-up was far less than 5%.

sharing relationship between [FBH] and Bear Stearns in determining the fairness of the mark-up involved here." However, the Commission did consider the FBH/Bear Stearns relationship, but found that FBH was not "entitled to pass along to Cayuga the costs of [the] arrangement with Bear Stearns by charging Cayuga prices that included an excessive mark-up" (A. 469). The Commission relied on its prior decision in In re DMR Securities, Inc., 47 S.E.C. 180, 182 (1979), in which the Commission rejected essentially the same argument, explaining that:

> Applicants' argument betrays a basic misunderstanding of the nature of mark-ups. A mark-up is not the equivalent of net profit. Rather, it is the spread between the current inter-dealer market price and the price charged the customer. Applicants' formulation would allow a dealer to pass along all his expenses to the customer, no matter how excessive, and to obtain in addition a guaranteed 5% net profit, whether or not the price charged was reasonably related to current market price. Such a result would clearly contravene the NASD's mark-up policy and the Board of Governors interpretation of that policy. [footnote omitted].

The fee FBH paid to Bear Stearns was for services it received in return, including clearance of trades and providing access to Bear Stearns' internal broadcast system. FBH could not pass on these general costs of doing business by increasing its mark-ups to customers. 27/ The contention (Br. 20) that FBH was thereby

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27/ Petitioners are closer to the mark when they argue (Br. 20) that FBH was the functional equivalent of an employee of Bear Stearns who is paid a commission at the rate of 75% of the mark-up charged to his customers. What they fail to appreciate is that in such circumstances the fairness of the (continued...)

"prohibited from earning a profit" is baseless. With a 5% mark-up, petitioners realized a return of over $100,000 on these two trades.

Petitioners' other contentions are equally without merit. The Commission properly rejected petitioner's claim that the mark-ups on these two transactions should be averaged with all the other trades FBH had effected for Cayuga. There was no agreement that mark-ups would be averaged, 28/ but even if there had been, the NASD rules do not permit it. Consistent with the fact that the proper measure of mark-ups requires an assessment of the circumstances surrounding the transaction, the NASD rules require that the mark-up on each transaction be fair. See In re W.N. Whelen & Co., Inc., 46 SEC Dkt. 1889, 1893 (August 28, 1990); In re Hamilton Bohner, Inc., 44 SEC Dkt. 1297, 1300-01

27/(...continued)
mark-up would still be based on the total mark-up charged to the customer, not just that portion that went to the salesman. Here, too, the mark-up is not based on that amount left after FBH's "functional employer" takes its share.

28/ The only evidence regarding averaging which is cited by petitioners (Br. 8) is an affidavit, submitted by Cayuga's president late in these proceedings (A. 363), after the DBCC decision, in which the president expressed his after the fact view that the bank was only concerned with "the overall average rate of commissions charged by Mr. Horner" (A. 363). The petitioners also claim (Br. 8) that FBH and Cayuga had an agreement to "charge for services on a 'bundled' commission basis." But this does not imply averaging of commissions or mark-ups. It only means that no separate fee for services is billed, but rather the fee "is bundled into the commissions which [FBH] earns from trades" (A. 144).

(September 8, 1989); <u>In re Staten Securities Corporation</u>, 47 S.E.C. 766, 768-769 (1982). The contrary rule argued for by petitioners would require inquiry into the circumstances of all transactions with a customer in order to determine if the dealer has engaged at any time in unfair practices. The NASD's rule, which requires an assessment of mark-ups at the time they are made, and in each transaction viewed separately, makes it a workable matter for customers and regulators to assess the dealer's pricing practices.

Petitioners also claim that under the NASD rules the firm was entitled to earn a profit and that since it earned only a small profit for the fiscal year in which these trades occurred -- and that only because Horner himself took no salary -- "[o]bviously, the mark-ups being charged by [FBH] were not unreasonably high" (Br. 15). Petitioners erroneously rely, in making this argument, on the portion of the rules which states that one factor to be considered in deciding whether a mark-up is fair is the fact that the dealer is "entitled to a profit." That provision only refers to the dealer's right to make a profit on a particular trade, and does not, as petitioners contend, guarantee dealers an over-all profit on their businesses. If it did, it would justify firms that are in overall financial trouble charging enormous mark-ups to compensate.

Nor does the fact that Cayuga was satisfied with Horner's services justify the mark-ups. As the Commission observed (A. 468), Cayuga's after-the-fact satisfaction with the mark-ups was

clearly influenced by the fact that it had been able to sell the bonds at a profit about nine months after purchase. But even if Cayuga was satisfied with the amount of the mark-ups, that would not justify them. The rules do not provide that a member may charge whatever mark-up in which a customer concurs.

Petitioners argue (Br. 18-19, 24-25) that the rules should be otherwise, that the proper amount of mark-up should be determined by whatever a "sophisticated" customer agrees to. 29/ But that is a policy argument which belongs in a different forum. The method of assessing mark-ups which petitioners argue for is not the method of regulation which the NASD adopted, which the Commission approved pursuant to its Congressional mandate, which

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29/ Horner's reliance in this regard on the Commission's decision in In re Wheeler Municipals Corporation, 47 SEC Dkt. 716 (October 3, 1990), is misplaced. In that case, a customer who was the beneficiary of an estate suggested that the dealer take a higher than usual mark-down (the equivalent of a mark-up in a sale by a customer) as a way of compensating the dealer for years of past service to the decedent and for assistance he had provided to the beneficiary regarding the estate. The Commission set aside the NASD's finding that the mark-downs were excessive. It noted that the NASD's policy allows services to be considered in setting markups and markdowns and that the NASD had refused to take into account the value of the services in determining if the mark-downs were excessive for the services provided. The Commission found that the mark-downs (between 5% and 5.8%) were appropriate for the services rendered, noting that the mark-downs had been suggested prior to the transactions by a sophisticated customer who believed they would be proper payment for the service provided. Here, in contrast, there is no evidence that Cayuga suggested these mark-ups as compensation for services rendered. And here the NASD and the Commission did take into account the value of FBH's services in allowing a 5%, but not higher, mark-up.

a long line of cases has applied, and to which the petitioners knew they were subject.

II. THE COMMISSION DID NOT ABUSE ITS DISCRETION IN SUSTAINING THE SANCTIONS IMPOSED BY THE NASD.

Petitioners contend that the fine affirmed by the Commission was excessive. In fact the fine -- which was based on the amount of improper profits realized by the petitioners on the transactions, plus an additional $5000 per transaction -- was appropriate, and the Commission acted within its discretion in affirming it.

The determination of what sanctions are appropriate "'is peculiarly a matter [within the Commission's] competence,'" since Congress has entrusted the Commission with the task of protecting the investing public. American Power & Light Co. v. SEC, 329 U.S. 90, 112 (1946), quoting Phelps Dodge Corp. v. NLRB, 313 U.S. 177, 194 (1941). When the Commission reviews sanctions imposed by the NASD, rather than ordering its own sanctions as it does in disciplinary proceedings that the Commission itself institutes, its role is limited to determining whether the NASD sanctions are "excessive or oppressive." 30/ Recognizing that the Commission

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30/ Section 19(e)(2) of the Securities Exchange Act, 15 U.S.C. 78s(e)(2), provides that in reviewing disciplinary action of a self-regulatory organization such as the NASD, if the Commission,

> having due regard for the public interest and protection of investors, finds * * * that a sanction imposed by a self-regulatory organization * * * is excessive or oppressive, [the Commission] may cancel, reduce, or require the remission of such sanction.

possesses broad discretion with respect to sanctions, this Court has refused to overturn the Commission's decision to affirm NASD sanctions absent a clear abuse of that discretion. Merritt, Vickers, Inc. v. SEC, 353 F.2d 293, 298 (2d Cir. 1965). Accord Seaton v. SEC, 670 F.2d 309 (D.C. Cir. 1982). Accordingly, this Court may not overturn the Commission's order as to sanctions in this case unless it finds that the sanctions imposed are "'unwarranted in law or * * * without justification in fact * * * .'" Butz v. Glover Livestock Commission Co., 411 U.S. 182, 185-86 (1973), quoting American Power & Light Co. v. SEC, supra, 329 U.S. at 112-13.

Petitioners have failed to satisfy the "formidable" burden (Nees v. SEC, 414 F.2d 211, 217 (9th Cir. 1969)) of demonstrating that the Commission abused its discretion in this case. Consistent with its role in reviewing NASD sanctions, the Commission determined that, in light of the excessive mark-ups charged in two transactions, and the serious nature of these infractions, the sanctions imposed by the NASD were not excessive or oppressive.

The fine imposed was only $10,000 above the excess (over 5%) profit petitioners reaped from the sales -- a total fine of $99,201.20 -- leaving petitioners with a net profit of about $106,000 on these two sales after deducting Bear Stearns' $68,000 share of the mark-ups. Petitioners nonetheless make two arguments in support of their contention that the fine was excessive. First, they contend (Br. 25-26) that Horner did not

know that he was violating the NASD guidelines and thought that the mark-ups were permissible because Bear Stearns personnel allegedly gave their approval of the mark-ups. Petitioners did not raise this matter before the Commission, and accordingly may not do so in this Court. See n.20, supra. 31/ Moreover, the contention is without merit, since Horner admitted in his testimony below that he was aware of the NASD's 5% mark-up guideline (A. 381) and that Bear Stearns did not exercise supervisory control over his business (A. 340-41).

Second, petitioners contend (Br. 26) that the fine is unfair because it represents a large percentage of the firm's net capital, and a multiple of the firm's minimum required net capital. This contention is without merit. The amount of a fine is not related to a firm's net capital. In re Matanky Securities Corp., 50 SEC Dkt. 837, 840 (December 18, 1991). Under petitioners' theory, they could have charged the most exorbitant mark-ups, and reaped extraordinary profits, and still be liable for only a small fine. The NASD appropriately keyed the amount of the fine to the amount of excessive profit realized on the two transactions. The Commission properly concluded that this

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31/ Although Horner did testify generally before the NASD DBCC that he believed Bear Stearns had approved the markups (A. 308-09), a contention undercut by later testimony he gave (see A. 340-41), the DBCC decision (A. 351-59) does not discuss the issue and petitioners did not raise it before the Commission. See Record Items 41, 45 (Petitioners' memoranda of law in support of their appeal to the Commission).

measure of penalty for such "serious misconduct" was neither excessive nor oppressive.

Finally, Horner contends, for the first time in this matter, that the NASD improperly imposed joint and several liability for these fines on him and his firm. This is another issue never raised before the Commission and thus, as noted, is not properly raised before this Court. In any event, Horner admitted that he personally transacted the trades at issue here and that he personally set the price he charged Cayuga for the bonds. Moreover, he benefited from the transactions since he owned 75% of the stock in FBH, while his wife owned the other 25% (R. 6 at 279, 41 at 8). Joint and several liability was appropriate under these circumstances, and it was not an abuse of discretion for the Commission to affirm the fine on that basis. 32/

32/ The NASD has often imposed joint and several liability on firms and officers of the firms and the Commission has affirmed those sanctions. See, e.g., In re J.V. Ace & Company, Inc., 47 SEC Docket 1874 (December 21, 1990); In re First Philadelphia Corporation, 47 SEC Docket 560 (September 25, 1990); In re W.N. Whelen & Co., Inc., 46 SEC Docket 1889 (August 28, 1990); In re LSCO Securities, Inc., 43 SEC Docket 1354 (May 3, 1989).

CONCLUSION

For the foregoing reasons, the order of the Commission should be affirmed.

Respectfully submitted,

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

ERIC SUMMERGRAD
Principal Assistant General Counsel

SUSAN S. MCDONALD
Special Counsel

Securities and Exchange Commission
Washington, D.C. 20549

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