BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of District Business Conduct Committee For District No. 7 Complainant, vs. Respondent Firm 1 and Respondent 2 Respondents.	DECISION Complaint No. C07950058 District No. 7 Dated: July 2, 1998

Respondent Firm 1 and Respondent 2 appealed, pursuant to NASD Procedural Rule 9310, an October 23, 1996 decision of the District Business Conduct Committee for District No. 7 ("DBCC"). This matter also was called for review pursuant to NASD Procedural Rule 9310.[1] For the reasons discussed below, we dismiss the allegations.

Background

Respondent 2 first entered the securities industry in January 1982. Respondent 2 holds registrations as a general securities representative, general securities principal, municipal securities representative, and municipal securities principal. Respondent 2 is the owner of Respondent Firm 1, which has been a member firm since May 1991.

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[1] The National Business Conduct Committee ("NBCC") of NASD Regulation, Inc. called this case for review after considering respondents' requests for remand and confidentiality of decision pending appeal. The National Adjudicatory Council ("NAC"), which, as approved by the Securities and Exchange Commission ("SEC" or "Commission"), became the successor to the NBCC on January 16, 1998.

Facts

The complaint, which was issued on September 25, 1995, consisted of a single cause alleging a violation of MSRB Rule G-30. The complaint alleged that Respondent Firm 1, acting through Respondent 2: effected 18 principal retail sales in municipal securities at prices that were above the prevailing market price; and effected four principal retail purchases in municipal securities at prices that were below the prevailing market price. The complaint alleged that the prices Respondent Firm 1 charged to its customers on the 18 retail sales[2] ranged from 4.1% to 48.5% above the prevailing market price. The complaint further alleged that the prices Respondent Firm 1 paid to its customers on the four principal retail purchases ranged from 5.0% to 11.1% below the prevailing market price. In support of these allegations, staff presented both documentary and testimonial evidence showing the methodology it used to compute the mark-ups and mark-downs.[3]

Respondent 2 testified that he specializes in distressed municipal bonds and that he primarily deals with institutional, not retail, customers. Respondent 2 asserted in his answer to the complaint that he had not solicited a new retail account in years and that the few retail customers he still serviced were either family accounts or old friends whose accounts he traded as a favor to those individuals. Respondent 2 testified that he had "pretty much completely phased out of the retail side and strictly trade[d] for [his] own account." We will analyze the mark-ups and mark-downs in turn.

Discussion -- Mark-Up Analytical Framework

MSRB Rule G-30(a) requires that a broker or dealer or municipal bond dealer purchase municipal securities for its own account from a customer or sell municipal securities for its own account to a customer at prices that are "fair and reasonable, taking into consideration all relevant factors." Under traditional mark-up analysis involving equity securities, there are two critical questions: (1) what was the prevailing inter-dealer market price upon which mark-ups and mark-downs may be based; and (2) what is the appropriate percentage that the price may be marked up or marked down?

In answering the first question -- what was the prevailing market price -- we must start by

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[2] These trades were divided into two separate groups by the NASD staff for District No. 7 ("District Staff") for purposes of analysis: trades 1 through 3 ("Trades 1 through 3") and trades 4 through 18 ("Trades 4 through 18").

[3] The documentary evidence was comprised of: Schedules A and B; order tickets and customer confirmations for the transactions effected by the Firm in the municipal bonds at issue; "blue sheet" information gathered by District Staff from other member firms showing the inter-dealer trading activity in the municipal bonds at issue and an analysis of this information prepared by District Staff; and Respondent Firm 1's daily trade register.

examining whether the broker was acting as a dealer or a market maker[4] in the security. See In re Alstead, Dempsey & Co., Inc., 47 S.E.C. 1034 (1984). Special consequences follow a determination that a firm is a market maker for purposes of a mark-up or mark-down analysis. If a firm is a market maker in an active and competitive market, the prevailing market price is generally the current inter-dealer price -- the price the firm or other market makers charge in actual sales to other dealers. In re Richard R. Perkins, 51 S.E.C. 380, 381 (1993); Alstead, supra. In addition, if a firm is a market maker, we can also look to validated quotations to determine prevailing market price. See In re LSCO Securities, Inc., 50 S.E.C. 518, 522 (1991); Alstead, supra.

If the dealer is not a market maker, the best evidence of the prevailing market price ordinarily is the dealer's contemporaneous cost. Alstead, supra. Contemporaneous cost means the price that the dealer paid to acquire the security in an actual transaction closely related in time to the sale to its customer. In re Sacks Investment Co., 51 S.E.C. 492, 495 (1993). That standard, according to well-established Commission precedent, recognizes that the prices paid for a security by a dealer in actual transactions closely related in time to its sales are normally a highly reliable indication of the prevailing market.[5] The Commission also has consulted inter-dealer trading away from a firm to determine the prevailing market price on the basis that these transactions represent "countervailing evidence" of prevailing market price. Sacks, supra at 496; In re Bison Securities, Inc. 51 S.E.C. 327, 330-31

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[4] Section 3(a)38 of the Securities and Exchange Act of 1934 ("Exchange Act Sec. 3(a)(38)") defines a market maker as a dealer that holds itself out, by entering quotations in an inter-dealer communications system or otherwise, as being willing to buy and sell securities for the dealer's own account on a regular or continuous basis. The Commission has consistently stated that a dealer is a market maker if it: enters bid and offer quotations in a published medium, communicates quotations to other dealers, and purchases stock from other dealers at or around the bid and sells to other dealers at or around the ask/offer price. In re Century Capital Corp. Of South Carolina, 50 S.E.C. 1280 (1992), aff'd, 22 F.3d 1184 (D.C. Cir. 1994); See also In re Sherman Fitzpatrick & Co., 51 S.E.C. 1048 (1944) (firm was not a market maker when it only effected one inter-dealer trade and did not otherwise hold itself out as being willing to buy and sell securities from other dealers); In re Century Capital Corp. Of South Carolina, 51 S.E.C. 486, 488 n.9 (1993), aff'd, 22 F.3d 1184 (D.C. Cir. 1994) (sporadic inter-dealer trading does not constitute market making activity). The Commission has also repeatedly stated that merely purchasing blocks of stock in the wholesale or retail markets for resale to retail customers does not constitute market making activity. In re LSCO Securities, Inc., 49 S.E.C. 1126, 1128 n.8 (1989); In re Adams Securities, Inc., 51 S.E.C. 311, 314 (1993).

[5] In equity cases, the Commission routinely looks to a dealer's purchases occurring within five business days either before or after the retail transaction at issue to determine contemporaneous cost. LSCO, 50 S.E.C. at 520; In re Nicholas A. Codispotti, 48 S.E.C. 842, 843 (1987). In a case involving municipal bonds, the Commission looked beyond the standard five-day window of review and used the firm's "most contemporaneous" purchase price to determine prevailing price. In re First Honolulu Securities, Inc., 51 S.E.C. 695, 699 (1993).

(1993); Century, 51 S.E.C. at 487 n.6.[6]

With respect to the second primary analytical question -- the appropriate percentage mark-up -- we rely on the factors that have been cited by the Commission in its Elysian Brief [7] and its cases and interpretive releases, by the NASD in its mark-up guidelines, and by the NBCC in its MMAR decision to determine the reasonableness of the mark-ups at issue.[8] These factors consist of the following: (1) industry experience (the Commission has noted that this is of particular importance in cases involving new products and has recommended consideration of maturity, order size, and availability); (2) market activity (the Commission has noted that an inactive market requires greater sales efforts and may justify a higher mark-up); (3) the amount of money involved and the size of the transaction (the Commission has noted that transactions involving large amounts of money should carry lower mark-ups); and (4) the nature of the firm's business (the Commission has stated that, in determining mark-ups, a firm may consider services provided to its customers beyond services that typical broker/dealer generally provides, such as research, financial planning and counseling).

In view of these general factors, we considered the following specific factors in determining the reasonableness of the mark-ups on the bonds at issue: that they traded more like equities; the nature of the trading market including, price, volatility, and the importance of issuer credit on price; the fact that Respondent Firm 1 was a firm that specialized in trading distressed municipal bonds; and, that a relatively illiquid market, such as the one at issue in this matter, often involves greater sales efforts that may justify a higher mark-up. Based on our discussion below, we do not reach a conclusion about the appropriate percentage mark-ups applicable to the mark-ups at issue or other distressed bonds generally.

The following analysis is limited to this particular matter and should not be viewed as instructive as to permissible mark-ups and mark-downs in other cases. This is because the mark-up and mark-down trades at issue involve a particular segment of the municipal bond market -- defaulted and distressed municipal bonds that were traded by only a small number of dealers. The record shows that,

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[6] In addition, in equity cases the Commission has looked at periods longer than five days before and after the retail trade to determine prevailing market price in cases in which there is little inter-dealer trading away from the firm in a security. See Bison, supra at 330; In re Orion Securities, Exchange Act Rel. No. 35001 (Nov. 23, 1994).

[7] See the Commission's amicus curiae brief filed December 1989 in the Elysian Federal Savings Bank v. First Interregional Equity, No. 88-3528, D.N.J. case.

[8] See MMAR Group, Inc. (NBCC, October 22, 1996); In the Matter of Lehman Brothers, Inc., Exchange Act Rel. No. 37673 (September 12, 1996); IM-2440 (interpretation of NASD's mark-up policy).

unlike conventional municipal bonds, these bonds were extremely illiquid[9] and did not trade against interest rates.

Discussion -- Mark-Ups

The trades at issue with respect to the alleged mark-ups involved Company 1 Bonds, which were distressed municipal bonds. The blue-sheet information that District Staff included in the record showed that only a handful of dealers were relatively active in this market.

The history of Company 1 Bonds is described in In re Donald Sheldon, 51 S.E.C. 59 (1992), and Class Plaintiffs v. City of Seattle, 955 F.2d 1268 (9th Cir.), cert. denied, 506 U.S. 953 (1992). In the early 1970s, Company 1 began construction on several nuclear power plants. To pay for that construction, Company 1 issued bonds, including Company 1 Bonds, totaling over $2 billion, which were issued to pay for two of those plants, projects 4 and 5. The projects were delayed by labor problems, environmental requirements and mismanagement, which, coupled with rising inflation, led to a tripling of the projected costs. In January 1982, when projects associated with Company 1's Bonds were 24% and 16% completed, respectively, construction was terminated. At that time, construction costs had almost reached the original estimated cost of the entire project due to cost overruns. Although 88 municipal and cooperative utilities had contractually agreed to pay the debt service on the Company 1 Bonds even if construction was never completed, only two of the 88 made their payments. Consequently, the Company 1 Bonds defaulted and the bondholders brought litigation. Notwithstanding the fact that the bonds were in default, they continued to be traded on the secondary market.

Although we recognize that equity mark-up principles may not be applied indiscriminately to debt securities,[10] we find that the Company 1 Bonds at issue in the present case traded in a manner similar to equity securities. The record shows that the prices of the different series of Company 1 Bonds were comparable despite differences in coupon rate or maturity date.[11] In fact, based on the

[9] The illiquid nature of this market is evidenced by the lack of trades in the blue sheet information and, in some cases, doubts about the issuers' ability to make interest payments.

[10] In the area of debt securities, it is sometimes difficult to determine when a firm is acting as a market maker and what constitutes a "contemporaneous" transaction when there are no inter-dealer trades within the traditional five-day period before or after the purchase or sale in question for purposes of determining the prevailing market price. In addition, trades within the five-day period before or after the purchase or sale might not be accurately characterized as "contemporaneous" if intervening changes in interest rates or other market events indicate that the trade should not be considered an accurate indicator of the prevailing market price. See, e.g., In re Partnership Exchange Securities Company, 51 S.E.C. 1198 (1994) ("PESCO").

[11] Although each of the bonds in Trades 1 through 3 had the same coupon rate, they had

trading data contained in the record, it appears that coupon rate affected the price of these bonds less than speculation and the forces of supply and demand. Although the Company 1 Bonds were traded in a manner similar to equity securities, they were, however, not like equity securities because they were illiquid and marked by erratic trading (like the bonds at issue in the mark-down trades at issue in this matter). With respect to both the Company 1 Bonds and the mark-down trades at issue, there were large fluctuations in the price of the bonds, which makes it difficult to have much confidence in a particular prevailing market price.

Schedule A identified 18 allegedly excessive mark-ups. All 18 trades involved Company 1 Bonds. Staff for District No. 7 divided the 18 trades into two groups, which we will discuss in turn.

Before analyzing Trades 1 through 18, we first determine whether Respondent Firm 1 was acting as a market maker in the Company 1 Bonds. On the basis of the record before us, we conclude that Respondent Firm 1 was not acting as a market maker in these bonds. Respondent Firm 1 did not list quotations in the Blue List of Current Municipal Offerings ("Blue List"),[12] nor could we conclude, on this record, that Respondent Firm 1 was buying and selling Company 1 Bonds on a regular or continuous basis, and there is no evidence to conclude that Respondent Firm 1 performed this function for other securities similar to the Company 1 Bonds or was ready to trade in Company 1 Bonds on request.[13] Indeed, given the unique factors concerning these securities, it is not clear that any securities could be considered "similar."

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different "CUSIP" numbers ("CUSIP Nos." or "CUSIP No.") and maturity dates. In the Company 1 Bonds series, each CUSIP No. represents a particular coupon rate and maturity date.

[12] The Blue List is published by a Standard & Poor's subsidiary and mainly contains data on municipal bonds (e.g., pertinent price, yield, and other data). It is the most comprehensive source of information on activity and volume in the secondary market for municipal bonds and other tax-exempt securities.

[13] In order to determine whether Respondent Firm 1 was acting as a market maker, we examined the blue sheet analysis ("Blue Sheet Analysis") that was prepared by Staff. Based on this evidence, we disagree with the DBCC's finding that "[Respondent Firm 1] was effectively functioning as a market maker in those securities." Although Respondent 2 testified that he had been trading Company 1 Bonds since 1984, we find no evidence in the record that Respondent Firm 1 was functioning as a market maker during the period at issue. In fact, the record supports the conclusion that, by early 1994 (the period under review), Respondent Firm 1 was simply purchasing Company 1 Bonds in the inter-dealer market for resale to retail customers. The record does not indicate that Respondent Firm 1 also was selling those bonds to other dealers during the relevant period. The Commission consistently has held that simply purchasing securities from other dealers for resale to retail customers does not constitute market-making activity. LSCO, 49 S.E.C. at 1128 n.8; Adams, 51 S.E.C. at 313 (1993).

Trades 1 through 3. The first group of trades consists of Trades 1 through 3. In each of those trades, Respondent Firm 1 bought the bonds from another dealer on January 26, 1994, for a price of 3.20.[14] On February 11, 1994, Respondent Firm 1 sold the same bonds to one retail customer at a price of 3.50.

The blue sheet information provided by Staff shows that these bonds were infrequently traded during the period that was blue-sheeted and that the trading was at widely erratic prices.[15] Based on the available data, our best determination of prevailing market price for the retail trades that occurred on February 11 (at a price of 3.50) was Respondent Firm 1's inter-dealer purchase on February 2, 1994 (at a price of 3.40).[16] Using 3.40 as the prevailing market price, we calculate the mark-up on the trades at issue at 3.4%. Based on the factors cited above that we used to assess the reasonableness of the mark-ups at issue, we are unable to conclude as a matter of law that mark-ups of 3.4% are unfair, given the unique facts and circumstances of this market. Accordingly, we dismiss the allegations as to Trades 1 through 3.

Trades 4 through 18. In each of the 15 trades at issue (Trades 4 through 18), Respondent Firm 1 acquired the bonds (which all had different coupon rates) from another dealer on September 15, 1993, for 2.02 a bond. The bonds were all sold to retail customers on October 1, 16 days later, at a price of 3.00 a bond.

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14 The notation "3.20," means that the bonds were traded at a price of 3.20 cents per dollar face amount.

15 The retail trades at issue occurred on February 11, 1994. The blue-sheet information shows that there were no inter-dealer trades at issue in February except for Respondent Firm 1's inter-dealer purchase on February 2, at a price of 3.40; a purchase on February 25 by one dealer, at a price of 1.00; and a sale by that same dealer, on the same day, to another dealer, at a price of 2.75. The only other inter-dealer trades that appear in the blue-sheet information occurred on March 1, 1994, at prices ranging from 1.00 to 2.75.

16 We have used the February 2 purchase because it is the "most" contemporaneous to the retail sales at issue (occurring seven business days prior to the retail trade at issue). The Commission has used a firm's "most contemporaneous" cost in an actual inter-dealer transaction that was outside of the traditional five-day period as the best evidence of prevailing market price in a case involving municipal bonds. First Honolulu, 51 S.E.C. at 699.

The subcommittee of the NBCC ("Subcommittee")[17] that heard this case on appeal requested additional blue-sheeting of the Company 1 Bonds that were traded one week before and one week after the retail trades at issue. As a result of this additional evidence, we determined that there was evidence of trades closer in time to the retail trades than that which was in the record when the case was presented to the DBCC. We examined the inter-dealer market before and after the retail trades at issue[18] to determine if there were one or more inter-dealer transactions that could be considered as better evidence of the prevailing market price. Sacks, 51 S.E.C. at 495. Even with the additional blue-sheeting, we found that the Company 1 Bonds were trading at erratic prices during the relevant period.[19] Given the erratic nature of the market during this period, we think that the ultimate benefit of the doubt needs to be given to respondents. Compare Bison, 51 S.E.C. at 330-331; R.B. Webster, 51 S.E.C. at 1276; Sacks, 51 S.E.C. at 495. We therefore have determined that the trade that occurred on September 24 (five business days prior to the retail trades at issue) at a price of 3.00 is the best

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[17] Although the Subcommittee that heard this appeal operated as a Subcommittee of the NBCC, this matter was decided by the NAC. By letter dated April 18, 1997, the Subcommittee informed the parties that pursuant to the discretionary authority granted under Procedural Rule 9312(a) (formerly Article III, Section 3(a) of the NASD's Code of Procedure), District Staff were directed to supplement the record with blue-sheeting of all of the Company 1 Bonds for the relevant period.

[18] We first look to contemporaneous purchases by Respondent Firm 1, absent countervailing evidence to determine prevailing market price. In this case, because there were inter-dealer trades that were more contemporaneous to the retail trades at issue than Respondent Firm 1's purchase of the bonds on September 15, 1993, we examine the inter-dealer market away from Respondent Firm 1 for countervailing evidence of the prevailing market price. The additional blue-sheeting permits us to examine a larger number of inter-dealer trades within a five-day period, before and after the retail trades at issue, as compared to the original blue-sheeting, which contained only a few inter-dealer trades within that period. LSCO, 50 S.E.C. at 520; Codispoti, 48 S.E.C. at 843.

[19] During the two-week period before and after the retail sales at issue (which represents the period that was blue-sheeted), the price of Company 1 Bonds in the inter-dealer market ranged from a low of 1.00 to a high of 3.675. The following reflects the price at which Company 1 Bonds were trading in the inter-dealer market within a five (business)-day window on either side of the retail trade date (October 4, 1993): 1.00, 2.00, 2.50, 2.62, and 3.00 on September 24 (five business days prior to the retail trades at issue); 1.87, 2.30, 2.47, and 2.58 on September 27 (four business days before the retail sales at issue); 1.25 and 2.25 on September 29 (two business days prior to the retail sale at issue); 1.61 on October 1 (the date of the retail sales at issue); 1.00, 1.25, 2.25, and 2.75 on October 4 (one business day after the retail sales at issue); 1.60 and 2.20 on October 5 (two business days after the retail sales at issue); 1.00 on October 7 (four business days after the retail sales at issue); and 2.37 and 2.75 on October 8 (five business days after the retail sales at issue).

evidence of the prevailing market price for Trades 4 through 18, which results in mark-ups of zero. Accordingly, we dismiss the allegations as to Trades 4 through 18.[20]

Discussion -- Mark Downs

The Commission has held that a firm's contemporaneous cost is the best evidence of the prevailing market price in determining whether a mark-up or mark-down is excessive or unfair, when a dealer is not acting as a market maker.[21] See In re BC Financial Corp., Exchange Act Rel. No. (June 30,1994); Alstead, supra; Barnett v. United States, 319 F.2d 340, 344 (8th Cir. 1963).[22] In one case,

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20 As with Trades 1 through 3, this finding is limited to the unique facts and circumstances of the trades at issue. In addition, although we dismiss the allegation as to Trades 4 through 18, we do not find support under traditional mark-up analysis for Respondent 2's practice of pricing Company 1 Bonds to retail customers based on the lowest end of the prices that were contained in the Blue List (i.e., at the inside ask price). Such practice is not an acceptable methodology for determining prevailing market price. See In re James E. Ryan, 47 S.E.C. 759, 762 (1982), aff'd sub nom. Ryan v. SEC, No. 82-7312 (9th Cir. May 23, 1983).

Further, we reject respondents' argument that evidence of prevailing market price can be determined by looking at the range of prices (from 3.00 to 6.45) that Firm B (a firm they claim was a market maker in the Company 1 Bonds during the relevant period) had assigned to the Company 1 Bonds held in Respondent Firm 1's account for purposes of transferring the account to another clearing firm in late August 1993 (approximately one month before the retail trades at issue). The transfer was administrative, and did not involve a purchase or sale. We are aware of no authority for using the prices at which bonds are transferred from one clearing firm to another as evidence of prevailing market price. With respect to respondents' claim that Firm B is a market maker in the Company 1 Bonds, there is no support in the record for such a claim. Although Firm B listed quotes in the Blue List, there is no evidence that it stood ready to buy and sell those bonds for its own account on a regular and continuous basis, as is statutorily required of a market maker under Exchange Act Section 3(a)38.

21 MSRB Rule G-30 requires municipal securities professionals to effect mark-up and mark-down transactions at a fair and reasonable price. Further, it is well-established that NASD members are required to charge their customers mark-downs that are reasonably related to the prevailing market price. Orion Securities, Inc., Exchange Act Rel. No. (November 23, 1994). With respect to each of the four allegedly excessive mark-downs, there was no evidence in the record that Respondent Firm 1 had published quotations or stood ready to buy and sell the bonds at issue for its own account on a regular and continuous basis. Exchange Act Sec. 3(a)38. Thus, we cannot conclude that Respondent Firm 1 was acting as a market maker with respect to the bonds at issue.

22 "The prevailing market price means the price at which dealers trade with one another, i.e., the current inter-dealer market." Alstead, supra at 1035. The Commission has consistently held that "[w]hen a dealer is not simultaneously making a market in a security, in the absence of

however, the Commission looked to the dealer's contemporaneous sales to other dealers in determining the fairness of its mark-downs. In re Hamilton Bohner, Inc., 50 S.E.C. 125 (1989). In Hamilton Bohner, the Commission used the dealer's sales to other dealers as evidence of the prevailing market price of the mark-downs at issue because the dealer, a non-market maker, had purchased shares from a retail customer for its own account and simultaneously had resold the shares to market makers, "presumably at their [the market makers'] bid." Id. at 127. As in the area of mark-ups, we also look to the inter-dealer market for evidence of the prevailing market price. See Sacks, supra, at 496; Bison, supra, at 330.

Although the 18 mark-ups discussed above involved defaulted Company 1 Bonds, the four mark-down transactions at issue do not involve Company 1 Bonds. These other bonds could, however, be characterized as "distressed bonds," and in general they traded at prices at a substantial discount to par. Based on the fact that these bonds were distressed, credit considerations were much more relevant to the prices that were quoted compared to municipal bonds that were not distressed. The bonds at issue with respect to the alleged mark-down violations are: Bond A (Trade 1); Bond B (Trade 2); Bond C (Trade 3); and Bond D (Trade 4). We will discuss each trade separately.

In view of the unique facts and circumstances of Trades 1, 2, and 4, we looked to the general factors cited in our discussion of the appropriate percentage mark-up on the Company 1 Bonds to determine the reasonableness of the mark-downs on Trades 1, 2, and 4. With respect to mark-down Trade 3, which involved distressed and illiquid bonds but no additional unique facts or circumstances, we determined the reasonableness of the percentage mark-down based on First Honolulu, supra. In First Honolulu, the Commission established that "mark-ups on municipal securities of over 4% usually are unfair" but, nevertheless, concluded that such policy might not have been clear to applicants in 1990 (the period under review in First Honolulu).[23]

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countervailing evidence, a dealer's contemporaneous cost is the best evidence of the current market." Id. Such transactions are generally considered to be a "highly reliable indication of prevailing market price." Id.

[23] The Commission also stated in First Honolulu that mark-ups below 4% (on the municipal securities at issue) might also have been unfair, but because the NASD had introduced no evidence that would have established the unfairness of mark-ups at those levels, the Commission set aside the NASD's findings as to mark-ups below 4%. Id. at 701. Thus, the Commission found mark-ups of above 5% to be violative, but set aside the findings of violation for the mark-ups at issue between 4% and 5%. Id.

Trade 1. At 2:28 p.m on May 2, 1994, Respondent Firm 1 purchased Company A bonds from Company A, a mutual fund, at a price of $88. At the exact same time, Respondent Firm 1 sold the bonds to Dealer 1, a dealer, for $93. At the DBCC hearing, Regional Counsel argued that the prevailing market price of the bonds was the $93 price that Respondent Firm 1 received from Dealer 1, resulting in a mark-down of 5.4%.

According to respondents, the documentary evidence does not accurately reflect the date of the transactions. Respondent 2 testified at the DBCC hearing that Respondent Firm 1 became firmly committed, pursuant to an oral agreement, to purchase the bonds from Company A at a price of $88 on April 21, 1994. Three days later, Respondent Firm 1 obligated itself to sell the bonds to Dealer 1 at a price of $93, pursuant to a written contract.[24] The agreement between Respondent Firm 1 and Dealer 1 permitted Dealer 1 the option of canceling the trade if the interest payment due on May 1, 1994 was not made. In any event, Respondent Firm 1 still would have been obligated to purchase the bonds from Company A. According to the testimonial and documentary evidence, the interest payment was made and Dealer 1 purchased the bonds on May 2. Based on the foregoing facts, Respondent Firm 1 argued that April 21, 1994 was the pertinent date for purposes of determining the prevailing market price.

We find that there is ambiguous evidence in the record as to the date of Respondent Firm 1's purchase from Company A. Respondents introduced a report by the Firm's expert in which the expert claimed that Respondent Firm 1 had provided a "sophisticated investor letter" dated March 23, 1994, which evidenced its agreement with Company A. Notwithstanding this statement, there is no evidence of the referenced document in the record. This purported evidence also conflicts with respondents' claim at the DBCC hearing that Respondent Firm 1 became obligated, pursuant to an oral agreement on April 21, to purchase the bonds at issue from Company A. There is evidence in the record, however, that Respondent Firm 1 became obligated to sell the bonds to Dealer 1 on April 24, 1994 (at a price of $93), pursuant to a written agreement. Based on that evidence, we can infer that Respondent Firm 1 likely would not have obligated itself to sell the bonds on April 24, if it did not already have an agreement in place to purchase the bonds. We also note that Staff did not present evidence to refute the existence of Respondent Firm 1's oral agreement with Company A to purchase the bonds. Based on the foregoing evidence, we conclude that the retail trade occurred on April 21 (at a price of $88) and that Respondent Firm 1's sale to Dealer 1 occurred on April 24 (at a price of $93). Except for Respondent Firm 1's sale to Dealer 1 at $93, there were no other inter-dealer trades prior to May 2 (despite District Staff's blue sheet efforts). After May 2, the inter-dealer trading occurred at prices in excess of $93.

We conclude that Respondent Firm 1's sale to Dealer 1, at a price of $93, is the best evidence of the prevailing market price for the trade at issue because it is most contemporaneous to the retail

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[24] Although the report provided by respondents' expert stated that Respondent Firm 1 had a copy of its agreement with Dealer 1, there is no evidence that it was ever introduced into the record.

trade at issue.[25] Using $93 as the prevailing market price, we calculate the mark-down at 5.4%. We cannot conclude, however, that a mark-down at that level is excessive based on the particular facts and circumstances of the trade at issue. In making this finding, we considered the fact that there was a dearth of trading activity in these bonds at the time of the retail trades at issue; that the bonds were distressed and illiquid; and that the customer that sold the bonds to Respondent Firm 1 is an institution with obvious sophistication in these matters. We considered the sophistication of the institution as a factor in determining whether the price at which Respondent Firm 1 purchased the bonds was an overall fair price. In reaching our decision, we also considered the fact that there was uncertainty about whether the interest payment would be made on May 1 (which is evidenced by the fact that Dealer 1 had the option of canceling the transaction if the interest payment was not made). Based on the forgoing, we dismiss the allegations as to Trade 1.

Trade 2. Respondent Firm 1 purchased defaulted Company B bonds on March 23, 1994 at a price of $88 from Company B. Respondent Firm 1 sold the same bonds to Dealer 1, later that day, at $93.50. At the DBCC hearing, Regional Counsel argued that the $93.50 sale price was evidence of the prevailing market price. Based on that price, Staff calculated a 5.9% mark-down. Respondents presented no alternative evidence of the prevailing market price, and, instead, merely questioned the figure that was presented by Staff.

Respondents argued at the DBCC hearing that it was reasonable to infer that Company B would not have agreed to accept Respondent Firm 1's price if there had been other, higher bids at the time Company B sold the Bond B bonds to Respondent Firm 1. Respondent 2 testified that, based on his belief that the bonds had more value than $70 to $78 per bond (which was the price at which another dealer had done a previous tender offer), he determined to do a tender offer for the bonds at a price of $88. On March 4, 1994, Respondent Firm 1 issued a written offer to brokers and dealers to purchase any or all of the bonds for $88.

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[25] The present case contains facts similar to those in Hamilton Bohner, a case in which the dealer purchased the securities at issue from a retail customer for its own account and simultaneously sold the securities to market makers. In Hamilton Bohner, the Commission used that sale as the best evidence of the prevailing market price of the retail trade at issue and determined that the mark-downs ranged from 5.3% to 10.2% below the prevailing market price. In the present case, the order tickets show that Respondent Firm 1 purchased the bonds from Company A on May 2, 1994, at 2:28 p.m., and that Respondent Firm 1 sold those bonds at the exact same time to Dealer 1. Thus, Respondent Firm 1's contemporaneous sale is the best evidence of prevailing market price in this instance. Further, we give the Firm the benefit of the doubt by using $93, rather than using a trade at a higher price that would have resulted in a higher mark-down. See, e.g., Bison, 51 S.E.C. at 330-31; R.B. Webster, 51 S.E.C. at 1276; Sacks, 51 S.E.C. at 495.

We believe that, in general, municipal bonds purchased by dealers in a tender offer context (where there are no ordinary dealer/customer relationships) are not easily amenable to a mark-down analysis because they are outside of the type of transactions for which mark-down policy was designed. Even if we were to apply a mark-down analysis, however, we are unable to conclude that the level of mark-down at issue is excessive for the reasons discussed below.

Applying traditional mark-down analysis to the facts of this trade, we find that Respondent Firm 1's sale to another dealer on March 23, 1994, the same day as the retail purchase, at a price of $93.50, is the best evidence of the prevailing market price. See Hamilton Bohner, supra (firm purchased securities at issue from a retail customer for its own account and simultaneously sold the securities to other dealers). In the present case, there was no blue sheet information regarding any inter-dealer trading activity within five business days after the retail trade at issue and no evidence of inter-dealer trades within five business days before the retail trade at issue.[26] Using $93.50 as the prevailing market price, the mark-down was 5.9%. Based on the facts and circumstances of this trade, we cannot find a mark-down at that level to be excessive. In reaching this conclusion, we considered: that the bonds were distressed and illiquid; that Company B sold the bonds at issue in response to Respondent Firm 1's written tender offer to the market at large; and that the transaction did not occur in the context of a traditional dealer/customer relationship. Under these circumstances, it is reasonable to infer that Company B, an institution that presumably is sophisticated in matters of tender offers, would not have agreed to accept Respondent Firm 1's price if there had been other, higher bids at the time of Respondent Firm 1's offer. Company B was in a position to determine if Respondent Firm 1's bid was the best offer it could obtain for the bonds during the relevant period. Accordingly, we dismiss the allegations as to Trade 2.

Trade 3. Respondent Firm 1 purchased Company 3 Bonds[27] from a retail customer on September 14, 1993 for $48. On October 6, 1993, Respondent Firm 1 sold the same bonds to Dealer 2, another dealer, for $51.87. Regional Counsel argued that the trade at $51.87 per share was evidence of the prevailing market price and that the mark-down therefore computed to 7.5%. Respondent's expert testified that another dealer's purchase from a retail customer at a price of $47.59 on September 14, 1993 was better evidence of the prevailing market price. Based on that price, respondents' expert computed Respondent Firm 1's mark-down at 3%.[28] We reject respondents'

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[26] The inter-dealer trades that were included in the Blue Sheet Analysis are as follows: one trade on March 15 at $90.25; two trades on March 11 at $91.81 and $91.70, respectively; and two trades on February 3 at $85 and $84.625, respectively.

[27] Respondents' expert stated in his report that the Company 3 Bonds were not actively traded and that the issuer of the Company 3 Bonds had defaulted on an interest payment on September 1, 1993.

[28] Respondents' expert testified that he added an imputed mark-down of 3% (based on another dealer's spread of 3%) to the Firm's purchase price to determine the prevailing market price.

attempt to use a retail purchase as evidence of the market price. The Commission has repeatedly noted that inter-dealer transactions are the best evidence of the prevailing market and that retail purchases (with an imputed mark-down) are examined only in the absence of inter-dealer transactions. See Perkins, 51 S.E.C. at 382, n.11 (1993). In the present case, there was an inter-dealer trade on September 14, 1993 (the date of the retail transaction), which the DBCC determined provided better evidence of the prevailing market price. That transaction occurred at a price of $50.50. Based on that price, the DBCC computed the mark-down at 4.9%, which it determined was fair under the circumstances.[29]

In the area of mark-ups, the Commission has looked to inter-dealer trades away from the Respondent Firm 1s evidence of prevailing market price, in the absence of evidence of contemporaneous cost. See Bison, supra, at 330-31; Sacks, supra, at 496. The same principle can be applied in the area of mark-downs. In the present case, the blue sheet information shows an inter-dealer trade away from Respondent Firm 1 on September 14, 1993 (the date of the retail trade at issue), at a price of $50.50. The only other inter-dealer activity was a sale by Respondent Firm 1 to another dealer on October 6, 1993, at a price of $51.87, and that dealer's sale to another dealer on the same day at a price of $53.18. The record contains no evidence of contemporaneous purchases or sales by Respondent Firm 1. Based on these facts, we have calculated the mark-down using the same approach as the DBCC. Like the DBCC, we used the inter-dealer trade away from Respondent Firm 1 (at a price of $50.50) on September 14, 1993, the same day of the retail trade in question, as the best evidence of the prevailing market price.

Based on the transaction price of $50.50, we calculate the mark-down for the retail purchase at 4.9%. Because the retail trade occurred on September 14, 1993, which was shortly before the Commission issued its decision in First Honolulu, it might not have been clear to respondents that mark-downs above 4% usually are unfair. Moreover, because of the unique circumstances involving these

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When retail purchases are used as evidence of prevailing market price, an imputed mark-down is added to the Firm's purchase price to reflect the fact that the price at which a dealer purchases securities from retail customers generally is less than the amount it would have paid for the security in the inter-dealer market. In re Richard R. Perkins, 51 S.E.C. 380, 383 (1993); First Honolulu, supra, at 699 n. 16.

[29] The DBCC did not explain its reasons for concluding that a mark-down of 4.9% would be "reasonable under the circumstances."

bonds and the market for them, we cannot conclude that the mark-down of 4.9% was excessive.[30] Accordingly, we dismiss the allegations as to Trade 3.[31]

Trade 4. On February 26, 1993, Respondent Firm 1 purchased Company 4, Bonds D, from a retail customer at a price of $66. One business day later (on March 1, 1993), Respondent Firm 1 sold the bonds to Dealer 1 for $70. Based on that price, District Staff computed the mark-down on the retail trade at 5.7%.

Respondent Firm 1 argued at the DBCC hearing that the $70 price that Respondent Firm 1 charged Dealer 1 on March 1, 1993, was not evidence of the prevailing market price on February 26 because of a change in circumstances that had occurred between Respondent Firm 1's acquisition of the bonds and its subsequent sale. According to Respondent 2's testimony, when Respondent Firm 1 initially purchased the bonds in the inter-dealer market (in the middle of February 1993), there was a serious question as to whether the issuer of the bonds was going to be able to make the interest payment that was due on March 1. Respondent 2 testified that he bought the bonds back from his customer on February 26 because he did not want his customer to incur any losses in the event the interest payment was not made (and the price of the bonds fell).[32] As it turned out, the original underwriter lent money to the issuer at the "last minute" so that there would be funds available to make the March 1 interest payment.

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[30] While 4.9% may well be excessive, we do not have any facts in this record as to what a reasonable percentage would be with respect to these bonds. Further, District Staff introduced no evidence that would establish the unfairness of mark-ups below 5% with respect to the bonds at issue. On the other hand, the record does not contain evidence for us to conclude, as the DBCC did, that the mark-down of 4.9% was reasonable.

[31] First Honolulu provides notice to the industry that mark-ups/mark-downs on municipal securities are usually below 4%. Thus, under traditional analysis, we apply First Honolulu's 4% level to trades that were executed after the decision was issued, and a 5% level to trades that were executed before the decision was issued. Thus, if the trades at issue had occurred after the decision in First Honolulu, we might have come to a different conclusion about whether the level of mark-down was excessive.

[32] Respondent 2 testified that because his customer had a large position ($2.5 million), he did not want to expose the customer, who was a friend, to the principal risk of what might happen on March 1 if an interest payment were not made. Respondent 2 further testified that he was the largest holder of the bonds at issue at the time and that he knew it was extremely uncertain whether the interest payment was going to be made on March 1.

We agree with the DBCC that the best evidence of the prevailing market price was the price at which Respondent Firm 1 sold the bonds to Dealer 1 on March 1 ($70).[33] Based on that price, we calculate the mark-down at 5.7%. Based on the unique circumstances of this trade, we cannot conclude that a mark-down at that level was excessive. In reaching this conclusion, we considered that there was not much evidence about the prices at which these bonds were trading (the blue sheet information showed only two inter-dealer trades and no retail trades); that the bonds were distressed and illiquid; and that the interest payment that was made on March 1 was unexpected, thus resulting in an increase in the price of the bonds.[34] Based on all of the above factors, we dismiss the allegations as to Trade 4.

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[33] We find the circumstances of Respondent Firm 1's retail purchase and resale one business day later to Dealer 1 to be analogous to the facts in Hamilton Bohner, where the Commission used the dealer's simultaneous (same day) sale to another dealer as evidence of the prevailing market price for the retail transaction. Hamilton Bohner, supra at 127.

[34] The record leaves us with questions about whether Respondent 2 knew that the interest payment would be made on March 1, notwithstanding his testimony that he had bought back the bonds from Respondent Firm 1's retail customer in an effort to prevent any loss to the customer in the event the interest payment was not made. Although Respondent 2 testified that it was uncertain that the interest payment would be made, he also testified that he was involved in the negotiations regarding the interest payment and that his plans were to try to "fix" the problem with the bonds. Nevertheless, we credit Respondent 2's testimony about the uncertainty regarding the interest payment, since District Staff did not introduce evidence to refute Respondent 2's testimony.

Conclusion

In light of our dismissal of the allegations of the complaint,[35] we impose no sanctions.[36]

On Behalf of the National Adjudicatory Council,

Joan C. Conley, Corporate Secretary

[35] We have considered all of the arguments of the parties. They are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed herein.

[36] By letter dated December 12, 1996, the NBCC denied respondents' request for a remand and approved, in part, their request for confidentiality as to the DBCC's decision pending resolution of the appeal/call for review. Specifically, the NBCC decided to edit out paragraphs 2 through 6 in the sanctions section of the DBCC's decision in the copies of the decision released to the public pending resolution of the appeal/call for review. We reaffirm the NBCC's decision as to respondents' motion for confidentiality as to the DBCC's decision. In addition, we permanently vacate and eliminate paragraphs 2 through 6 in the sanctions section of the DBCC's decision.