NASD REGULATION, INC.
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. JOSEPHTHAL & CO., INC. (BD No. 3227) New York, NY, DAN D. PURJES (CRD No. 711172) Spofford, NH, and PAUL H. FITZGERALD (CRD No. 812775) Larchmont, NY, Respondents.	Disciplinary Proceeding No. C3A990071 Hearing Officer—Andrew H. Perkins **Hearing Panel Decision** May 15, 2001

The Respondents, an NASD member firm, its Chief Executive Officer, and its head of trading and capital markets, were charged with biding for and purchasing securities during a distribution of the stock in which the Respondent firm was a participant, in violation of Section 10(b) of the Exchange Act, Rule 10b-6, and NASD Conduct Rules 2110 and 2120; and with dealing unfairly with the firm's customers during the distribution by failing to disclose the existence and magnitude of the internal sales credit applicable to the securities subject to the distribution, in violation of NASD Conduct Rules 2110, 2120, and 2310. The Extended Hearing Panel censured each of the Respondents and fined the firm and its Chief Executive

Officer $500,000 each and ordered that they jointly and severally pay restitution in the total amount of $1,478,789.65. The Panel fined the firm's head of trading and capital markets $100,000.

Appearances:

For the Department of Enforcement: Rory C. Flynn; Jacqueline D. Whelan, and Roger D. Hogoboom.

For Josephthal & Co., Inc.: William R. McLucas, Joseph K. Brenner, and Derek L. Gaubatz, WILMER, CUTLER & PICKERING, Washington, DC; and Donald G. McCabe, New York, NY, Of Counsel.

For Dan D. Purjes and Paul H. Fitzgerald: John F.X. Peloso, Kevin T. Rover, and John G. Moon, MORGAN, LEWIS & BOCKIUS LLP, New York, NY.

DECISION

I. INTRODUCTION

This disciplinary proceeding arises out of an investigation by NASD Regulation, Inc. ("NASD Regulation") into the trading of VictorMaxx Technologies, Inc. ("VictorMaxx") common stock by Josephthal & Co., Inc. ("Josephthal" or the "Firm"), a National Association of Securities Dealers, Inc. ("NASD") member firm. NASD Regulation's investigation commenced in the summer of 1996 following an on-site examination of Josephthal, at which time NASD Regulation Staff observed records of what they considered to be unusually heavy activity in VictorMaxx stock during May 1996. Following further investigation, the Department of Enforcement (the "Department") determined that Respondents Josephthal, Dan D. Purjes ("Purjes"), and Paul H. Fitzgerald ("Fitzgerald") (collectively the "Respondents")[1] had violated Section 10(b) of the Securities

[1] Matthew Balk also was charged with violating NASD Conduct Rules 2110 and 2310. Balk, however, settled those charges before the hearing commenced. Accordingly, this Decision applies only to the remaining Respondents.

Exchange Act of 1934 (the "Exchange Act"), SEC Rule 10b-6 thereunder,[2] and NASD Conduct Rules 2110, 2120, and 2310. On December 21, 1999, the Department filed a two-cause Complaint in this proceeding.[3] In summary, the first cause alleges that the Respondents continued to bid for and purchase VictorMaxx stock during a distribution of the stock in which Josephthal was a participant, in violation of Section 10(b) of the Exchange Act, Rule 10b-6, and NASD Conduct Rules 2110 and 2120; and the second cause alleges that the Respondents dealt with Josephthal's customers unfairly during the distribution, in violation of NASD Conduct Rules 2110, 2120, and 2310.

II. PROCEDURAL HISTORY

The Department filed the Complaint in this proceeding on December 21, 1999. Each of the Respondents answered and requested a hearing. On August 14, 2000, the Respondents jointly moved to amend their Answers. The Hearing Officer granted the motion, and on September 5, 2000, Respondents Purjes and Fitzgerald filed their Amended Answers, and, on September 11, 2000, Josephthal filed its Amended Answer.

On May 26, 2000, the Department filed a motion for summary disposition against Josephthal, and the Respondents filed a motion for summary disposition on the Second Cause of the Complaint. The Department's motion included more than 200 separate affidavits and several hundred questionnaire responses from third-party witnesses. In total, the Department's motion exceeded 3000

---

[2] On December 18, 1996, the Commission adopted a comprehensive revision of Rules 10b-6, 10b-7, 10b-8, and 10b-21, which became effective on March 4, 1997. Among other things, these amendments deemed Rules 101 and 102 under Regulation M as successor rules to Rule 10b-6. See Anti-Manipulation Rules Concerning Securities Offerings, Exchange Act Release No. 38,067 (Dec. 20, 1996). However, Rule 10b-6 applies to the alleged misconduct in this proceeding because it occurred before the amendments took effect.

[3] The NASD has jurisdiction of this disciplinary proceeding. Josephthal is a member of the NASD, and each of the individual Respondents is registered with the NASD. See Article XII and Article XIII, By-Laws of the National Association of Securities Dealers, Inc.

pages. In light of the scope and complexity of the Department's motion, Josephthal was granted additional time to respond. Josephthal filed its response on June 30, 2000.

On August 15, 2000, the Extended Hearing Panel (the "Panel") denied both motions for summary disposition. As to each, the Panel concluded that there were disputed, material issues of fact, which were not properly subject to summary disposition under Code of Procedure Rule 9264.

The Panel, composed of the Hearing Officer and two current members of the District Committee for District 10, conducted the hearing on September 11, 12, 14, and 15, 2000, in New York, New York. The Department offered the testimony of 14 witnesses and 54 exhibits, of which 53 were admitted into evidence. The Panel rejected Exhibit C044, which is a collection of some 140 customer affidavits the Department had filed with its motion for summary disposition. The Panel rejected the affidavits on the ground that the Department had not sufficiently demonstrated their reliability, which is a precondition to the use of hearsay evidence such as this.

The individual Respondents testified on their own behalf and, along with Josephthal, offered the testimony of three other witnesses. The Respondents also offered 58 exhibits, which were admitted into evidence.

On November 1, 2000, the Parties submitted post-hearing briefs and proposed findings of fact and conclusions of law.

On February 15, 2001, the Hearing Officer requested additional post-hearing briefing in light of the National Adjudicatory Council's decision in Dep't. of Enforcement v. Michael Galasso, Jr., No. C10970145 (NAC Feb. 5, 2001). Those briefs were filed on March 1 and March 16, 2001.

III. FINDINGS OF FACT

A. The Respondents

1. Josephthal & Co., Inc.

Josephthal is a registered broker-dealer located in New York, New York, which joined the NASD in 1964. Over the years, Josephthal has undergone several name changes.[4] Prior to October 1991, the Firm was known as Rosenkrantz, Lyon & Ross, Inc. From October 1991 to October 1997, the Firm was known as Josephthal Lyon & Ross, Inc. From October 1997 to the present, the Firm has been Josephthal & Co. Inc. Josephthal became a member of the New York Stock Exchange ("NYSE") in 1982 and joined the American Stock Exchange in 1988. (Ex. C055 ¶¶ 1-3.)[5]

2. Dan D. Purjes

Purjes first entered the securities industry in 1978 in a non-registered capacity with NASD member firm Morgan Stanley & Co. In 1980, Purjes joined former member firm L.F. Rothschild, Unterberg, Towbin, Inc. as a General Securities Representative. From October 1982 to August 1983, Purjes was associated with Bear, Stearns & Co., Inc. as a General Securities Representative and as a trainee in corporate finance. From 1983 to May 1985, Purjes was associated with former member firm Rooney Pace, Inc., as a General Securities Representative and a member of the corporate finance department. Purjes joined Josephthal in 1985 as a retail broker and the senior member of the Firm's Corporate Finance Department. When he joined Josephthal, Purjes acquired a 5% ownership interest in the Firm. In 1988, Purjes acquired an additional 50% interest in Josephthal and became

---

[4] For clarity, all references to Josephthal shall use its current name.

[5] References to the evidence are cited as follows: Complainant's exhibits are cited as "Ex. C__," and Respondents' exhibits are cited as "J__." Exhibits C055, C056, C057, and C058 are Stipulations. References to the hearing transcript are cited by the day of the hearing and the transcript page number as follows: "Sept. __ Tr. at __."

Josephthal's Chief Executive Officer. At that time, Josephthal was a relatively small firm, and Purjes had "hands on" involvement with its management.[6] Peter Sheib ("Sheib") was Josephthal's only other manager between 1988 and 1992. (Ex. C055 ¶ 23; Ex. C056 ¶¶ 4-8, 12; Sept. 14 Tr. at 97-100, 103-04.)

Under Purjes' leadership, Josephthal grew rapidly from 40 to approximately 750 employees. As a result, starting in 1992, Purjes began to bring in other senior managers to assist with Josephthal's day-to-day management. By May 1996, Purjes, Sheib, and Fitzgerald were joined by Senior Managing Directors Sherwood Larkin ("Larkin"), Scott Weissman ("Weissman"), Matthew I. Balk ("Balk"), Charles Roden, Lawrence Rice, James Raphalian, and Richard Sichenzio to comprise a *de facto* committee of senior management that met regularly to review the Firm's business and operating activities and to make management decisions. Despite its increase in size and the addition of these other managers, Purjes continued to run Josephthal in an informal style. For example, many management meetings were conducted while the managers congregated in one or another's office or the hallway. (Ex. C055 ¶ 31; Ex. C056 ¶ 13; Ex. C057 ¶ 6; Sept. 12 Tr. at 130; Sept. 15. Tr. at 14-15, 35.)

In May 1996, Purjes continued to own approximately 50% of Josephthal Holdings, Inc. ("Holdings"), the holding company that now owns Josephthal. In May 1996, Purjes was Josephthal's Chairman and Chief Executive Officer ("CEO"), and, at all times relevant to this proceeding, he was registered with the NASD as a General Securities Principal. (Ex. C055 ¶¶ 24-27; Ex. C056 ¶¶ 9, 10, 12; Sept. 14 Tr. at 100-103.)

---

[6] Purjes also functioned as a retail broker. Indeed, during the first eight years as Josephthal's majority owner, Purjes was one of Josephthal's largest retail producers. He also participated in corporate finance activities during this period. (Set. 14 Tr. at 107-08.)

Purjes currently owns more than 80% of Holdings and is Chairman of its Board of Directors, but he is no longer the Chairman and CEO of Josephthal. Purjes designated Fitzgerald CEO of Josephthal a week or two before the hearing. (Ex. C055 ¶ 26, 29; Ex. C056 ¶ 11; Sept. 14 Tr. at 123-24, 209-10.)

3. Paul H. Fitzgerald

Fitzgerald first entered the securities industry in 1967 when he became employed by the New York Stock Exchange ("NYSE"). Fitzgerald's last position at the NYSE was Vice-President, Member Firm Surveillance. Fitzgerald left the NYSE in 1975 and joined former NASD member firm Thomson McKinnon Securities Inc. as a General Securities Representative. When he left Thomson McKinnon in 1982, Fitzgerald was an Executive Vice-President responsible for branch office administration. Between 1982 and 1992, Fitzgerald worked for four firms: Instinet (as Director of Sales and Marketing), Manufacturers Hanover Trust Company (where he set up a broker-dealer), Dominick & Dominick (first as the CEO of that firm's Canadian subsidiary and later as the CEO of the parent firm) and Reich & Co. (as CEO). In September 1992, Fitzgerald joined Josephthal as National Sales Manager, and in January 1996, Purjes promoted Fitzgerald to Senior Managing Director for Capital Markets. Fitzgerald is now Chairman of the Board of Directors and CEO of Josephthal. At all times relevant to this proceeding, Fitzgerald has held several licenses, including the Series 7 (General Securities Representative), the Series 24 (General Securities Principal), the Series 53 (Municipal Securities Principal), and the Series 4 (Options Principal). (Ex. C055 ¶¶ 28-30; Ex. C057 ¶¶ 2-5; Sept. 15 Tr. at 6-7.)

In 1996, Fitzgerald had line responsibility for "all equity trading, syndicate institutional sales and institutional research."[7] (Sept. 15 Tr. at 33; Ex. C007, at 8.) All traders ultimately reported to Fitzgerald as head of capital markets, and in that position Fitzgerald reviewed Josephthal's inventory position runs on a daily basis. (Sept. 12 Tr. at 75; Sept. 15 Tr. at 72-73.) In turn, Fitzgerald reported to Sheib, Josephthal's President and Chief Operating Officer. (Ex. C006, at 9.)

4. Matthew Balk

Balk first entered the securities industry in June 1984 as a General Securities Representative with Josephthal, after obtaining a Masters of Business Administration from New York University. Up until the time covered by this Complaint, Josephthal was the only NASD member firm for which Balk ever worked. During May 1996, Balk was a General Securities Principal and Senior Managing Director for Equity Marketing at Josephthal. At that time, Balk held a minority ownership interest in Holdings, and he reported to Sheib. (Ex. C055 ¶ 36; Sept. 12 Tr. at 70, 121, 194-95; Sept. 14 Tr. at 115.)

Balk resigned from Josephthal on July 1, 1999, and is currently associated with NASD member firm, H.C. Wainwright & Co., Inc. (Ex. C055 ¶ 37; Sept. 12 Tr. at 188.)

In August 2000, Balk settled the charges alleged against him by the NASD in Cause Two of the Complaint and agreed to a $65,000 fine, a 45-day suspension in all capacities and a four-month suspension as a principal. (Sept. 12 Tr. at 106.)

---

[7] Fitzgerald also had staff (non-supervisory) responsibility for regulatory, administrative, and operational matters. (Ex. C007, at 8.)

B. Josephthal's Management Structure and Trading Department

1. Senior Management

Historically, management authority at Josephthal was concentrated in Purjes' hands. As he added senior managers between 1992 and 1996, Purjes slowly moved some responsibility for the day-to-day management of the Firm to those line managers, but all significant decisions still required his approval. By late 1995, the formal reporting structure showed Purjes as the Chief Executive Officer with three direct reports: Sheib, Executive Vice President and Chief Operating Officer; Weisman, Managing Director and Director of Investment Banking; and Balk, Managing Director, Special Equities. All of the remaining senior managers reported to Sheib, including Fitzgerald, Managing Director, Capital Markets. Up through 1995, there was no office of the President; Purjes filled this role. (Ex. C005; Sept. 14 Tr. at 112-15.)

To understand the management structure of the trading department at Josephthal in early 1996, it is necessary to understand the relative roles of Fitzgerald, Weisman, and Balk. Purjes brought Fitzgerald on board in September 1992 as a national sales director responsible for retail sales. Within a few months of joining Josephthal, Fitzgerald assumed the task of rebuilding the Firm's trading department. He also was asked to take over the capital markets group (institutional department), which was faltering. Thereafter, Purjes promoted Fitzgerald to Managing Director of Capital Markets. Thus, by mid-1995, all trading activity reported directly to Fitzgerald. This included over-the-counter trading, institutional equity sales and trading, institutional equity research, and fixed income sales and trading. One of the early moves Fitzgerald took to increase the profitability of the

trading department was to hire Mark Silverman and Allan Blumenfeld[8] in 1993 to trade Josephthal's proprietary securities on a profit and loss basis. Silverman and Blumenfeld reported to Fitzgerald. (C003, at 14; Sept. 11 Tr. at 221-23; Sept. 15 Tr. at 9-10; Ex. C005; Ex. C007, at 7.)

At the same time that Fitzgerald was moving to shore up the trading department, Purjes hired Weisman to head up the investment banking department under his direct supervision. With Josephthal's growth, Purjes felt that he did not need to personally manage every corporate finance project—only those that interested him or that bore considerable economic risk for the Firm, such as new issues. (Sept. 14 Tr. at 109, 112.)

Balk's role as Managing Director, Special Equities, was unique. Purjes had created his position because Balk otherwise did not fit within Josephthal's evolving structure. Balk had started at Josephthal as a broker trainee in 1984 and worked his way up to the position of Branch Manager. He also had acquired a small amount of Josephthal stock in the early 1990's. However, when the Firm moved its headquarters in 1992 or 1993, Balk was left behind to run the old office. Balk did not like this, and he lobbied hard to be included with the other shareholders at the Firm's headquarters. Although there was really no role for Balk to play at headquarters, in an effort to accommodate him, Purjes created the position of Managing Director, Special Equities, which position reported directly to himself. Balk's responsibilities in this position involved helping to market the Firm's proprietary products to the retail salespeople, which products consisted of such things as new issues and private placements. Essentially, it was a marketing function. Purjes testified that he intended to place Balk into this position until he could figure out what further role Balk would play as the Firm evolved. (Sept. 12 Tr. at 127; Sept. 14 Tr. at 113-14.)

---

[8] Ron Powell also was hired along with Silverman and Blumenfeld, but he left in 1994. (Sept. 11 Tr. at 251.)

Josephthal's formal organizational structure changed in early 1996. Purjes promoted Sheib to President and Chief Operating Officer and moved Weisman and Balk under him. Thus, with this change, Sheib had overall responsibility for Josephthal's operations, including sales, compliance, accounting, and back-office operations. Purjes' plan was to make Sheib the Firm's Chief Executive Officer at the end of 1996 so that Purjes could devote more time to his other business interests. (Ex. C055 ¶¶ 32-35; Ex. C056 ¶¶ 14-17; Ex. C057 ¶¶ 7-10; Sept. 14 Tr. at 106, 115.)

Although Josephthal now had a more formal organizational structure, the culture of the Firm did not change. In practice, the Firm's management style remained very informal. Indeed, many decisions regarding the day-to-day running of the Firm were made in informal meetings in the hallways or in impromptu office meetings. There was no evidence whatsoever that Purjes, Fitzgerald and Sheib used the formal hierarchy described above to remove themselves from making front-line decisions regarding the Firm's operations and investments. Accordingly, despite Purjes' desire to spend less time at Josephthal's offices,[9] he remained at the center of the decision-making process throughout 1996. (Ex. C006, at 8; Ex. C007, at 30.)

2. The Trading Department

In May 1996, Josephthal's trading room was divided into four areas: (i) over-the-counter or proprietary trading; (ii) institutional trading; (iii) trading room liaison; and (iv) house account trading. (Sept. 11 Tr. at 227; Sept. 12 Tr. at 50.)

---

[9] Purjes testified that in May 1996 he was spending less than 50% of his time in the office. (Sept. 14 Tr. at 115, 252.)

(a) The Proprietary Traders

Silverman and Blumenfeld co-managed proprietary trading on a profit-and-loss basis. Essentially, their responsibilities were to trade a list of stocks on the Firm's behalf. Their compensation consisted of the following three components: first, they shared 40% of the monthly net trading profits[10] for the proprietary trading account which they managed[11]; second, they shared a percentage of the monthly net trading profits for the proprietary trading accounts managed by the other "for profit" traders[12] in the proprietary trading group; and third, they shared a percentage of the monthly gross sales credits allocated to all customer transactions at Josephthal, including transactions in "house stocks"[13] such as VictorMaxx.[14] During the first half of 1996, Silverman and Blumenfeld were assisted by Michael Confessore ("Confessore"), a salaried assistant trader. (Sept. 11 Tr. at 260-62, 275, 311-15; Sept. 12 Tr. at 50; Ex's. J206-07.)

(b) The Trading Room Liaisons

The trading room liaison desk, which was manned by Duggan and Rosenfeld, was created to free Silverman and Blumenfeld (and the other proprietary traders) from the burden of communicating with the sales force and allow them to devote their full time to trading. The liaisons' principal role was to act as the intermediary between the brokers and the traders. They were not traders. They

---

[10] "Net trading profits" consisted of gross trading profits less gross sales credits. (Sept. 11 Tr. at 249; Ex's. J206-07.)

[11] Silverman and Blumenfeld shared a proprietary trading account. (Sept. 11 Tr. at 252.)

[12] There were seven or eight other traders plus their assistants in the proprietary trading group. Each of these traders had their own proprietary trading account. (Sept. 11 Tr. at 252; Sept. 12 Tr. at 50.)

[13] The term "house stocks" refers to issues that were underwritten by Josephthal and for which there no longer was any demand. These stocks would be taken out of the Josephthal's proprietary trading accounts and transferred to the house account. Fitzgerald and Purjes decided which stocks would be transferred to the house account. (Sept. 11 Tr. at 233.)

took brokers' orders and got them executed through a trader. In contrast to the proprietary traders who received a percentage of the trading profits, Duggan and Rosenfeld were salaried.[15] As discussed in the preceding section, Duggan and Rosenfeld reported to Fitzgerald and Purjes. (Sept. 11 Tr. at 286-89; Sept. 12 Tr. at 198-200; Sept. 14 Tr. at 135-36.)

(c) The House Traders

The last area of Josephthal's trading department that is relevant to this Decision is the house account, which was manned by Coon. His principal function was to "baby sit" the securities in the house account for Purjes and Fitzgerald. Coon monitored the activity in the house account and reported all significant activity to Purjes and Fitzgerald, who then directed Coon as to the action he should take. Thus, although Coon traded the stocks in the house account, he did not exercise any independent judgment regarding the trades he made. All of his trades were first approved by either Fitzgerald or Purjes. (Sept. 11 Tr. at 290; Sept. 12 Tr. at 217-20.)

3. Supervision of the Trading Department

Although there was little or no disagreement among the Parties regarding the organization of the trading room, there was considerable disagreement regarding its supervision. Purjes and Fitzgerald went to great lengths to distance themselves from any supervisory responsibility for the trading department, including Silverman and Blumenfeld.[16] Purjes and Fitzgerald also claimed that Silverman and Blumenfeld were responsible for the liaison desk and the house account. Their

---

[14] According to the formula, they received 2.5% of all gross sales credits from $750,000 to $1,500,000 and 4% of all gross sales credits in excess of $1,500,000. (Ex. J206-07.)

[15] In 1996, Duggan and Rosenfeld were paid $75,000 and $150,000, respectively. (Sept. 12 Tr. at 199; Ex. C007, at 14.)

[16] At the hearing, Fitzgerald admitted only that he had "administrative" responsibility for the traders. (Sept. 15 Tr. at 32.)

testimony, however, was substantially contradicted by Fitzgerald's prior on-the-record testimony and by the hearing testimony of Silverman, Blumenfeld, Coon, and Duggan.

Blumenfeld testified that he reported to Purjes on all major decisions, such as stock positions, and to Fitzgerald for general management issues concerning the proprietary trading group. Blumenfeld further testified that Purjes, although not in the office on a daily basis, was active in the trading room. Silverman corroborated his testimony. According to Silverman, he reported to Fitzgerald, but Purjes and Fitzgerald both monitored the positions taken by the traders. Purjes got a list of the trader's positions at the end of each day. As to the liaison desk and the house account, Silverman and Blumenfeld both testified that those individuals reported to directly to Purjes and Fitzgerald. (Sept. 12 Tr. at 49-50; Sept. 11 Tr. at 231-32, 241.)

Coon similarly testified that Purjes, Fitzgerald and Sheib directed his actions regarding trading in the house account. For example, only they could authorize him to accumulate a long position. As to other matters, he would look to Silverman and Blumenfeld. (Sept. 12 Tr. at 215-17.)

Likewise, Duggan testified that he reported to Fitzgerald, the person who hired him. (Sept. Tr. at 200.)

Fitzgerald's testimony at the hearing is contradicted in large part by the testimony he gave at his on-the-record interview on September 26, 1996. At the interview, Fitzgerald unequivocally stated that he supervised the liaisons and the house trader—Duggan, Rosenfeld and Coon.[17] With regard to their relationship to the proprietary trading desk, Fitzgerald explained that they worked alongside Silverman and Blumenfeld, not under them. Accordingly, if any one of them had an issue, he would

---

[17] In his interview, Fitzgerald candidly admitted that "loosely on an administrative basis" he looked to Duggan as the person running the liaison department, but he had never "formally established that, so [Duggan, Rosenfeld, and Coon] could come to [him] directly." (Ex. C007, at 16.)

take it to Fitzgerald, but, he added, they also could go to Purjes and Sheib, depending on who was available at the time. Fitzgerald further testified that this was not a formal reporting structure—"the system evolved that way." (C007, at 13, 16, 19.)

Upon consideration of the foregoing and the Hearing Panel's observation of the witnesses' overall demeanor, the Panel finds that Fitzgerald was primarily responsible for the supervision of trading at Josephthal, including the liaisons and the house trader. The Panel further finds that Fitzgerald, Purjes and Sheib jointly managed the Firm's trading strategies, and that Purjes controlled all significant trading decisions, such as the acquisition of a substantial inventory position in any particular stock. Although Purjes had started the process of turning the reins over to Sheib, Purjes still had the major stake in the Firm and he therefore maintained tight control over any decisions that placed his capital at risk.

C. The VictorMaxx IPO

VictorMaxx, a designer and seller of virtual reality products for home use, was listed on the Nasdaq SmallCap Market on August 10, 1995, when it completed its initial public offering ("IPO"). Josephthal was the managing underwriter for the VictorMaxx IPO. (Ex. C055 ¶¶ 38-39.)

Virtual reality is a computer-generated audio/visual environment where users experience the effect of immersion in a virtual world. Virtual reality was originally developed by the military and academic institutions as simulation (*i.e.*, pilot training) and research tools. VictorMaxx was an early entrant into the emerging market for virtual reality products designed for home use, principally video games played using a 3D headset. At the time of the IPO, VictorMaxx was the only publicly-traded company in the United States in the new virtual reality market. (Sept. 15 Tr. at 113-15; Ex. C035, at 14-19.)

In its IPO, VictorMaxx sold approximately 2.7 million shares of common stock at $6.00 per share and an equal number of warrants at $0.25 each.[18] Josephthal placed approximately 91% of the VictorMaxx IPO stock with its customers, with the remaining 9% allocated to other broker-dealers. VictorMaxx also filed a Form S-1 Registration Statement with the Securities and Exchange Commission ("SEC") to register an additional 1,146,271 shares ("the Selling Securityholder Shares") to be offered for sale pursuant to Rule 415 under the Securities Act of 1933. The Selling Securityholder Shares were subject to 13-month lock-up agreements; therefore, they were not available for sale on the open market without Josephthal's consent. According to Josephthal's records, by May 31, 1996, only 37,500 of the Selling Securityholder Shares had been released from the lock-up agreements and were thereby available for sale into the open market. (Ex. C019, at 3, 7; Ex. C055 ¶¶ 39-45; Ex. C056 ¶ 19; Ex. C057 ¶ 12.)

D. Josephthal's Trading and Market-Making Activities in VictorMaxx Stock

Following the IPO, Josephthal commenced research coverage of VictorMaxx. Josephthal published an initial research report in September 1995, which rated VictorMaxx as a "speculative buy." This was a recommendation to purchase the securities, but it recognized the high degree of risk involved because VictorMaxx was a new company in an emerging market. The initial research report was followed by research notes published in October and December 1995 and April 1996. The research reports and notes were disseminated to the Josephthal sales force. (Ex. C055 ¶ 53; Sept. 15 Tr. at 115, 119-20; Ex. C035.)

Josephthal continued research coverage of VictorMaxx from September 1995 through November 1996. This coverage was accomplished by, among other methods, frequent

---

[18] Each warrant entitled the holder to purchase one share of common stock at an initial exercise price of $7.20.

communications with VictorMaxx's management and following public press releases and reports relating to the company. In addition to distributing published research reports and notes, Josephthal's research analyst regularly communicated information relating to VictorMaxx to the Josephthal sales force on an informal basis, periodically making announcements about VictorMaxx over the Firm's internal announcement system (sometimes referred to as the "squawk box" or the "hoot and holler") and by distributing internal memoranda. The research analyst also had a few one-on-one discussions with Josephthal brokers concerning VictorMaxx. Throughout the period in question, the research department rated VictorMaxx stock as a "speculative buy." (Sept. 15 Tr. at 116-18, 120-22, 125; Ex's. J4–13, 32, 57.)

When VictorMaxx began trading after its IPO, Purjes, Josephthal's CEO, instructed the Firm's over-the-counter traders to accumulate VictorMaxx stock. Purjes had been intensely involved in bringing VictorMaxx public, in large part because he liked VictorMaxx's prospects but also because he was actively involved with new issues at the time. Not only had Purjes headed Josephthal's Corporate Finance Department from 1988 to 1993, but he also kept a close hand on new issues due to the great capital risk they involved in comparison to Josephthal's limited capital base. Fitzgerald, Josephthal's Senior Managing Director of Capital Markets, was also involved in the decision to accumulate VictorMaxx stock. (Sept. 11 Tr. at 237, 239-40; Sept. 14 Tr. at 125; 130-33; Sept. 15 Tr. at 61-66.)

From August 10, 1995 to early December 1995, the price of VictorMaxx stock declined steadily from the IPO price[19] to approximately $1.50 per share. By contrast, from March 1, 1996

---

[19] VictorMaxx traded as high as $6.75 on the first day of trading and closed that day at $5.50 per share. (Ex. C055 ¶ 42.)

through May 16, 1996, the price of VictorMaxx remained relatively stable, varying between $1.75 per share and $2.50 per share, and for the most part staying within a $.25 range of $2.00. (Ex. C055 ¶ 93; Ex's. C029–30.)

During the nine months that followed VictorMaxx's IPO, Josephthal was the dominant market maker[20] for its stock. Although there were several other firms making a market in the security, none was particularly active. As a result, Josephthal paid very little attention to them and did the lion's share of the trading itself. Josephthal was indeed the volume leader in VictorMaxx stock. Throughout that period, Josephthal's transactions averaged 64% of the total monthly volume in VictorMaxx stock, while the next closest broker-dealer accounted for only 11%. And, in May 1996, Josephthal accounted for nearly 86% of the sales volume and 46% of the purchase volume in VictorMaxx stock, while the next highest broker-dealer accounted for only 2.3% and 6.5% of the sales and purchase volume, respectively. Most of the time, Josephthal was the lead on both the bid and ask price for VictorMaxx. During this period, Josephthal dominated and controlled the market for VictorMaxx stock. (Ex. C055 ¶¶ 48, 51-52; Ex. C058 ¶¶ 6-8; Ex. C007, at 29, 31-32; Sept. 15 Tr. at 36.)

Josephthal tried to stabilize the price of VictorMaxx stock by keeping it as close to the offering price as it possibly could. However, there was not enough buying interest to do so. When customers wanted to sell, Josephthal often was their only choice. As a result, and in spite of its efforts to reduce its inventory, by the close of trading on May 15, 1996, Josephthal had incurred a

---

[20] To "make a market" means to maintain firm bid and offer prices in a given security by standing ready to buy or sell round lots at publicly quoted prices. A broker-dealer is called a market maker in the over-the-counter market and a specialist on the exchanges. Barron's Dictionary of Finance and Investment Terms 316 (4th ed. 1995).

realized loss of $2,509,454 on the VictorMaxx stock Josephthal had acquired as part of its usual market-making activities since the IPO in August 1995. Of these realized losses, $2,266,066 had been incurred by Josephthal in its fiscal year ending March 31, 1996, as a result of its trading activity (exclusive of underwriting account activity and error accounts activity) in VictorMaxx during the period from the August 1995 IPO through March 31, 1996. Josephthal incurred the remaining $243,388 of realized losses during the period from April 1 through May 15, 1996, as a result of its trading activity in VictorMaxx. Josephthal's unrealized loss on its opening position on May 16, 1996, of approximately 619,050 shares was approximately $167,067. Purjes knew the approximate amount of these losses. (Ex. C007, at 28-29, 32-33; Ex. C055 ¶¶ 83-84; Ex. C056 ¶ 33-36; C057 ¶ 25-28; Sept. 11 Tr. at 236-37; Sept. 12 Tr. at 53; Sept. 14 Tr. at 132.)

In September or October 1995, Purjes had authorized the transfer of 500,000 shares of VictorMaxx stock from Josephthal to its parent, Josephthal Holdings, Inc. ("Holdings"). At the close of trading on May 15, 1996, Holdings had an unrealized loss of approximately $1,128,125 on these shares. Holdings realized a portion of this loss when it later transferred 242,000 shares back to one of Josephthal's proprietary trading accounts. (Ex. C055 ¶¶ 78, 85; Ex. C056 ¶ 35; Ex. C057 ¶ 27.)

Josephthal's sales force did not sell a single share of VictorMaxx stock to the Firm's customers between May 1 and May 16, 1996. At the close of trading on May 16, 1996, Josephthal held a long position of 619,050 shares of VictorMaxx stock in one of its proprietary trading accounts. Holdings held an additional long position of 500,000 that same day. Three members of Josephthal's senior management— Purjes, Sheib, and Balk—held another 97,635 shares in their personal

accounts. Cumulatively, these shares equaled 44.45% of the public float.[21] According to Purjes, at that time VictorMaxx stock was Josephthal's only "substantial" position in inventory. (Ex. C006, at 30-31; Ex. C055 ¶¶ 57, 77-82; Ex. C056 ¶¶ 9, 27-31; Ex. C057 ¶¶ 23-24; Ex. C058 ¶ 9.)

E. Marketplace Blockage Charge on VictorMaxx Stock

Due to the size of Josephthal's VictorMaxx position, by the Spring of 1996, Josephthal had to take increasingly larger marketplace blockage charges[22] on its VictorMaxx holdings. For example, as of April 30, for net capital purposes Josephthal had to take a blockage charge of $1,191,031 on its VictorMaxx stock, which had a market value of $1,256,675. The size of the blockage charge led Purjes and Fitzgerald to view the VictorMaxx stock as having no value for net capital purposes.[23] As a result, Fitzgerald looked at the VictorMaxx position as "just another piece of inventory that we really didn't need to have." And, although Josephthal always had sufficient net capital, Purjes viewed the blockage charge as "a significant hit." (Ex. J23, at 22; Ex. C020, at 2; Ex. C007, at 35-36; Sept. 14 Tr. at 205-06, 211-22; Sept. 15 Tr. at 38-39.)

---

[21] The "float" is the number of shares of a corporation that are outstanding and available for trading by the public. Barron's Dictionary of Finance and Investment Terms 198 (4th ed. 1995)

[22] In calculating net capital, if a broker-dealer holds a significant position in a single security in relation to the liquidity of the security in the marketplace, the broker-dealer may have to take a marketplace blockage charge. When it is established that the marketplace can absorb only a limited number of a security's shares for which a ready market seems to exist, the non-marketable portion of that position is subject to a 100% deduction. The number of shares exceeding the aggregate of the most recent four-week inter-dealer trading volume should be considered non-marketable and subject to a 100% deduction, unless the broker-dealer can demonstrate that a ready market exists for these shares. Those securities purchased by the computing broker-dealer during the most recent four-week period are excluded from the determination of trading volume. *See* SEC Rule 15c3–1(c)(2)(vii).

[23] Josephthal was also under pressure from the NYSE to carry in inventory as little low-priced stock as possible.

F. The VictorMaxx Special—May 1996

1. Josephthal's Use of "Specials" to Propel Sales

At an impromptu gathering of Josephthal's senior management on May 16, 1996, which is discussed in detail below in subparagraph 2, the decision was made to run a "special" on VictorMaxx stock. The term "special" at Josephthal referred to the practice of offering securities from inventory to the sales force at a discount as a sales incentive. Where an offering of stock was subject to a "special," the brokers had an opportunity to earn higher than normal compensation. (Sept. 14 Tr. at 161; Sept. 15 Tr. at 8-9, 42, 57.)

The use of "specials" or sales credits to encourage the sales force was fairly common at Josephthal—particularly for house stocks. Both Purjes and Fitzgerald were aware of the practice and viewed it as a proper device to encourage the sales force to push slow-moving inventory. Indeed, anytime a "special" was offered to the sales force, it first had to be approved by senior management. Purjes and Fitzgerald testified that when Josephthal was acting as a principal and selling stock, the stock generally was available to the brokers at the offer, or between the mid-point in the spread and the offer, and that a "special" made stock available to the brokers between the bid and the mid-point in the bid-offer spread. (Sept. 14 Tr. at 161-62, 224, 239; Sept. 15 Tr. at 79.)

2. Authorization of VictorMaxx Special

The VictorMaxx Special that precipitated the burst of selling by a number of Josephthal's brokers in May 1996 originated with the May 16 meeting in Sheib's office. Although there was considerable testimony and disagreement regarding the details of this meeting, in

substance everyone agreed that the idea and authorization for the VictorMaxx Special came out of this meeting.[24]

As was the custom at Josephthal, several of Josephthal's senior managers had gathered in Sheib's office at the end of the day. The original participants were Purjes, Fitzgerald, Sheib, Larkin, and Weissman. The main topic of conversation was the Israeli stock conference that Purjes had hosted that day. On his way out of the office, Balk popped his head in the door to Sheib's office, at which point someone asked him what was going on. He responded that "a number of brokers had called [him] recently and said they were a little bit upset they had no IPOs, no private placement, no house products of any sort coming out of banking." (Sept. 12 Tr. at 82.) Balk then questioned whether there was anything in the pipeline. At that point an unidentified person suggested that VictorMaxx be "made available" to the brokers. By this the participants understood that they were talking about making VictorMaxx stock available to the brokers with a credit. In other words, they understood that VictorMaxx was to be offered as a "special." (Sept. 12 Tr. at 82-85; Sept. 14 Tr. at 155-161, 166; Sept. 15 Tr. at 14-17; Ex. J31.)

At the time the suggestion was made to offer VictorMaxx stock to the sales force as a special, Purjes and Fitzgerald both knew that Josephthal:

1) had accumulated a large position in the stock over the past nine months (which Fitzgerald knew was about 30% to 40% of the float);[25]

2) had no meaningful inventory at that time in any other stock;[26]

3) had lost more than $2.5 million trading that stock;[27]

[24] The participants had not planned to discuss VictorMaxx. Indeed, there was no agenda for the meeting at all. (Sept. 12 Tr. at 141-43; Sept. 14 Tr. at 158; Sept. 15 Tr. at 14-16, 35.)

[25] Ex. C056 at ¶ 36; Ex. C057 at ¶ 28; Ex. C006 at 15-16, 31; Ex. C007 at 45, 51; Sept. 14 Tr. at 193; Sept. 15 Tr. at 37.

[26] Ex. C006 at 16; Sept. 14 Tr. at 195-96.

4) had, together with Holdings, another $1.3 million in unrealized losses on their positions;[28]

5) had written off its VictorMaxx stock holdings for which it was getting no capital credit;[29] and

6) was in a position to dominate and control trading in VictorMaxx stock.[30]

There is little agreement about what transpired at the meeting once the suggestion was made to make VictorMaxx stock available to Josephthal's sales force. According to Balk, a short discussion ensued about offering the stock to the sales force at or below the bid, which at the time was $1.75 per share. Balk believed Sheib, who was sitting at his desk in front of his Quotron, suggested offering the stock to the sales force with a credit of a quarter point off the bid. To Balk's best recollection they discussed offering the stock at $1.50 before finally settling on $1.75. (Sept. 12 Tr. at 85-86.)

Purjes and Fitzgerald deny Balk's account. Purjes testified that he could not recall many specifics about the meeting on May 16. Generally, he recalled that they were discussing the Israeli stock conference when Balk arrived. Balk then commented that technology issues were hot, but there was a lack of product for the brokers to sell. In response, someone suggested VictorMaxx. Purjes said that shortly thereafter Balk left without speaking to him about VictorMaxx. According to Purjes, he did not react to the suggestion of a special for VictorMaxx because in the past the specials had not generated much interest. According to Purjes, he would have expected to sell no more than 25,000 to 50,000 shares. (Sept. 14 Tr. 159-60, 173, 227-28.)

---

[27] Ex. C055 at ¶¶ 84-86; Ex. C056 at ¶¶ 34-36; Ex. C057 at ¶¶ 26-28.

[28] Ex. C055 at ¶¶ 84-86; Ex. C056 at ¶¶ 34-36; Ex. C057 at ¶¶ 26-28.

[29] Ex. C006 at 57; Ex. C007 at 35-36; Sept. 14 Tr. at 203; Sept. 15 Tr. at 38, 40.

[30] Ex. C006 at 32-33, 59; Ex. C007 at 29, 31-32, 34, 61-62, 65; Sept. 15 Tr. at 36.

Fitzgerald testified similarly. He also could not recall many details of the meeting, but he was able to confirm that Balk made the comment that there was no product available for the brokers to sell. Apart from that he did not recall anything more being said about VictorMaxx. He cannot remember whether he left the meeting before Balk. (Sept. 15 Tr. at 16-19.)

In contrast to his testimony at the hearing, at his on-the-record interview in 1996 Fitzgerald testified that the group did discuss the VictorMaxx special in some detail, including the price at which they were willing to sell it. Specifically, when asked during the investigation who authorized the VictorMaxx special, Fitzgerald answered as follows:

> [W]e kind of collectively decided that where we were—where we were willing to sell it and then said to Mathew [Balk], go out and see if you can drum up some interest on it from the sales force. (Ex. C007, at 40-41.)

Likewise, the testimony is conflicting concerning what happened following the suggestion that VictorMaxx be made available to the sales force. Balk says that Purjes left to go next door to his office and that Balk followed him because he wanted to confirm that Purjes was truly interested in offering VictorMaxx stock to the sales force and, if so, how much stock he would authorize to be made available. Balk testified that he and Purjes had a short discussion in Purjes' office during which Purjes asked Balk whether he thought the sales force would have any interest in selling VictorMaxx stock if it was made available to them at the bid. When Balk expressed skepticism, Purjes asked him whether the sales force would have more interest in selling the stock if it was made available at a quarter point off the bid (*i.e.*, $1.50 per share). Balk replied, "Clearly . . . the cheaper the stock is the more attractive it would be." Balk claims that Purjes then told Balk to offer the sales force the stock at $1.50 per share and to start with the VictorMaxx stock in the Firm's trading account—which Balk knew to be a substantial amount. If there was a strong selling interest, Purjes told Balk to let him

know, as more shares were available in another account. When they finished their conversation, Balk says that they returned to the meeting in Sheib's office and that a few minutes later the meeting broke up. (Sept. 12 Tr. at 86-89, 155.)

Balk further testified that as the meeting broke up he stepped out into the hall and asked Fitzgerald if he thought there would be a problem in selling the VictorMaxx stock with such a large credit. Balk did not recall Fitzgerald's response. But Balk further testified that he asked both Fitzgerald and Sheib to "check it out." Purjes and Fitzgerald both flatly deny that any conversations with Balk took place following the initial discussion in the meeting. (Sept. 12 Tr. at 89-90; Sept. 14 Tr. at 160-63, 173, 198-99.)

Balk next testified that the following day, May 17, before he announced the VictorMaxx Special to the sales force over the Firm's hoot and holler system, he went to Fitzgerald and Sheib to verify that he should proceed. Balk claims that Fitzgerald told him that he did not see anything wrong, and Sheib said he had checked it out. From this, Balk concluded that he could proceed with the VictorMaxx Special. (Sept. 12 Tr. at 94, 163-67.)

The Panel finds the more credible version of events to be that the size of the sales credit was discussed at least briefly on May 16 because neither Balk nor the traders had the authority to authorize a special. This is particularly true of Coon, the house trader, who had no independent authority whatsoever and verified all trading decisions with Purjes or Fitzgerald. All of the credible evidence supports Balk's contention that Purjes and Fitzgerald approved the amount of the sales credit before Balk announced the VictorMaxx Special on May 17.

3. Announcement of VictorMaxx Special

Once Balk had the necessary approval for the VictorMaxx Special, Balk released the news to the sales force. First, Balk went to the trading room and told Duggan, the liaison trader assigned to VictorMaxx, that he could offer VictorMaxx stock to the registered representatives at $1.50 per share (a quarter point off the bid). Next, Balk went back to his office and announced over the hoot and holler system that a special was available, and that those office managers who were interested should call him for more details. Balk testified that he limited the announcement in this manner so that he would not be deluged with phone calls from the sales force. As the managers called, Balk reiterated what he previously told Duggan—that VictorMaxx stock was available to the sales force, below market, at $1.50 per share. The gross sales credit was the difference between $1.50 and the selling price. (Sept. 12 Tr. at 99-101, 167-69.)

Fitzgerald was immediately informed by Duggan that the VictorMaxx Special was being rolled out to the sales force.[31] Duggan told Fitzgerald the details of the VictorMaxx Special "to make sure he [was] aware of it." Duggan explained his reason for reporting to Fitzgerald as follows:

> Q. This sales credit on VictorMaxx, did you discuss the sales credit on VictorMaxx with anyone else at the firm?
>
> A. When I was made aware of it, I just mentioned it to Mr. Fitzgerald this is what the special was going to be offered to make sure he would be aware of it. And just to, again, perform my function, I guess, as liaison to provide information.
>
> Q. Why would you mention this to Mr. Fitzgerald?

[31] Fitzgerald admits that he knew about the VictorMaxx "special" while it was still going on. (Sept. 15 Tr. at 54-55.)

A. He was, again, the gentleman who hired me. I thought he should be aware.

(Sept. 12 Tr. at 205.)

4. Impact of the VictorMaxx "Special"

The impact of the VictorMaxx special was immediate and dramatic. Unlike the specials that had been run on VictorMaxx over the preceding four to five months when little or no stock was sold, in this instance the considerable sales credit caused a stampede. On the first day alone, May 17, 1996, Josephthal sold 348,950 shares of VictorMaxx—12.75% of the float—to its customers. In total, between May 17 and May 31, 1996, Josephthal's sales force sold 988,475 shares of the stock in approximately 414 transactions. This amounted to more than 36% of the float, and, in terms of trading volume, more than 750% of the total monthly volume in VictorMaxx for all broker-dealers in April 1996. In comparison to the total monthly volume for all other broker-dealers in May 1996, Josephthal's volume was almost 500% greater. The magnitude of Josephthal's selling efforts also is demonstrated by comparing Josephthal's average daily retail volume of VictorMaxx stock with the average daily volume for all other broker-dealers of VictorMaxx stock. Josephthal's average daily retail volume of VictorMaxx stock between May 17 and May 31, 1996, was 1500% greater than the average daily volume for all other broker-dealers for the previous six weeks. (Sept. 12 Tr. at 102, 177, 206; Sept. 15 Tr. at 97; Ex. C023, at 48; Sept. 11 Tr. at 94-95, 108-09; Ex. C055 ¶¶ 60-61, 63-64; Ex. C058 ¶¶ 11-15; Ex. C021, at 19-21; Ex. C027; Ex. C027A; Ex. C028.)

The VictorMaxx Special dramatically affected Josephthal's capital position. As a result of the special, Josephthal successfully sold its entire inventory position of VictorMaxx stock, and more than half of what was in Holdings' account. The May sell off of VictorMaxx stock freed up

$1,191,031 in capital for which Josephthal received no credit the previous month. In other words, Josephthal had a 55% increase in its net capital position as a result of the VictorMaxx Special. (Ex. C055 at ¶¶ 60-61; Ex. C058 at ¶¶ 11-12; Ex. J23 at 3; Ex. J29; Sept. 14 Tr. at 206-07, 274-75.)

G. Commissions and Selling Practices

Balk told the sales managers that the sales force could get VictorMaxx at $1.50 per share (a quarter point off the bid). (Sept. 12 Tr. at 99-101, 167-69.) Thus, the brokers who chose to participate in the VictorMaxx Special knew, up front, that the gross sales credit was everything above $1.50 per share.

Between May 17 and 31, 1996, Josephthal's customers who bought VictorMaxx stock paid an average of $2.10 per share, and the average gross sales credit was $0.54 per share. This gross sales credit averaged 26% of the customers' total investment in VictorMaxx stock. At times the gross sales credit rose to as high as $0.75 on customer purchases executed at $2.25 per share, which equates to a 33% gross sales credit. The average gross sales credit of $0.54 per share at all times exceeded the inside spread for VictorMaxx stock reflected on the Nasdaq. So, too, did the average net sales credit the registered representatives were actually paid. The exact amount the registered representative received depended on his or her payout schedule with Josephthal. On average, however, the payout amounted to approximately 50% of the gross sales credit.[32] (Ex. C036; Sept. 11 Tr. at 120, 155-56, 158-59, 177-78, 188, 208-10; Sept.12 Tr. at 12; Sept. 14 Tr. at 56.)

A sampling of Josephthal's commission records illustrates the extent to which the VictorMaxx sales credit exceeded commissions paid by the Firm for other securities transactions

[32] Many of the registered representatives received payouts ranging from 50% to 75% of the gross sales credit. (Sept. 11 Tr. at 159.)

during May 1996. (Ex. C036; Ex. C037.) Josephthal paid no other commission in May 1996 that, as a percentage of the customer's total investment, exceeded 10%. (Ex. C037.)

None of the selling brokers told their customers about the VictorMaxx Special sales credit, and Josephthal's trade confirmations did not disclose it. Indeed, the trade confirmations indicated that Josephthal sold the stock to the customer at the reported price without including any mark-up.[33] The Josephthal brokers also did not advise their customers of the extent of the sales campaign that was underway or of the volume of sales being generated by the inordinately high commission. The evidence also established that neither Purjes nor Fitzgerald did anything to restrain the selling brokers or to assure that Josephthal's customers were receiving accurate, relevant information about VictorMaxx. They both admit that they saw no need to instruct the selling brokers of the unusually high credit, and, therefore, they did nothing. As explained by Josephthal's in-house counsel in a letter sent to the NASD during the investigation that led up to the filing of the Complaint in this matter, "compensation to the registered representative was a matter between the registered representative and the firm and not material to customers." (Ex. C038; Sept. 11 Tr. at 123-24; Ex. C055 at ¶ 69; Ex. C058 at ¶ 20;. Sept. 14 Tr. at 9-10, 24, 34-35, 46; Sept. 15 Tr. at 44-46; Ex. C006, at 33-36; Ex. C007, at 51-54, 61-63; Ex. C019, at 4.)

Stimulated by the prospect of earning the extraordinarily large sales credit, many of Josephthal's brokers who sold VictorMaxx stock in May 1996 made affirmative misrepresentations

---

[33] The Hearing Panel notes that the copies of the customer account statements that Josephthal received from its clearing house, Bear Stearns, referenced the sales credits, while the copies of the account statements that were sent to the customers did not. (Sept. 11 Tr. at 137-40.)

and engaged in other high pressure sales tactics. The customer questionnaires[34] (Ex. C045) the Department collected reveal striking similarities in the methods employed in making these solicited transactions. For example, numerous customers reported that their broker made unwarranted price predictions. Customers were told such things as: VictorMaxx "was a can't miss stock that would at least double in the next few months;"[35] the "stock should double within one year and triple shortly after that;"[36] VictorMaxx stock was "poised to move to the $5-$6 range;"[37] the "firms [sic] analysts expect stock price to go into the $8 to $10 range by the end of 96;"[38] VictorMaxx stock was "a sleeper that would go to $20.00 in no time;"[39] and because of the company's technology, it was a "home run."[40] Some registered representative even alluded to impending news, not yet released, that

---

[34] The Respondents opposed the introduction of the customer questionnaires (Ex. C045) on the grounds that they contained unreliable hearsay. The Respondents argued that the customers' responses were shaped by the manner in which the Department posed the questions. In further support of their argument that the responses were fabricated to enable the customers to recover their lost investments, the Respondents point out that none of the customers complained at the time the trades were made. All of their complaints arose after the Department informed them of the size of the sales credit on the VictorMaxx transactions. The Panel overruled the Respondents' objections in part and admitted the questionnaires into evidence. The Panel agreed with the Respondents that the responses relating to the size of the sales credit were unreliable because the introductory paragraph directed them to answer the questions on the basis that the registered representative "earned a sales credit of $.50 per share." This statement is incorrect, as the registered representative did not receive the entire amount of the sales credit. Accordingly, the Panel disregarded the responses to question 5, which asked the customers to indicate if their decision to purchase VictorMaxx stock would have been influenced if the registered representative had told them that he or she would receive a sales credit of $.50 per share on the purchase. Cf. District Bus. Conduct Comm. Dist. No. 2 v. Gallison, No. C02960001, 1999 NASD Discip. LEXIS 8, at *11-13 (N.A.C. Feb 5, 1999) ("hearsay statements may be admitted as evidence and may, under certain conditions, form the sole basis for findings of fact").

[35] Ex. C045, at 112.

[36] Id. at 193.

[37] Id. at 28; Sept. 14 Tr. at 21-22.

[38] Ex. C045, at 248.

[39] Id. at 179.

[40] Id. at 265.

would cause the price of the stock to go up.[41] These predictions were baseless. VictorMaxx was a speculative security, and there was no available news relating to VictorMaxx or any sudden market demand for VictorMaxx stock that would have justified these predictions.

Many of the customers also complained that the brokers were "pushy" and "aggressive"[42] or that they used "high pressure" sales tactics.[43] Other customers indicted that Josephthal's sales force bought VictorMaxx in their accounts without their authorization.[44] And in some instances, the customers indicated that their broker sold securities out of their account without authorization to finance the purchase of VictorMaxx stock.[45] The customer questionnaires further indicate that in some instances the brokers not only did not disclose the extraordinary sales credit, but they affirmatively represented that there would not be any commissions charged on the trades,[46] or the brokers represented that they would charge a reduced commission.[47] Finally, some customers reported that, when they later tried to sell their VictorMaxx stock, their registered representatives refused to take their calls or follow their instructions.[48]

The foregoing facts demonstrate that there were widespread sales abuses accompanying the VictorMaxx Special in May 1996.

---

[41] See, e.g., Ex. C045, at 4, 43, 154.

[42] See, E.g., Id. at 295, 308, 314; Sept. 14 Tr. at 22.

[43] Ex. C045, at 122; Sept. 14 Tr. at 22.

[44] E.g. C045, at 37, 64, 96, 101, 136, 185, 195, 208, 216-218, 225, 239, 256, 261, 267, 273, 292, 301, 310, 312, 324. See also Sept. 14 Tr. at 6, 9, 14, 54-55, 64-65.

[45] Ex. C045, at 37, 96, 216.

[46] Id. at 12, 14, 46, 72, 81, 109, 179, 231, 248, 269; Sept. 14 Tr. at 65.

[47] Ex. C045, at 134, 154, 191, 213; Sept. 14 Tr. at 35, 65.

[48] Ex. C045, at 33, 298.

H. VictorMaxx Trading After the Special

The price of VictorMaxx stock remained relatively stable throughout the period of the VictorMaxx Special. The inside bid reached a high of $2.125 per share (never falling below $1.75 per share), and the inside offer reached a high of $2.25 per share (never falling below $1.96875 per share). Shortly thereafter, however, unwilling to accumulate a substantial position once again, Josephthal allowed the price of VictorMaxx stock to fall. As Josephthal's counsel candidly stated: "One thing of course which Josephthal was no longer willing to do was to accumulate another one million shares of stock."[49] As a result, although Josephthal continued to make a market in VictorMaxx stock,[50] by the end of June 1996, the bid had fallen to $0.875 per share. (Ex. C055 at ¶¶ 70, 72; Sept. 15 Tr. at 45.)

On October 24, 1996, VictorMaxx was delisted from the Nasdaq SmallCap Market because it did not meet the maintenance criteria for continued listing. At the time of the hearing, it was traded on the pink sheets;[51] however, there were no quotations for the stock. According to NASD Regulation Staff's profit and loss schedule for each customer that purchased VictorMaxx during the May 1996 distribution, Josephthal's customers lost $1,478,789.65 on their investment in VictorMaxx.[52] (Ex. C055, at ¶ 76; Sept. 11 Tr. at 125-27; Ex. C039.)

---

[49] Ex. C018, at 11.

[50] Josephthal continued to dominate trading in VictorMaxx for three months following the end of the VictorMaxx Special, reporting a total of 626,820 shares—70% of the total reported volume. (Ex. C022; Sept. 11 Tr. at 91.) During June's rapid price decline, Josephthal shared or held the sole inside bid for approximately 87.78% of the time. (Ex. C055, at ¶ 75.)

[51] The "pink sheets" are a daily publication of the National Quotation Bureau that details the bid and asked prices for over the counter (OTC) stocks. The pink sheets give current prices the listed stocks and the market makers who trade each stock. Barron's Dictionary of Finance and Investment Terms 419 (4th ed. 1995).

[52] Ten customers sold at a profit, making a little more than $400. (Sept. 11 Tr. at 127.)

IV. CONCLUSIONS OF LAW

A. Rule 10b-6 Violations—Cause One of the Complaint

Rule 10b-6 was promulgated by the SEC under Section 10(b) of the Exchange Act, and was intended to assure prospective investors in a securities offering that the price of the offering had not been influenced improperly by persons with a significant interest in the success of the offering. See, e.g., SEC v. Blinder, Robinson & Co., 542 F. Supp. 468, 477 (D. Colo. 1982), aff'd,748 F.2d 1415 (10th Cir. Colo. 1984), cert. denied, 471 U.S. 1125 (1985). It was an anti-manipulation rule intended to prevent persons participating in a distribution of securities from artificially conditioning the market and to protect the integrity of the market as an independent pricing mechanism.[53] See Review of Antimanipulation Regulation of Securities Offerings, Exchange Act Release No. 33,924 (Apr. 19, 1994). Rule 10b-6 prohibited persons or entities engaged in a "distribution" of securities from bidding for or purchasing for their own account the security being distributed until after the completion of the distribution or from attempting to induce other persons to purchase the security being distributed.[54] To find a violation of Rule 10b-6, the Panel must find that Josephthal participated in a distribution of securities and, at the same time, purchased or bid for the securities. See, e.g., District Bus. Conduct Comm. Dist. No. 10 v. A.S. Goldmen & Co., Inc., No. C10960208, 1999 NASD Discip. LEXIS 18, at *24 (NAC May 14, 1999).

---

[53] The SEC adopted a comprehensive revision of Rule 10b-6 that became effective on March 4, 1997. These revisions made Rules 101 and 102 under Regulation M successor rules to Rule 10b-6. See Anti-Manipulation Rules Concerning Securities Offerings, Exchange Act Release No. 38,067 (Dec. 20, 1996). Since the conduct at issue here occurred prior to the effectiveness of the revisions, Rule 10b-6 is applicable in the present case.

[54] The provisions of Rule 10b-6 applied to issuers, selling shareholders, underwriters, prospective underwriters, dealers, brokers, and other persons who have agreed to participate or are participating in the distribution, as defined in Rule 10b-6(c)(5), and their "affiliated purchasers," as defined in Rule 10b-6(c)(6), including broker-dealer affiliates.

The Parties stipulated that throughout the period May 17 to 31, 1996, Josephthal maintained two-sided quotes for VictorMaxx stock in the Nasdaq SmallCap Market and, in its capacity as a market maker, continued to bid for and purchase VictorMaxx stock from other dealers. (Ex. C055 at ¶ 66.) Accordingly, the central issue is whether Josephthal was at the same time engaged in a distribution of VictorMaxx stock.

1. Distribution

Rule 10b-6(c)(5) defined a distribution as an offering of securities distinguished from ordinary trading transactions by the "magnitude" of the offering and the presence of "special selling efforts and selling methods." To constitute a distribution, both elements must be present. The SEC has indicated that "the definition of distribution must remain flexible to permit the protections afforded by Rule 10b-6 'to evolve with changes in the practices and methods of offering securities.'" A.S. Goldmen, 1999 NASD Discip. LEXIS at *25 (quoting Exchange Act Release No. 33,924). "The term 'distribution' is to be interpreted 'in light of [Rule 10b-6's] purposes as covering offerings of such a nature or magnitude as to require restrictions upon open market purchases by participants in order to prevent manipulative practices.'" Id. (quoting Billings Associates, Inc., 43 S.E.C. 641, 648 (Dec. 28, 1967).

(a) Magnitude

The SEC has stated that the factors relevant to the magnitude element include: "the number of shares for sale, the trading volume that those shares represent, the percentage of outstanding shares, and the public float." A.S. Goldmen, 1999 NASD Discip. LEXIS at *25 (quoting Exchange Act Release No. 33,924).

Here, it is uncontested that the volume of sales between May 17 and May 31, 1996, was sufficient to meet the magnitude element. VictorMaxx stock was a thinly traded security,[55] which had drawn little interest by Josephthal's sales force in the period immediately preceding the period in question. In fact, between May 1 and May 16, 1996, Josephthal had no sales of VictorMaxx stock. However, once the VictorMaxx Special was announced, Josephthal's sales force was able to sell Josephthal's entire inventory position in less than a week. Indeed, Josephthal ended up with a short position of 277,000 shares, which it partly covered by transferring stock from the holding company back to Josephthal's proprietary account. Over the two-week period, Josephthal sold 988,475 shares in 414 transactions. The 988,475 shares represented more than 36% of the public float. On the first day alone, Josephthal's sales force sold almost 12.75% of the float.[56] The Panel finds that Josephthal's sales effort satisfied the magnitude element of Rule 10b-6. See A.S. Goldmen, 1999 NASD Discip. LEXIS at *26.

(b) Special Selling Efforts and Selling Methods

The Panel also finds that the evidence shows clearly that Josephthal employed special selling efforts and selling methods. Contrary to the Respondents' assertions, there was nothing ordinary about the VictorMaxx Special and the frenetic effort Josephthal's sales force mounted on May 17, 1996, to push VictorMaxx stock out to their customers. The SEC has stated that "[t]he presence of special selling efforts and selling methods may be indicated in a number of ways, including the payment of compensation greater than that normally paid in connection with ordinary trading

[55] Billings Associates, Inc., 43 S.E.C. at 641 (thin trading by other market makers relevant to deciding whether there was a distribution). Purjes and Fitzgerald knew the stock was thinly traded. (Sept. 14 Tr. at 197; Ex. C018, at 5-6.)

[56] Cf. First Albany, 50 S.E.C. 890 (1992) (9.5% of the outstanding shares constituted sufficient magnitude).

transactions." Prohibitions Against Trading By Persons Interested In A Distribution, Exchange Act Release No. 34-19565, 1983 SEC LEXIS 2274, at *12 n.13 (Mar. 4, 1983); see also A.S. Goldmen, 1999 NASD Discip. LEXIS at *29. The SEC also has found evidence of special selling efforts when a firm's sales force has been mobilized to sell a particular stock.[57] For example, in First Albany the SEC found evidence of special selling efforts when, as part of the daily announcements to the branch offices, representatives from First Albany's research and trading departments described the stock; referred to the research report that had been distributed to the firm's registered representatives by that date; informed the firm's registered representatives that the firm had a substantial position in the stock; and advised the registered representatives of the desirability of selling the stock. First Albany, 50 S.E.C. 890 (1992).

In the present case, Josephthal mobilized the sales force through the creation and announcement of the VictorMaxx Special, which was intended to, and did, induce the sales force to market VictorMaxx stock aggressively. Ultimately, a significant portion of Josephthal's sales force joined the resulting selling effort, including Sheib, Josephthal's President. The evidence further demonstrates that the brokers knew that they could get as much VictorMaxx stock as they could sell at $1.50 per share and that there was no restriction on the price for which they could offer the stock. Many brokers entered unauthorized trades and engaged in high pressure and fraudulent sales tactics typically associated with "boiler room"[58] operations, including making baseless price predictions. The sales force also did not disclose any of the material facts regarding the extraordinary nature of the

---

[57] The SEC views "any major sales campaign" as a distribution. Exchange Act Release No. 33,924.

[58] A "boiler room" is defined as a "place where high-pressure salespeople use banks of telephones to call lists of potential investors (known in the trade as sucker lists) in order to peddle speculative, even fraudulent,

compensation they would receive on the sale of VictorMaxx stock or that the Firm was in a position to dominate and control the market for VictorMaxx stock. Indeed, in some instances, the brokers misrepresented the nature of the compensation they would receive. Using these tactics, the sales force was permitted to generate a large short position that was covered, in part, by the transfer of shares from the holding company. The combination of these factors provides compelling evidence that Josephthal engaged in special selling efforts and selling methods with respect to VictorMaxx stock.

2. Josephthal Violated Rule 10b-6

Because the VictorMaxx sales effort in May 1996 satisfied the two characteristics of a distribution (magnitude and special selling efforts and methods), the Panel concludes that Josephthal, through the participation of Purjes and Fitzgerald, engaged in a distribution of VictorMaxx shares in violation of Rule 10b-6.

The Respondents argued that even if the Panel finds that Josephthal engaged in a distribution of VictorMaxx stock, they cannot be found to have violated Rule 10b-6 absent proof of scienter. The Respondents relied on the opinion in SEC v. Burns, 614 F. Supp. 1360 (S.D. Cal. 1985), aff'd, 816 F.2d 471 (9th Cir. 1987). In Burns the court relied on the fact that Section 10(b) of the Exchange Act was one of the statutory authorities under which the SEC promulgated Rule 10b-6. The court also relied on the Supreme Court's decisions in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), and Aaron v. SEC, 446 U.S. 680 (1980), which rejected the SEC's argument that Rule 10b-5 (also promulgated under Section 10(b)) did not require proof of scienter. The Supreme Court held that because scienter was a statutorily–defined element of Section 10(b), a rule enacted under Section

---

securities. They are called boiler rooms because of the high-pressure selling." Barron's Dictionary of Finance

10(b) must itself require proof of scienter. Under the holdings of Hochfelder and Aaron, the Burns court reasoned that Rule 10b-6 also must require proof of scienter. See Burns, 614 F. Supp. at 1363.

The Department countered that the Supreme Court has not yet ruled on whether scienter is a required element under Rule 10b-6, and that Burns is the only case that has so held. The Department instead points to a number of SEC decisions in which it claims that the SEC has taken the position that when Rule 10b-6 applies, its prohibitions are absolute.[59] Thus, according to the Department, scienter is not required.

The Panel need not resolve this conflict, however, because, as discussed in the following section, the evidence is sufficient to support a finding that the Respondents acted with scienter.

3. Purjes and Fitzgerald Violated Rule 10b-6

Purjes and Fitzgerald portray themselves as victims of Balk's misconduct surrounding the VictorMaxx Special and his false testimony at the hearing. They also strenuously portray themselves as having absolutely no knowledge of the details of the VictorMaxx Special and the ensuing trading that it set in motion. In summary, each attempted to divorce himself from any participation in the trading in Josephthal's house account, including specifically the secondary distribution of VictorMaxx stock between May 17 and May 31, 1996. The Panel rejects their arguments. For the reasons discussed below, the Panel determines that Purjes and Fitzgerald were intimately involved in Josephthal's trading and market making activities—including the VictorMaxx Special and the resulting distribution. Indeed, the evidence demonstrates that Purjes and Fitzgerald collectively made all of the decisions regarding trading in the house account and that they were the only ones who had

---

and Investment Terms 54 (4th ed. 1995).

[59] See, e.g., Jaffee & Co., 44 S.E.C. 285 (1970), aff'd in relevant part and vacated in part sub nom. Jaffee & Co. v. SEC, 446 F.2d 387 (2d Cir. 1971).

the authority to suspend Josephthal's normal market-making activity once the distribution commenced in order to comply with Rule 10b-6.

The evidence demonstrates that Purjes had an intense involvement with VictorMaxx that started with the IPO. He was actively involved in taking VictorMaxx public in part because he took an interest in the company. Purjes personally made the decision to accumulate VictorMaxx stock over the nine months following the IPO. His interest in VictorMaxx continued through the distribution in May 1996. Purjes was the principal at Josephthal who signed the letters that released VictorMaxx shares from the lockup agreements. Purjes, along with Fitzgerald, authorized the transfer of VictorMaxx from the proprietary trading desk to the house account once interest in VictorMaxx dried up. And, once it was in the house account, he and Fitzgerald directly oversaw all trading in the stock. The house traders—Confessore and Coon—did nothing more than monitor activity in the stock and report to Purjes and Fitzgerald. As Coon described it, he was just "babysitting" the stock for Purjes and Fitzgerald. Purjes also was personally involved in the earlier unsuccessful attempts to reduce Josephthal's inventory position by inducing the sales force with smaller sales credits. Without question, Purjes and Fitzgerald controlled the trading of VictorMaxx stock in the house account. There is no credible evidence that Balk or the house traders had any independent authority regarding the trading of VictorMaxx stock.

In addition to controlling the trading of VictorMaxx stock, in May 1996, Purjes and Fitzgerald were well aware of the deteriorating market for VictorMaxx stock and Josephthal's dominant inventory position. They also both knew that the Firm was receiving very little capital credit for the stock and that it would be in the Firm's and their best interests to reduce the VictorMaxx inventory position, which was the largest position Josephthal carried at the time. As discussed in the findings of

fact above, in May 1996, Purjes and Fitzgerald knew that Josephthal: (i) had accumulated a significantly large position in VictorMaxx stock; (ii) had no other significant inventory position; (iii) had lost more than $2.5 million trading the stock; (iv) had, together with Holdings, another $1.3 million in unrealized losses on their positions; (v) had written off the stock for capital credit purposes; (vi) was in a position to dominate and control trading in the stock; and (vii) had been a market maker in the stock since the IPO.

The Panel rejects Purjes and Fitzgerald's professed ignorance.[60] The evidence demonstrates that Josephthal's inventory position was being depleted rapidly. (Sept. 15 Tr. at 43-44.) Fitzgerald could see this from his routine review of Josephthal's inventory positions, and he heard about it from conversations in the office. (Ex. C007, at 46.) Fitzgerald's assertions at the hearing that he paid no attention to the sell-off and that he attached no significance to it are unbelievable. The Panel finds it equally unbelievable that Purjes and Fitzgerald did not know that the VictorMaxx inventory position

---

[60] Purjes' and Fitzgerald's lack of credibility is demonstrated by reviewing the breadth of evidence the Panel would have to reject in order to accept their testimony. The overwhelming weight of the evidence contradicts their claim of ignorance. Indeed, to credit their testimony, the Panel would have to reject a significant amount of the largely corroborated or uncontested evidence. The Panel would have to believe that Purjes was completely unaware of and divorced himself from the VictorMaxx distribution, despite a history of intimate involvement with the stock. The Panel would also have to conclude that Duggan, a salaried trader, was able to dispose of 619,050 shares of VictorMaxx—Josephthal's largest position—and sell short 277,000 more during a two-week sell-off, with a "special" that offered the stock to the sales force at a quarter point below the bid, without Purjes or Fitzgerald knowing about it. To believe Purjes' and Fitzgerald's version of the facts, the Panel also would have to disregard the largely unchallenged and corroborated testimony of Silverman, Blumenfeld, Confessore, Duggan, and Coon—testimony pointing to Purjes and Fitzgerald as the principals responsible for trading house stocks, including VictorMaxx, as well as Balk's consistent, although disputed, testimony. The Panel also would have to disregard Fitzgerald's sworn investigative testimony given on September 26, 1996 (four months after the VictorMaxx distribution), wherein he said the liaison desk (which included traders Duggan and Coon) was outside of Silverman's and Blumenfeld's supervision and reported directly to himself. The Panel would also have to credit Purjes' and Fitzgerald's testimony at the hearing, where, for the very first time, they accused Balk as the principal responsible for the VictorMaxx Special. At no time during the investigation or the pre-hearing phase of this case did the Respondents offer this version of events. Finally, to accept Purjes' and Fitzgerald's hearing testimony, the Panel would have to disregard Fitzgerald's investigative testimony wherein he stated that the decision to sell VictorMaxx, including the price at which the stock was to be offered to the brokers, was a collective decision of management.

had been released to the sales force substantially below the bid. At the very least, the dramatic burst of selling activity should have put Fitzgerald on inquiry notice. As the head of trading, Fitzgerald was obligated to investigate this sensational turn of events—particularly in light of the fact that Coon reported directly to him when Purjes was not in the office, as was the case at the time.

Likewise, the Panel concludes that Purjes knew exactly what was unfolding with regard to the VictorMaxx inventory position. Purjes, Fitzgerald, and Sheib managed the Firm as a team. They collectively made all significant decisions regarding the Firm's assets. The Panel finds unbelievable Purjes' testimony that he did not follow up on the progress of the VictorMaxx Special for the two weeks after he left Josephthal on the evening of May 16 for his trip to Israel. The VictorMaxx position in large part represented Purjes' personal investment, which he closely monitored.

The Panel's conclusion is further corroborated by Purjes' own testimony regarding his reaction when Sheib told him that the sales force had developed a short position. According to Purjes, while he was still traveling in the Middle East, Sheib spoke to him by telephone and advised him that the Firm had sold a "substantial amount of VictorMaxx," and they were now "short in the account." (Sept. 14 Tr. at 176.) According to Purjes, they then discussed how to cover the short position, and Purjes ended up telling Sheib to do "what he thought was best." (Id. at 177.) According to Purjes, he gave it no further thought and expressed no surprise to learn that, in the short time he had been gone, the Firm had been able to dispose of more than 900,000 shares when it had not been able to sell any over the previous two weeks. This testimony is especially suspect when compared to Purjes' claim that he had only anticipated that the Firm would sell 25,000 to 50,000 shares as a result of the VictorMaxx Special. (Sept. 14 Tr. at 228.) Purjes was not surprised (and therefore took no action after speaking to Sheib) because he already knew what was going on, which was consistent

with the decision senior management had made before he left on his trip. Josephthal had launched a major selling effort to get rid of as much VictorMaxx stock as possible.

In conclusion, the Panel finds that Purjes and Fitzgerald jointly authorized the VictorMaxx Special for the purpose of inducing the sales force to get rid of the inventory by selling it to the Firm's customers. As Fitzgerald testified at his on-the-record interview, they collectively decided to "just get rid of" the VictorMaxx stock. (Ex. C007, at 40.) The VictorMaxx stock in the house account was under their direct control, and they were the principals responsible for the trading activity in that account. Thus, they were primarily responsible for the Rule 10b-6 violations. The Respondents thereby also violated NASD Conduct Rules 2110 and 2120. See Goldmen, NASD Discip. LEXIS 18, at *23-31.

B. Unfair Dealing with Customers—Cause Two of the Complaint

Cause Two of the Complaint alleges that Josephthal, Purjes, and Fitzgerald dealt unfairly with the customers who purchased VictorMaxx stock as a result of the overly aggressive selling efforts the VictorMaxx Special generated. Specifically, Cause Two alleges that Purjes and Fitzgerald made no effort to disclose or cause the disclosure of the special sales credit, the magnitude of the selling effort underway at Josephthal, or the recent poor performance of VictorMaxx and its stock. (Compl. ¶ 34.) The Department alleges that their unfair dealing constituted violations of NASD Conduct Rules 2110, 2120, and 2310 (IM 2310-2).

The Respondents strenuously challenge the factual and legal basis underlying the Department's theory of unfair dealing. The Respondents' central argument is that "there is no statute, regulation, rule, or judicial decision requiring disclosure of internal sales credits." (Post-Hearing Br. of Resp't Josephthal & Co. Inc. at 16.) Accordingly, the Respondents argue that it

would be fundamentally unfair, and violate their right to due process, to hold that Josephthal acted with intent to defraud or in bad faith by not causing its brokers to disclose the sales credit in this case.

The Respondents rightly point out that none of the NASD Conduct Rules the Respondents are accused of violating requires disclosure of internal sales credits. In addition, in May 1996, it was a common industry practice not to disclose internal sales credits—including credits provided by a firm as "an extra incentive to sell securities the firm wishes to liquidate from its inventory." Exchange Act Release No. 22,397, 50 Fed. Reg. 37648, 37652 n.44 (Sept. 17, 1985) (SEC release recognizing practice of providing internal sales credits as incentive to sell securities the firm wishes to liquidate from inventory, but not requiring disclosure of such internal credits on trade confirmations pursuant to SEC Rule 10b-10); see also NASD Notice to Members 95-67 (Aug. 1995) (providing example of transaction involving non-disclosure of internal sales credits); Exchange Act Release No. 36,548, 60 Fed. Reg. 63,092 (Dec. 8, 1995) (NASD release recognizing practice of including internal sales credit paid to broker in total sales price reported to customer, but not indicating any obligation to disclose existence or amount of internal credit); NASD Notice To Members 82-20 (Mar. 1982) (noting that sales credit paid to broker is "an internal concern of the members"). But these authorities and industry practices do not have the range Respondents suggest, and the sales credit in this case is vastly different from the type contemplated by accepted industry practice. By all accounts, the sales credit in this case was greater than anything the Respondents had ever seen.

Brokers owe a fundamental duty of fair dealing to their customers. See, e.g., District Bus. Conduct Comm. Dist. No. 9 v. Goodman, No. C9B960013, 1999 NASD Discip. LEXIS 34, *33-34 (N.A.C. Nov. 9, 1999). Embedded in this duty is the requirement that when making a

recommendation, the broker must disclose facts bearing on the risks associated with the recommended security that he knows and that are reasonably ascertainable. Hanly v. SEC, 415 F.2d 589, 597 (2d Cir. 1969). Conversely, "[w]here the [broker] lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information." Id. This duty of fair disclosure applies to the broker's commissions and other compensation where the non-disclosure may be material to the customer's decision to purchase the security the broker has recommended.

> The failure to disclose such commissions deprives the customer of the knowledge that his registered representative might be recommending a security based upon the registered representative's own financial interest rather than the investment value of the recommended security. Misrepresenting or omitting to disclose a broker's financial or economic incentive in connection with a stock recommendation constitutes a violation of the antifraud provisions.

Chasin v. Smith Barney & Co., 438 F.2d 1167, 1172 (2d Cir. 1970).

Brokers are not excused from the duty to disclose such commissions and compensation by the fact that there is not a specific rule requiring the disclosure of non-excessive sales credits. Cf. SEC v. Feminella, 947 F. Supp. 722, 731 (S.D.N.Y. 1996) (failure to disclose sales credit added to markup violated the antifraud provisions of the federal securities laws). Indeed, "the SEC has established through its enforcement actions the principle that charging undisclosed excessive commissions constitutes fraud." See Ettinger v. Merrill Lynch, Pierce, Fenner & Smith, 835 F.2d 1031, 1033 (3d Cir. 1987).

Without question, the sales credit in this case was excessive. For example, the analysis the Department performed of a sample of Josephthal's commission records illustrates that Josephthal paid no other commission in May 1996 that approached the size of the VictorMaxx sales credit. The

sampled records indicate no other case where Josephthal paid a commission exceeding 10% of the customer's total investment, and the Respondents could not point to any other instance where a similar sales credit had been applied.

The sales credit in this case was enormous. The evidence clearly demonstrates that it was sufficiently large to influence Josephthal's sales force to act in its own self-interest and push VictorMaxx stock on the Firm's customers. Accordingly, the Panel finds that the sales credit was excessive and that the size of the sales credit was a fact that Josephthal was required to disclose. Further, the Panel finds that the non-disclosure of the size of the VictorMaxx sales credit deprived the customers who purchased VictorMaxx stock of material information[61] that might have been useful to them in deciding whether to purchase the stock. Feminella, 947 F. Supp. 731.

Josephthal, Purjes, and Fitzgerald violated NASD Conduct Rules 2110 and 2120 by failing to disclose or cause the disclosure of the VictorMaxx Special. Conduct Rule 2120 provides that "[n]o member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive, or fraudulent device." Rule 2120 is an anti-fraud provision that "is the equivalent of SEC Rule 10b-5." Market Regulation Comm. v. Shaughnessy, No. CMS950087, 1997 NASD Discip. LEXIS 46, at *24 (N.B.C.C. June 5, 1997). To find a violation of Conduct Rule 2120, there must be a showing of material "misrepresentations and/or omissions in connection with the purchase or sale of securities" which were made with scienter. Id. Scienter under Rule 2120 can be

[61] An omitted fact is "material" if there is a substantial likelihood that a reasonable investor would view it as "significantly" altering the "total mix" of information available about the investment. Basic, Inc. v. Levinson, 485 U.S. 224, 232 (1988). The determination of materiality is judged by the standard of a reasonable investor having the same experience, sophistication, level of knowledge, and information as the investors actually involved in the transactions at issue. See Ferdinand Drexel Inv. Co. v. Alibert, 723 F. Supp. 313, 329-30 (E.D. Pa. 1989), aff'd, 904 F.2d 694 (3d Cir.), cert. denied, 498 U.S. 856 (1990).

demonstrated by showing the respondent acted intentionally or recklessly. Here, the Panel finds that Purjes and Fitzgerald intentionally withheld material information from the Firm's customers who purchased VictorMaxx shares that were subject to the VictorMaxx Special, or at the least they exhibited a reckless disregard for the welfare of those customers by failing to instruct the selling brokers to disclose the credit.

Purjes and Fitzgerald also violated NASD Conduct Rule 2110 by failing to disclose or cause the disclosure of the VictorMaxx Special because it was unethical to take advantage of the customers who purchased VictorMaxx stock in response to the selling blitz generated by the excessive sales credit they authorized regardless of whether their conduct also violated any other NASD Conduct Rule or the federal securities laws. Conduct Rule 2110 "is not limited to rules of conduct but rather . . . it states a broad ethical principle." Timothy L. Burkes, 51 S.E.C. 356 (1993). The NASD has authority to impose sanctions for violations of "moral standards" even if there was no "unlawful" conduct. Benjamin Werner, 44 S.E.C. 622 (1971). As the NAC stated recently in explaining the broad scope of Rule 2110:

> The ethical standards imposed in disciplinary proceedings go beyond legal requirements and depend on general rules of fair dealing, the reasonable expectations of the parties, marketplace practices, and the relationship between the firm and the customer. In re E.F. Hutton & Co., Inc., 49 S.E.C. 829 (1988) . . . "[A] member's failure to live up to obligations owed to a customer or to a fellow member constitutes a breach of 'just and equitable principles of trade.'" In re NASD, Inc., 19 S.E.C. 424 (1945). The rule "sets forth a standard intended to encompass a wide variety of conduct that may operate as an injustice to investors or other participants in the marketplace." In re Daniel Joseph Alderman, 52 S.E.C. 366, 369 (1995), aff'd, 104 F.3d 285 (9th Cir. 1997).

Department of Enforcement v. Shvarts, No. CAF980029, 2000 NASD Discip. LEXIS 6, at *11 (N.A.C. June 2, 2000).

The non-disclosure of the sales credit in this case—due to its magnitude—operated as an injustice to the customers who purchased VictorMaxx stock. They were entitled to know that the registered representatives who were recommending the stock had an inordinate stake in the transaction. By inducing the sales force with this incentive and then looking the other way while the sales force dumped Josephthal's entire inventory onto its customers, Purjes and Fitzgerald, and Josephthal acting through Purjes and Fitzgerald, violated their obligation of fair dealing, and they thereby violated NASD Conduct Rule 2110.

On the other hand, the Panel finds that the Department failed to show that the Respondents violated NASD Conduct Rule 2310. Conduct Rule 2310 provides that, in recommending to a customer the purchase of a security, a representative must have "'reasonable grounds for believing that the recommendation is suitable for such customer' based on the customer's other security holdings and financial situation and needs." District Bus. Conduct Comm. Dist. No. 1 v. McNabb, No. C01970021, 1999 WL 515761, at *13 (N.A.C. Mar. 31, 1999). The rule is violated if there is a showing that a member lacked reasonable grounds for believing that its recommendation of a particular security was suitable for customers or failed to obtain information concerning the suitability of a recommendation before executing the transaction. See District Bus. Conduct Comm. Dist. No. 1 v. Moore, No. C01970001, 1999 WL 1022136, at *4 (N.A.C. Aug. 9, 1999). Here, however, the Department offered no evidence to support a finding that Josephthal sold VictorMaxx to unsuitable customers. None of the customer witnesses called by the Department testified that the stock was unsuitable for them, and none of the Department's documentary evidence addressed suitability. Accordingly, the charge that the Respondents violated Conduct Rule 2310 is dismissed.

V. SANCTIONS

A. General Considerations

The Panel has concluded that the Respondents violated SEC Rule 10b-6 by continuing to bid for and purchase securities during a secondary distribution, and that they violated NASD Conduct Rules 2110 and 2120 through unfair dealing with Josephthal's customers. There currently is no Sanction Guideline that specifically addresses these violations. Consequently, the Panel refers to the General Principles Applicable To All Sanction Determinations,[62] the Principal Considerations In Determining Sanctions,[63] and to the Sanction Guideline applicable to misrepresentations or material omissions of fact for guidance,[64] bearing in mind that the NASD Sanction Guidelines "do not prescribe fixed sanctions for particular violations," but rather provide a starting point in the determination of remedial sanctions. Of the Principal Considerations applicable to this case, the Panel finds the following factors particularly significant:

First, the Respondents' misconduct caused considerable customer loss. More than 360 individual investors lost a total of $1,478,789.65.

Second, there is considerable evidence of sales practice abuses that should have raised red flags about the manner in which the sales force responded to the excessive sales credit on the VictorMaxx stock. Purjes and Fitzgerald, however, ignored their responsibility to monitor the trading in the house account because it benefited them and the Firm.

---

[62] NASD Sanction Guidelines 3-8 (2001 ed.).

[63] Id. at 9-10.

[64] Id. at 96. The Guideline for "Misrepresentations Or Material Omissions Of Fact" suggests in egregious cases a fine of between $10,000 and $100,000 and a suspension or bar. The Guideline also states that Adjudicators may increase the recommended fine amount by adding the amount of a respondent's financial benefit.

Third, none of the Respondents took any corrective action, such as paying restitution to customers, before the NASD discovered their misconduct.

Fourth, none of the Respondents has acknowledged their misconduct.

Fifth, Purjes and Fitzgerald testified falsely at the hearing.

Sixth, Purjes and Josephthal have relevant disciplinary histories. Josephthal's CRD record reflects 19 prior disciplinary actions, of which seven involved allegations that the Firm in one manner or another put its interests ahead of its customers. Of those, however, the Panel places particular significance on one. On May 6, 1996, two weeks before the violations in this proceeding, Josephthal and Purjes settled two NASD investigations, which included allegations of violations of Rule 10b-6. Although the Rule 10b-6 allegations were not the focus of those proceedings, and the actual violations occurred years earlier, the timing of the settlements is relevant to the determination of sanctions in this case because those earlier cases had placed a spotlight on Josephthal's obligations to treat its customers fairly. Indeed, on May 13, 1996, Josephthal issued a press release in which Purjes was quoted as saying:

> The resolution of these matters with the NASD concludes a very expensive and time-consuming process. Josephthal has consented to this settlement to remove any doubt as to the firm's commitment to treat its customers fairly and properly.

(Ex. C055 at ¶ 104.) Josephthal was censured and fined $572,364.15; Purjes also was censured. In addition, Purjes agreed to requalify as a General Securities Representative and a General Securities Principal, which he has never done. The Firm's disciplinary history and Purjes' failure to comply with the terms of the settlement agreement reflect a grave disregard for their compliance obligations, which warrants the imposition of more severe sanctions than the maximum suggested by the Guideline.

Finally, the Panel notes that the Respondents' misconduct was egregious and deserving of serious sanctions. Respondents' actions placed the investing public at risk and harmed the industry as a whole by interfering with free market forces. Moreover, Respondents' conduct demonstrated "a marked insensitivity to their obligation to deal fairly with customers." Frank L. Palumbo, 52 S.E.C. 467, 1995 SEC LEXIS 2814, at *35 (1995).

B. SEC Rule 10b-6 Violations

In assessing sanctions under the First Cause of the Complaint, the Panel finds that Fitzgerald is less culpable than Purjes and Josephthal. Although Fitzgerald was responsible for trading, the evidence shows that Purjes controlled the important decisions regarding the house stocks. Because Purjes had the lion's share of the equity in the Firm, he treated the house account as if it were his personal trading account. Virtually no action could be taken in the account without his express approval. In the present case, the Panel has found that without Purjes' approval the VictorMaxx Special could not have been implemented. Accordingly, he bears more responsibility for the resulting harm and violations than does Fitzgerald.

Based on the factors discussed above, the Panel orders that Respondents be censured; that Josephthal be fined $500,000; that Purjes be fined $500,000; and that Fitzgerald be fined $100,000. Purjes and Josephthal also are jointly and severally ordered to pay restitution to the customers reflected on the attached schedule in the total amount of $1,478,789.65, plus interest thereon at the rate set forth in Section 6621(a) of the Internal Revenue Code, 26 U.S.C. § 6621(a)(2), from June 1, 1996, until the date that restitution is paid.[65]

---

[65] NASD Sanction Guidelines 15. Satisfactory proof of payment of the restitution, or of reasonable and documented efforts undertaken to effect restitution, shall be provided to the staff of NASD Regulation no later

As to Josephthal, the Panel further orders that it retain at its own expense, within 60 days of the date this Decision becomes final, a qualified independent consultant who is acceptable to the staff of NASD Regulation. The consultant shall review the Firm's policies, practices, and procedures with particular attention to its procedures regarding compliance with Regulation M (formerly Rule 10b-6). The consultant shall provide to the Firm (and the Firm shall provide to NASD Regulation staff) a written explanation as to whether the Firm's procedures are consistent with federal securities laws and the rules and regulations of NASD Regulation. If the consultant determines that the Firm is not in compliance, the consultant shall provide the Firm (and the Firm shall provide NASD Regulation staff) with an explanation of the manner in which the Firm is not in compliance, recommendations regarding changes to the Firm's procedures, and recommendations as to implementation of the recommended changes. The Firm thereafter shall adopt and implement the proposed changes. The Firm and its employees shall cooperate with the consultant and shall place no restrictions on the consultant's communications with NASD Regulation staff. For a period of two years following the date of the Consultant's last report, the Firm shall not employ or otherwise hire the consultant.

The Panel also orders that Purjes be suspended in all capacities until he requalifies as a General Securities Representative and a General Securities Principal, as he was required to do under the terms of the settlement entered into in May 1996. In the event that Purjes fails to requalify in both capacities within two years after this Decision is final, the suspensions shall become a bar as to

---

than 180 days after the date when this Decision becomes final. If, for any reason, Purjes and Josephthal are unable to locate a customer after diligent and documented efforts to do so within such period, or such additional period as agreed to by the staff of NASD Regulation, Purjes and Josephthal shall forward such unpaid restitution and interest to the appropriate escheat, unclaimed property or abandoned property fund for the state in which the customer last resided.

each capacity in which he has not requalified. The Panel finds that this sanction is warranted because of the total disregard he has exhibited for the regulatory authority of NASD Regulation.

C. Unfair Dealing with Customers

The Panel also believes that serious sanctions are warranted for the violations alleged in the Second Cause of the Complaint. The non-disclosure of material information operated as a fraud upon the customers who purchased VictorMaxx stock from Josephthal, causing great financial loss. The Respondents acted with a total disregard for the welfare of the Firm's customers. Accordingly, for the violations found under the Second Cause of the Complaint, the Panel would censure each of the Respondents; fine Josephthal and Purjes $500,000 each; and fine Fitzgerald $100,000. Further, the Panel would order Purjes and Josephthal to jointly and severally pay restitution to the customers reflected on the attached schedule in the total amount of $1,478,789.65,[66] plus interest thereon at the rate set forth in Section 6621(a) of the Internal Revenue Code, 26 U.S.C. § 6621(a)(2), from June 1, 1996, the end of the distribution period, until the date that restitution is paid. However, because the Panel finds that the violations under the two Causes of Complaint were part of a common course of conduct, the Panel will not impose separate sanctions for the violations under each Cause of the Complaint.

VI. ORDER

Therefore, having considered all the evidence,[67] the Panel orders that Respondents be censured; that Josephthal be fined $500,000; that Purjes be fined $500,000; and that Fitzgerald be

[66] The amount of restitution awarded includes the customers realized and unrealized losses. This is appropriate because the evidence established that there no longer was a market for VictorMaxx stock.

[67] The Hearing Panel has considered all of the arguments of the Parties. They are rejected or sustained to the extent they are inconsistent or in accord with the views expressed herein.

fined $100,000. Purjes and Josephthal also are jointly and severally ordered to pay restitution to the customers reflected on the attached schedule in the total amount of $1,478,789.65, plus interest thereon at the rate set forth in Section 6621(a) of the Internal Revenue Code, 26 U.S.C. § 6621(a)(2), from June 1, 1996, until the date that restitution is paid.

As to Josephthal, the Panel further orders that it retain at its own expense, within 60 days of the date this Decision becomes final, a qualified independent consultant who is acceptable to the staff of NASD Regulation. The consultant shall review the Firm's policies, practices, and procedures with particular attention to its procedures regarding compliance with Regulation M (formerly Rule 10b-6). The consultant shall provide to the Firm (and the Firm shall provide to NASD Regulation staff) a written explanation as to whether the Firm's procedures are consistent with federal securities laws and the rules and regulations of NASD Regulation. If the consultant determines that the Firm is not in compliance, the consultant shall provide the Firm (and the Firm shall provide NASD Regulation staff) with an explanation of the manner in which the Firm is not in compliance, recommendations regarding changes to the Firm's procedures, and recommendations as to implementation of the recommended changes. The Firm thereafter shall adopt and implement the proposed changes. The Firm and its employees shall cooperate with the consultant and shall place no restrictions on the consultant's communications with NASD Regulation staff. For a period of two years following the date of the Consultant's last report, the Firm shall not employ or otherwise hire the consultant.

The Panel also orders that Purjes be suspended in all capacities until he requalifies as a General Securities Representative and a General Securities Principal, as he was required to do under the terms of the settlement entered into in May 1996. In the event that Purjes fails to requalify in

both capacities within two years after this Decision is final, the suspensions shall become a bar as to each capacity in which he has not requalified.

Except as specifically stated above, these sanctions shall become effective on a date set by the NASD, but not sooner than 30 days from the date this Decision becomes the final disciplinary action of the NASD.

Finally, Respondents are jointly and severally assessed hearing costs in the amount of $7,837, consisting of transcript costs in the amount of $7,087 and administrative expenses of $750.

____
Andrew H. Perkins
Hearing Officer
For the Extended Hearing Panel

Copies to:

Rory C. Flynn, Esq. (by first-class and electronic mail)
Jacqueline D. Whelan, Esq. (by first-class and electronic mail)
Roger D. Hogoboom, Jr., Esq. (by first-class and electronic mail)
Josephthal & Co., Inc. (by FedEx, next day delivery, and first-class mail)
Dan D. Purjes (by FedEx, next day delivery, and first-class mail)
Paul H. Fitzgerald (by FedEx, next day delivery, and first-class mail)
Joseph K. Brenner, Esq. Esq. (by facsimile and first-class mail)
Donald G. McCabe, Esq. Esq. (by facsimile and first-class mail)
Kevin T. Rover, Esq. Esq. (by facsimile and first-class mail)
William D. Briendel, Esq. Esq. (by facsimile and first-class mail)