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BEFORE THE

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C.

In the Matter of the Application of

J.W. Korth & Company, LP

For Review of Action Taken by

Financial Industry Regulatory Authority

File No. 3-19206

BRIEF OF THE FINANCIAL INDUSTRY REGULATORY AUTHORITY IN OPPOSITION TO APPLICATION FOR REVIEW

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I. INTRODUCTION

J.W. Korth & Company, LP ("Korth" or the "Firm") appeals a May 23, 2019 decision of the National Adjudicatory Council ("NAC") to the Securities and Exchange Commission. RP 2849-52.[1] The record unequivocally demonstrates between April 2009 and December 2011, Korth charged excessive markups and markdowns on 51 bond transactions, in violation of MSRB Rules G-17 and G-30, NASD Rule 2440, and FINRA Rule 2010. These excessive markups and markdowns, which ranged from between 3.10 to 8.33 percent, harmed Korth's customers by causing them to pay more for their bond purchases, or receive less for their bond sales, than they would have if Korth's prices were fair. For these violations, the NAC censured the Firm, ordered it to pay restitution to its affected clients, and ordered it to retain an independent consultant.

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[1] "RP" refers to the record page number in the certified record.

Korth responded to the NAC's decision with the instant appeal to the Commission. It filed a brief entitled "Motion for Stay of Disciplinary Action Taken by FINRA and Brief in Support Thereof."[2] In its brief, Korth maintains that the NAC did not properly consider the additional evidence it provided on appeal, which the Firm argues supports its pricing. However, the NAC considered the documents and determined that the conclusory and self-serving factual representations made by Korth were not supported by the attached documents and were insufficient to rebut the prima facie case made by FINRA's Department of Enforcement ("Enforcement") that the markups and markdowns were excessive.

In addition, Korth argues that FINRA gave the Firm no specific guidance that charges more than 3 percent would be deemed excessive. This argument fails because nowhere in the NAC decision, or in FINRA informational material, does FINRA state that all markups in excess of 3 percent are excessive. In fact, the NAC decision finds that in certain bond transactions, Korth's markups up to 3.5 percent were not unreasonable. Korth also makes broad policy arguments and requests that the Commission undertake a review of FINRA's approach to markup enforcement, but such relief is not available in this proceeding.

The NAC's findings of violations are fully supported by the record and the sanctions it imposed— a censure, order to pay restitution, and order that it retain an independent consultant—are neither excessive nor oppressive and narrowly tailored to remediate the Firm's violations. As explained more fully in this brief, the Commission should reject Korth's primary arguments on appeal that its markups and markdowns were fair. FINRA respectfully asks the

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[2] On September 5, 2019, the Commission denied as moot the portion of Korth's brief requesting a stay of the sanctions. *See* https://www.sec.gov/litigation/opinions/2019/34-86890.pdf.

Commission to follow well-established precedent and affirm the NAC's findings of violations and the sanctions it imposed.

II. FACTUAL BACKGROUND

A. The Firm

Korth has been a member of NASD/FINRA since 1983. RP 269. The Firm is also a member of the Municipal Securities Rulemaking Board ("MSRB"). *Id.* The Firm, headquartered in Lansing, Michigan, maintains three branch offices and derives nearly all of its revenue from the sale of municipal bonds and corporate debt securities. RP 270.

Korth focuses its business on fixed income products and the Firm generates the majority of its revenue from servicing financial advisors, institutions, and wealthy individuals with diversified fixed income accounts. RP 254.

Prior to February 2009, the Firm's policy related to markups included a maximum of 3.5 percent internal markup/markdown on bond transactions. RP 1412. In February 2009, the Firm revised its policy, raising the maximum markup or markdown to 3.9 percent. *Id.* In an email to the Firm's staff, the Firm's chief compliance officer ("CCO"), Michael Gibbons, noted that:

> Jim [Korth] and I have been discussing some of our policies and we agree that due to the current environment some changes are warranted. While our costs have basically stayed the same, the market environment has created a slowdown in our trading volume. Therefore, the average cost per ticket has risen for us. While we must obviously adhere to the FINRA 2440 markup rule (5% guideline as it's known), and the FINRA Fair Dealing Rule, we have decided to allow markups of up to a 3.9% limit as opposed to our standard 3.5%. This doesn't mean that every trade should be marked at 3.9% because in many cases that would not be warranted. Please use your best judgment. RP 1405.

James Korth, the Firm's founder and Managing Partner, acknowledged that he was responsible for both the Firm's markup policy and the February 2009 increase, which he decided was necessary because the firm simply "needed to make more money." RP 1414. In determining

the threshold for his increased markup policy, Mr. Korth explained that he was seeking to avoid analyzing each individual markup/down. Mr. Korth explained:

> Basically, I just threw 3.9 out there as a target that we should really pay attention to so we are 25 percent, roughly, inside of the 5 percent rule so I wouldn't have this kind of a day, quite honestly. That was really why I did it . . . and we wouldn't have to analyze every trade to — you know, to a tremendous extent. RP 1415.

B. Overview of Markups and Markdowns at Issue

The transactions at issue in this appeal consist of 38 municipal bond transactions and 13 corporate bond transactions that occurred between April 2009 and December 2011. With respect to the municipal bond transactions, the relevant trade data shows that there were no interdealer trades between the time Korth purchased the bonds and the time it sold them to customers. RP 1057-1098; 1173; 1181-1222. In most instances the Firm sold the bonds to customers on the day it bought them or the next trading day. *Id.* In no instance did more than five days elapse between the firm's purchase and the subsequent sale to a customer. RP 1053.

With respect to the corporate bond transactions, the trade data similarly shows that each transaction was an intraday trade (i.e., the Firm acquired the bond and sold it to a customer the same day). RP 1055; 1255. Many of the purchases and sales occurred simultaneously. RP 1055. On average, the Firm's purchase and sale to a customer occurred within approximately 30 minutes of each other, and the maximum time that elapsed between the Firm's purchase and its sale to a customer was approximately 200 minutes. RP 1253.

Based on the trade data and industry practice, FINRA calculated the markups and markdowns on each of the transactions at issue based on Korth's contemporaneous costs. Using that methodology, FINRA calculated markups on the municipal bond transactions ranging from 3.10 percent to 8.33 percent and markups and markdowns on the corporate bond transactions

ranging from 3.24 percent to 5.56 percent. RP 1053; 1055. Korth has not challenged these calculations on appeal.

C. Guidelines for Determining Whether a Markup or Markdown is Excessive

Neither the MSRB nor FINRA has articulated an absolute threshold above which markups or markdowns will be deemed to be excessive.[3] Markups in excess of 5 percent above the prevailing market price on equities are considered excessive, but courts, the Commission, FINRA, and the MSRB have also noted that markups on debt securities historically have been lower than those on equity securities. *First Honolulu Sec., Inc.*, 51 S.E.C. 695, 697 n.9 (1993); *see also Staten Secs. Corp.*, 47 S.E.C. 766, 767 (1982) ("As a general rule, markups on municipal bonds are significantly lower than those for equity securities."); *SEC v. Feminella*, 947 F. Supp. 722, 729 (S.D.N.Y. 1996). The Commission has repeatedly stated that markups on municipal securities "should fall below five percent absent exceptional circumstances." *Anthony A. Grey*, Exchange Act Release No. 75839, 2015 SEC LEXIS 3630, at *33 n.38 (Sept. 3, 2015); *First Honolulu*, 51 S.E.C. at 698-99 ("our opinions suggest that, although some markups on municipal bonds may reach 5%, that figure might be acceptable in only the most exceptional cases").

Furthermore, with respect to both municipal and corporate bonds, the Commission has cautioned that markups and markdowns below 5 percent may be excessive. *Mark David Anderson*, Exchange Act Release No. 48352, 2003 SEC LEXIS 3285, at *25 (Aug. 15, 2003) (finding markups as low as 1.42% to be excessive, stating, "It is well-settled, for example, that

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[3] In its brief, Korth refers to the so-called "5% policy" or "5% guideline." However, FINRA made clear that that policy was "a guide, not a rule" and that markups "of 5% or even less may be considered unfair or unreasonable." IM-2440-1(a). Moreover, the guideline does not apply to transactions in municipal securities, which constitute the majority of the transactions at issue on this appeal. *See* IM-2440-2 at n.1.

markups and markdowns on municipal securities may be excessive although they are substantially below 5%."); *First Honolulu*, 51 S.E.C. at 698, 701 (finding markups above 4 percent on municipal and corporate bonds to be excessive and noting that "we, along with the NASD and the MSRB, have made clear that no particular percentage provides a safe harbor and that markups below five percent may be unfair"); *Inv. Planning, Inc.*, 51 S.E.C. 592, 598 (1993) ("the industry has been repeatedly warned that markups below 5% are by no means protected").

Enforcement's expert witness, Charles Paviolitis, opined, based on his decades of experience in the industry, that Korth's markups on the municipal bond transactions were inconsistent with industry practice. According to Paviolitis, the industry norm was to charge markups ranging from 0.25% to 3%. RP 1228-1229; 1240. In addition, expert Vikram Kapoor similarly opined that the markups Korth charged its customers on the corporate bond transactions at issue far surpassed the average markups charged by other dealers on the same bond. RP 1347-1348.[4]

III. PROCEDURAL HISTORY

A. The Complaint and Hearing Panel Decision

On December 10, 2014, Enforcement filed a two-cause complaint against the Firm. RP 1-46. Cause one alleges that Korth charged unfair prices on sales of municipal securities in 44 transactions, in violation of MSRB Rules G-30 and G-17. Cause two alleges that Korth charged unfair prices on sales, or paid unfair prices in purchases, of corporate bonds and CMOs in 18 transactions, in violation of NASD Rule 2440, IM-2440-1, and FINRA Rule 2010.

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[4] In its brief, Korth maintains that Paviolitis was discredited by the Hearing Panel. This is not the case. While the Hearing Panel and the NAC did not rely on certain aspects of his expert opinion, they relied on both Paviolitis and Kapoor to establish that contemporaneous cost is the best evidence of the prevailing market price and what the appropriate range of markups are. The Firm has provided no argument for overturning the NAC's reliance on either expert.

Korth filed an answer on January 7, 2015, and an amended answer on March 5, 2015, in which it denied allegations of wrongdoing and requested a hearing. RP 50-71; 253-286.

Korth filed a motion to compel the testimony of Richard Ketchum, then FINRA's CEO, at its hearing, which FINRA's Office of Hearing Officers denied. RP 599-606; 667-670. After this denial, Korth withdrew its request for a hearing. RP 689-694. Both Korth and Enforcement presented their cases on the papers and without a hearing. Based on the written briefs and the parties' exhibits, the Hearing Panel issued its decision on January 26, 2017. RP 1515-1541. The Hearing Panel found that Korth charged excessive markups and markdowns on the 38 municipal bond transactions and 13 corporate bond transactions at issue in this appeal. RP 1535. Specifically, for cause one the Hearing Panel found that Korth's markups on municipal bond sales in excess of three percent were not fair and reasonable as to Trades 10-19, 22-26, 29-32, 35, and 43-51, as identified in the Hearing Panel decision. *Id.* In addition, the Hearing Panel found that Korth's markups on municipal bond sales in excess of 3.5 percent were not fair and reasonable in Trades 1-7, 20, 21, and 36. *Id.* For cause two, the Hearing Panel concluded that Korth's markups and markdowns on corporate bonds in excess of three percent were not fair and reasonable as to Trades 2, 4-14, and 18. *Id.*

For these 51 trades, the Hearing Panel independently reviewed the relevant trade data. Based on that review, the Hearing Panel agreed with Enforcement's experts that the prevailing market price should be determined based on Korth's contemporaneous costs. RP 1519-1523. The Hearing Panel found that, with respect to the municipal bond transactions, most of Korth's purchases "occurred one to two days prior to its sales to customers" and that "no intervening inter-dealer trades occurred." RP 1520-1521. With respect to the corporate bond transactions, the Hearing Panel found that all of the trades "occurred on the same day as the firm's sales to

customers." RP 1521. The Hearing Panel specifically rejected Korth's bid/ask methodology for calculating markups and markdowns, refusing to find that the market for these bonds was best represented by interdealer quotations rather than its own contemporaneous costs. RP 1522.

After concluding that Korth's contemporaneous costs were the best indicator of the prevailing market price, the Hearing Panel next calculated what it determined to be a fair and reasonable markup or markdown for each transaction at issue. Based on the relevant trade data, and taking into consideration factors relevant to pricing such as the nature of the bonds, their maturity and yield, issue size, and liquidity, the Hearing Panel found that a markup or markdown of 3 percent would be fair and reasonable for most of the bonds, and for the remainder, that the markup or markdown should not have exceeded 3.5 percent. RP 1523-1535.

Moreover, the Hearing Panel specifically rejected Korth's efforts to justify the markups and markdowns in excess of 3 percent or, as appropriate, 3.5 percent based on the cost of the special services that the firm allegedly provided to customers, because the Firm failed to provide any evidence that would support the markups or markdowns. RP 1524-1525.

As to sanctions, the Hearing Panel censured the Firm and ordered it to pay restitution in the amount of the excess markup or markdown paid by each affected customer. RP 1535-1537. The Hearing Panel also directed Korth to retain an independent consultant "with experience in establishing pricing procedures for sales and purchases of debt securities to review the firm's pricing procedures with a view towards ensuring, going forward, that [Korth] does not charge prices in excess of what is fair and reasonable, taking into consideration all relevant factors." RP 1536.

B. Proceedings Before the NAC

On February 1, 2017, Korth appealed the Hearing Panel's decision. RP 1543. Because Korth decided against having a full evidentiary hearing below, the Firm sought to introduce additional evidence to support its markups and markdowns on appeal. On April 7, 2017, Korth filed an Amended Motion for Leave to Provide Additional Evidence, for an Extension of Time to File Its Opening Brief, for Its Opening Brief Not to Exceed 80 Pages with Unlimited Exhibits. RP 1635-1641. A subcommittee of the NAC granted Korth's motion to provide additional evidence, but denied the remaining requests. RP 1717-1722. Between August 21 and August 30, 2017, Korth filed its opening brief and attached its additional evidence, which included post hoc narrative descriptions, including declarations prepared for the appeal, of each transaction and other evidence that was not created contemporaneously with the transactions at issue. RP 1745-2092. On September 18, 2017, Enforcement filed a Motion to Strike Korth's Additional Evidence and Prohibit Additional Submissions. RP 2093-2099. The NAC subcommittee granted Enforcement's motion to strike on the grounds that the evidence was irrelevant; testimonial in nature; was created after the relevant time period; consisted of narrative arguments that circumvent the 25-page limit of the briefs; and was not timely filed. RP 2405-2410.

However, the subcommittee allowed Korth to re-submit additional evidence with its reply brief, so long as the evidence was contemporaneous with the bond transactions at issue and any argument regarding the transactions was contained in the body of the reply brief. As instructed, Korth attached the additional evidence to its reply brief (the "Reply Brief"). It contained the same information as originally stricken. RP 2427-2646.

On May 23, 2019, the NAC issued its decision which affirmed the Hearing Panel's findings and sanctions. RP 2825-2847. The NAC decision noted that the additional evidence

provided by the Firm did not justify the markups and markdowns charged to its customers. This appeal followed. RP 2849-2852.

IV. ARGUMENT

A. The NAC Properly Concluded That Korth Charged Excessive Markups and Markdowns in Violation of FINRA and MSRB Rules

The NAC properly concluded that between April 2009 and December 2011, Korth violated MSRB Rules G-30 and G-17 by charging excessive markups in 38 sales of municipal securities and NASD Rule 2440, IM-2440, and FINRA Rule 2010 by charging excessive markups in nine sales of corporate debt securities and excessive markdowns in four purchases of corporate debt securities. The NAC found that Korth's excessive markups and markdowns on the 51 transactions ranged from between 3.10 to 8.33 percent. The NAC found excessive markups and markdowns by following the customarily accepted analysis of determining the prevailing market price, calculating the markup, and then considering any evidence presented that would rebut the calculation of the prevailing market price and justify the markup or markdown.

1. Applicable Rules

MSRB and FINRA[5] rules obligate their respective member firms to deal fairly with customers and require member firms to charge prices that are fair and reasonable.

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[5] FINRA Rule 2121 superseded NASD Rule 2440, IM-2440-1, and IM-2440-2, effective May 9, 2014. *See* SR-FINRA-2014-023, http://www.finra.org/industry/rule-filings/SR-FINRA-2014-023, Exchange Act Release No. 72208, 79 Fed. Reg. 30,675 (May 21, 2014). NASD Rule 2440, IM-2440-1, and IM-2440-2 were applicable during the relevant period.

MSRB Rule G-30 requires municipal securities dealers to charge prices that are of a "fair and reasonable amount, taking into account all relevant factors." MSRB Rule G-30.[6] The rule provides several factors that may be relevant in determining the fairness and reasonableness of municipal securities transaction prices, including: the fair market value of the securities at the time of the transaction, in the best judgment of the broker; the expense involved in effecting the transaction; the fact that the broker is entitled to a profit; and the total dollar amount of the transaction. *Id.* MSRB has also issued interpretive guidance setting forth additional factors that may be relevant, including: the availability of the security in the market; the price or yield of the security; the maturity of the security; and the nature of the professional's business. *See* MSRB Interpretations of Rule G-30, Report on Pricing (Sept. 26, 1980).[7] MSRB has advised that, in determining whether a municipal bond has been fairly and reasonably priced, the "most important" consideration is "the resulting yield to the customer." *Id.* at 3, P 13.

Similarly, NASD Rule 2440 provides that if a member "sells for his own account to his customer, he shall . . . sell at a price which is fair, taking into consideration all relevant circumstances."[8] The rule itemizes some of the factors relevant to the analysis, "including market conditions with respect to such security at the time of the transaction, the expense involved, and the fact that [the firm] is entitled to a profit." *Id.*

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6 FINRA has jurisdiction to enforce MSRB Rules pursuant to Section 15B of the Securities Exchange Act of 1934 ("Exchange Act"). 15 U.S.C. § 78o-4(c)(5).

7 Available at http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-30.aspx?tab=2)

8 NASD IM-2440-1 and NASD IM-2240-2 provide additional guidance on pricing and markups and markdowns.

Both MSRB and FINRA have "just and equitable" rules. MSRB Rule G-17 provides that, "[i]n the conduct of its municipal securities or municipal advisory activities, each broker, dealer, municipal securities dealer, and municipal advisor shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice." A firm that charges unfair prices in sales of municipal securities violates both MSRB Rules G-17 and G-30. *See Grey*, 2015 SEC LEXIS 3630, at *16-17. FINRA Rule 2010 provides that "[a FINRA] member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade." NASD IM-2440-1 states that "[i]t shall be deemed a violation of [FINRA] Rule 2010 . . . for a member to enter into any transaction with a customer in any security at any price not reasonably related to the current market price of the security."

Under both sets of rules, determining whether Korth's markups and markdowns were excessive required a two-step analysis. Because the markup or markdown is computed by taking "the difference between the price charged to the customer and the prevailing market price," FINRA first determined the prevailing market price for each of the bonds at issue. *Grey*, 2015 SEC LEXIS 3630, at *17 (quoting *Grandon v. Merrill Lynch & Co.*, 147 F.3d 184, 189 (2d Cir. 1998)); *see also* IM-2440-1(a)(3) ("The mark-up over the prevailing market price is the significant spread from the point of view of fairness dealings with customers in principal transactions."); IM-2440-2(b)(1) ("A dealer that is acting in a principal capacity in a transaction with a customer and is charging a mark-up or mark-down must mark-up or mark-down the transaction from the prevailing market price."). It then determined whether Korth's markups and markdowns, "as calculated based on prevailing market price, were fair and reasonable." *Grey*, 2015 SEC LEXIS 3630, at *17-18.

2. The NAC Correctly Used Korth's Contemporaneous Cost To Determine Prevailing Market Price[9]

The NAC properly concluded that Korth's contemporaneous cost was the appropriate method of determining the prevailing market price. On appeal, Korth has provided no argument to the contrary.

A dealer's contemporaneous cost is presumed to be the best measure of prevailing market price because "prices paid for a security by a dealer in actual transactions closely related in time to its sales are normally a highly reliable indication of the prevailing market." *Grey*, 2015 SEC LEXIS 3630, at *19 (quoting *First Honolulu*, 51 S.E.C. at 697). "When a dealer asserts a different prevailing market price for a bond sold to a customer, the dealer must provide sufficient evidence to overcome the presumption that contemporaneous cost is the best measure of prevailing market price." *Grey*, 2015 SEC LEXIS 3630, at *19 (citations omitted).

Consistent with these well-established principles, the NAC held that, for all of the trades at issue on appeal, Korth's contemporaneous cost represented the best evidence of prevailing market price. The NAC, like the Hearing Panel below, relied in part on the opinions of Enforcement's two expert witnesses, both of whom opined that the best indicator of prevailing market price was Korth's contemporaneous cost. Paviolitis concluded that there were no interdealer trades that would reflect a contemporaneous market significantly different from the Firm's interdealer purchase prices and that Korth's contemporaneous cost was the best evidence

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[9] On appeal to the Commission, Korth appears to have abandoned the argument that FINRA incorrectly used the Firm's contemporaneous costs to determine prevailing market price and, therefore, incorrectly calculated the markups and markdowns that were charged to customers. Although the Firm does not appear to make arguments related to the appropriateness of contemporaneous cost analysis, we discuss it nonetheless.

of prevailing market price. RP 1176-1177. Kapoor's review of the trading data revealed that there were no other interdealer transactions in the corporate bonds between the time the Firm acquired the bonds and sold the bonds to its customers. RP 1255. Given the lack of interdealer transactions and the proximity between the Firm's acquisition and disposition of the bonds, Kapoor opined that contemporaneous cost was the most appropriate, and in fact the only, method of determining prevailing market price for the transactions at issue. *Id.*

The Hearing Panel independently analyzed the same trade data reviewed by Enforcement's experts. Based on that review, the Hearing Panel agreed with the experts that the prevailing market price should be determined based on the Firm's contemporaneous costs. The Hearing Panel found that, with respect to the municipal bond transactions, most of Korth's purchases occurred only one to two days prior to its sales to customers and that no intervening interdealer trades occurred. RP 1520-1521. With respect to the corporate bond transactions, the Hearing Panel found that all of the trades occurred on the same day as the Firm's sales to its customers. RP 1521. On the basis of this evidence, all of which showed the absence of intervening interdealer transactions suggesting any change in the market, the NAC correctly held that the burden shifted to Korth to "overcome the presumption that contemporaneous cost represents the prevailing market price." *Id.*

For many of the 38 municipal bonds at issue on appeal, the Firm did not dispute that Enforcement properly calculated the prevailing price using contemporaneous cost. For the remaining transactions, Korth attempted to rebut this presumption below by claiming that its markups should be calculated based not on the Firm's contemporaneous cost but rather on the best available interdealer quotes or bid/ask at the time of the customer transaction. Korth failed to offer any basis for departing from the general rule against using offers and bids to determine

prevailing market price. Instead, Korth asked the NAC to simply defer to the firm's business judgment. As Korth argued, "[c]onsidering the nature of our business and services we provide and the experience level of our staff, it is logical that we are qualified to use our best judgment in determining when a dealer's quote does or does not accurately reflect the market when bonds are concerned." RP 1749. This argument falls far short of satisfying Korth's burden to prove the validity of its calculating markups and markdowns based on offers and bids. Given the absence of any countervailing evidence, the Commission should affirm the use of contemporaneous cost as the basis for determining the prevailing market price, and should sustain the NAC's findings.

3. The NAC Properly Concluded that the Firm's Markups and Markdowns Were Excessive

The record before the Commission provides sufficient evidence, including expert opinions, that not only supports the NAC's reliance on contemporaneous cost as the prevailing market price, but also establishes that the markups and markdowns Korth charged over and under the prevailing market price were excessive.

As to the municipal bonds at issue, Paviolitis reviewed documents in the record, including the trade data, and independently researched and reviewed trade data derived from EMMA, relevant official statements, ratings information, and material event notices related to the municipal transactions. RP 1226. Paviolitis opined that the industry norm was to charge markups ranging from 0.25 percent to three percent and that the Firm's 3.9 percent internal policy related to markups on municipal bond transactions was inconsistent with the custom and practice in the municipal bond market during the relevant period of time. RP 1228-1229.[10]

[10] Both the Hearing Panel and the NAC rejected Paviolitis' conclusion that the appropriate maximum markup for the trades at issue was two percent and did not rely on this aspect of his opinion.

With respect to the corporate bonds, Kapoor reviewed the documents in the record, including TRACE data for a two-month period surrounding the transactions at issue. RP 1254. Furthermore, Kapoor used a three percent threshold to calculate excessive markups and markdowns. Kapoor concluded that Korth "had a statistically significant higher markup on the securities at issue than the highest markup of the other dealers with a 95 percent degree of confidence. RP 1347-1348."[11]

The Hearing Panel independently analyzed the same trade data reviewed by Enforcement's experts. After concluding that the Firm's contemporaneous costs were the best indicator of the prevailing market price, the Hearing Panel next calculated what it determined to be a fair and reasonable markup or markdown for each transaction at issue. Based on the relevant trade data, and taking into consideration factors relevant to pricing, such as the nature of the bonds, their maturity and yield, issue size, and liquidity, the Hearing Panel found that a markup or markdown of three percent was fair and reasonable for most of the bonds. For the remaining transactions (municipal bond Trades 1-7, 20-21, 36), the Hearing Panel found that the markup or markdown should not have exceeded 3.5 percent.

Armed with these analyses, and conducting its own de novo review of the record, the NAC properly determined that the markups and markdowns charged by the Firm were not

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[11] As to equity transactions, FINRA recognized in its Regulatory Notice 11-08 that:

> Five percent is significantly higher than the average markup, markdown or commission currently charged by most firms in equity transactions. In a recent study conducted by an independent consultant, based on a sample of more than 161,000 equity transactions with customers, the mean markup was 2.2 percent and the average or median markup was 2 percent. Markdowns were even lower: the mean markdown was 1.9 percent and the median markdown was 1.3 percent.

2011 FINRA LEXIS 35 (Feb. 2011)

reasonable. For example, in municipal bond Trade 11, the NAC concluded that a 3.89 percent markup was unreasonable where Korth purchased 45,000 bonds and, within six minutes, sold the bonds to a customer. In corporate bond Trades 13 and 14, the NAC concluded that a 3.75 percent markup unreasonable where Korth sold the bonds to two customers after it held the bonds in inventory for one minute. The NAC then appropriately shifted the burden to Korth to demonstrate that the markups and markdowns were in fact, reasonable. The Firm was unable to make such a showing.

4. The NAC Properly Shifted the Burden to Korth

On appeal, as below, Korth argues that the NAC improperly shifted the burden of proof to the Firm to demonstrate that its markups and markdowns were not excessive. It maintains that because some of the markups were within its 3.9 percent markup policy, and some were below 5 percent, the burden does not shift.[12] Opening Br. at p. 9.[13] There is no legal or logical support for this assertion, and the NAC's burden shifting should be affirmed.

Rather than focus on standards to determine the fairness or reasonableness of a markup, as articulated in MSRB and FINRA rules, the Firm incorrectly concentrates on the actual numeric percentage. The Firm concluded, without any actual supporting case law, that the Commission only shifted the burden to respondent to justify its markups on municipal or corporate bonds when the markup was more than 5 percent. It thus argues that it is only when FINRA presents evidence that a firm's markup met or exceeded five percent that the burden shifts to a firm to show that the facts surrounding these transactions justified higher markups. This is incorrect and not supported by case law. Rather, the burden shifts to a firm to justify its markup once FINRA presents evidence that a firm's markup is unfair or unreasonable, *regardless of the numeric percentage*. It is well-settled that markups and markdowns on

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[12] This argument blatantly ignores the fact that some of the Firm's markups and markdowns exceeded 5 percent.

[13] Korth's brief does not contain page numbers. FINRA counted the cover page as p. 1.

municipal and corporate securities may be excessive although they are substantially below five percent. The Commission has previously has shifted the burden to a respondent where the markup was below five percent.

For example, in *Mark David Anderson*, the respondent's markups on municipal bonds ranged from 1.42 percent to five percent, and the Commission shifted the burden to the respondent to justify the markups. *Anderson*, 2003 SEC LEXIS 3285, at *29. Here, the NAC's shifting of the burden to Korth to "explain why, notwithstanding the evidence to the contrary, [its] pricing was fair" was wholly consistent with well-established Commission precedent. *Id.* (quoting *Richard R. Perkins*, 51 S.E.C. 380, 383 n.16 (1993)); *see also Grey*, 2015 SEC LEXIS 3630, at *18 ("Once the relevant enforcement party presents evidence demonstrating that the markups were excessive, the dealer may introduce evidence to attempt to justify the markups."); *Donald T. Sheldon*, 51 S.E.C. 59, 77 (1992) (once the Division of Enforcement presented evidence establishing the excessiveness of the markups, "the burden shifted to [respondent] to refute that evidence"), *aff'd*, 45 F.3d 1515 (11th Cir. 1995).

The fairness of the markup depends on the criteria articulated in MSRB and FINRA rules and the facts and circumstances unique to each trade, not a hard and fast percentage. *See First Honolulu*, 51 S.E.C. at 701 ("The NASD, as proponent of the issue, had the burden of introducing prima facie evidence of the excessiveness of the markups. The NASD met this burden by presenting evidence that the transactions at issue existed, the size of the transactions, the nature of the securities, the prices paid by [respondents] contemporaneously, and the prices charged to the customers. Once the NASD presented evidence of the markups, the burden shifted to [respondents] to refute this evidence."). Therefore, the Commission should affirm the NAC's burden shifting to Korth.

In a similar vein, the Firm further argues that "FINRA gave us no specific guidance that charges of more than 3.00% would be presumed excessive and a review of the guidance generally and publically provided showed no mention of at 3.00% markups as an enforcement guideline." Opening Br. at p. 3. However, the NAC's decision does not stand for the

proposition that any markup or markdown of more than three percent on a bond transaction is per se unfair. Rather, based on the facts and circumstances surrounding the particular transactions at issue here, the NAC concluded that *in this case*, markups in excess of three percent, or in several instances 3.5 percent, were unfair and unreasonable. Indeed, the Firm's argument's concerning a 3 percent markup cap are undermined by the explicit findings in the decision, in which a 3.5 percent markup was used for some of the trades. Thus, the Commission should affirm the propriety of the NAC's shifting of the burden to Korth to demonstrate that its markups and markdowns were reasonable.

5. The Evidence Introduced by Korth Does Not Support its Markups and Markdowns[14]

Regardless of the methodology used, the Firm argues that each and every markup was fair and reasonable given the nature of the transactions and amount of research conducted by the Firm. However, the NAC correctly concluded that Korth has not proffered sufficient evidence to support its contention that it invested significant time and energy into each of the bond sales at issue, above and beyond what was required. None of the Firm's trade "narratives" contained in its Reply Brief are supported by contemporaneous evidence sufficient to justify the excessive markups and markdowns. The additional evidence includes emails and IMs, printouts from the MSRB's EMMA, offering materials, and news articles. Korth summarizes its attached evidence as "emails, research reports, instant messages, communications with customers, communications with chief financial officers of issuers, prospectus and offering memorandum cover sheets showing the complicated nature of the issues. . . ." Opening Br. at p. 8. The NAC properly

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[14] Korth incorporates by reference its Opening Brief before the NAC as well as its Reply Brief (which is the narrative portion of its original filing that was stricken). RP 1747-1770; 2427-2447. These two briefs themselves consist of 43 pages of argument. This incorporation violates SEC Rule of Practice 450(c), which explicitly prohibits "[i]ncorporation of pleadings or filings by reference into briefs submitted to the Commission." 17 C.F.R. § 201.450(c)

concluded that none of these documents were indicative of any extraordinary expenses incurred and did not satisfy the burden placed upon the Firm to justify its markups and markdowns.

Furthermore, the Firm's Reply Brief contains conclusory and self-serving factual representations about, among other things, the nature of the bonds, the supposed benefits to investors from buying the bonds, and the market action and pricing history during the relevant period.[15] None of the evidence presented by the Firm substantiates its claim that the cost of providing allegedly special services to customers justified its markups and markdowns. The Firm notes that it often required extensive research to make recommendations to customers. However, the Firm does not quantify the time or expense that it supposedly devoted to each transaction or provide any records it maintained reflecting the time that it devoted to particular customers, much less establish that its expenses were unusual. *See Robert Marcus Lane*, Exchange Act Release No. 74269, 2015 SEC LEXIS 558, at *35-36 (Feb. 13, 2015) (rejecting argument that markups were justified by "extensive credit analysis and valuable services that were indirectly paid for only through bond transactions" because respondent failed to provide proof of the claim); *Dennis Todd Gordon*, Exchange Act Release No. 57655, 2008 SEC LEXIS 819, at *49 (Apr. 11 ,2008) (rejecting argument that respondent's markups were justified by the extra effort that the firm devoted to executing the transactions at issue because respondent provided no documentation to validate the claim).

Similarly, a firm cannot charge excessive markups in order to recoup costs associated with researching and educating clients. In this vein, the Firm seems to admit that the expenses supporting its business model, rather than any extraordinary effort, were the driver for its

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[15] The NAC's decision to allow Korth to produce additional evidence does not change the fact that the Firm chose not to have a hearing before the Hearing Panel. The time for the Firm to provide testimony was then – and not before an appellate body.

markups and markdowns. During oral argument, Michael Gibbons, the Firm's CCO, was pointedly asked to give examples of the types of services it provided clients that justified its markups:

> MR. ROGERS: Mr. Gibbons, can you give me an example of something that your firm did during the time period in question with respect to research or, you know, extraordinary and unusual types of services that were to the benefit of the end user of client that is above and beyond what is normally required for just, you know, understanding the product that you are selling? Give me an example of something that you guys were doing that is really extraordinary.
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> MR. GIBBONS: One thing I think that is important is our firm uses -- but at the time we would have had probably five Bloomberg terminals, maybe four. I would have to really think about that, you know, because the traders all had their own Bloomberg terminals. And Bloomberg terminals are expensive and they are the lifeline in the bond market. I mean there's auto X type stuff, you know, ATS's are becoming more popular now. But really a lot of discussion goes to this Bloomberg. But our reps also -- we have a Bloomberg that our reps are able to use. And that's a huge asset I think because there's a lot of firms, in my opinion, I guess I can't definitely state that because, you know, I am not there. But a lot of large firms I don't think grant their representatives unfettered access on Bloomberg because our reps are on there all the time doing the same thing, looking for bonds for their clients. Whereas a lot of firms just only offer things in their own inventory for their reps to kind of market to their client. So our firm being fairly small, we are, I think, in tune with what types of bonds our clients are looking for. And that's why it's valuable for the reps to have those kind of tools. Also, to answer your question, the ability to take down a position a buck, 300,000, a hundred thousand, 200,000, that is a big service that we provided for our clients. The market, particular in that time period, was very competitive –
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> MR. MEEGAN: If I could just ask a question on that. You mean that you are willing to risk your own capital to –
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> MR. GIBBONS: Yes, without taking the proper client orders –
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> MR. MEEGAN: So you are taking stuff in inventory without knowing that you can turn around and sell it, is what you're saying?
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> MR. GIBBONS: Exactly. Because the traders would identify something they felt was beyond (inaudible) in it. So competitive that if you take the time to say, okay, we like this bond out there and then try to contact your clients, you know, maybe there's ten different clients that could buy ten bonds of this hundred block you see, by the time you do that, that bond may or may not be there. But when you

take the capital risk by taking that down, we are making those bonds available for those clients, which is one of the relevant factors that's cited as far as services.

MR. MEEGAN: That's really just being in the business, though.

MR. GIBBONS: Well, when you're talking about a small firm who – it's a lot harder I think for a small firm to do something like that to be in a position -- we would call a position trade and not a market-maker because market-maker is defined in the debt markets, to be honest with you.[16] But a position trader, you know, to take a position down and then market it to your clients like that to give them that opportunity that they might not have is something that's important. RP 2715-2716.

Gibbons' justifications for the markups – that the small size of the Firm and its business model entitled it to charge more in part because it took risks and allowed its representatives unfettered access to several Bloomberg terminals - is insufficient to support the markups charged. The Firm made similar arguments before the NAC, when it listed out its "high necessary expenses" as including Bloomberg Terminals, trading platforms like Knight and Municenter, the cost of providing its proprietary web-based system Shop4bonds to customers, and the postage and handling fee that the clearing firm charges Korth for its trades. RP 1764.

Finally, Korth has acknowledged that in some instances it used markups and markdowns to get paid for other work the firm did for the same customer that was unprofitable. RP 2429. The Firm argues that this conduct was permissible and they should not be penalized for it. But that is not a legitimate basis for charging an excessive markup. The "fact that [a respondent] may not have made a profit on one transaction cannot justify an excessive markup in an unrelated transaction with the same customer." *Staten Sec. Corp.*, 47 S.E.C. at 768-69; *see also Inv. Planning, Inc.*, 51 S.E.C. at 597 ("[T]he price charged in each transaction must be fair.

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[16] Gibbons' testimony also acknowledges that the Firm was not acting as a market-maker, as the Firm had argued in its briefs before the NAC. In its decision, the NAC properly concluded that the Firm did not demonstrated that it was a market maker.

Accordingly, a lack of profit on some transactions for a customer cannot justify excessive markups on others.").

Therefore, the Commission should affirm the NAC's finding that the Firm's markups and markdowns were excessive.

B. Korth's Additional Arguments Fail

1. Consideration of Markets at the Time of the Trading is Not Relevant

Korth argues that the NAC erred in not taking into consideration that the trades in question occurred during the "Financial Crisis 2009-2011." It maintains that "[a]t that time all investors required additional comfort and reassurance through research to purchase every security." Opening Br. at 10. Regardless of market conditions and a firm's trading volume, its markups/markdowns to its customers must be fair relative to the prevailing market price. And the Firm was required to demonstrate the reasonableness of its markups and markdowns once Enforcement made a prima facie showing that the Firm's markups and markdowns were not reasonable. It failed to do so based upon alleged market volatility or any other factor.

2. The Relief Sought By Korth is Not Available in This Appeal[17]

The Firm seeks additional remedies in its brief, including an overarching review of FINRA's approach to markup enforcement. However, such relief is beyond the scope of the SEC's authority in a proceeding to review FINRA disciplinary action pursuant to Exchange Act Section 19(e). *See* 15 U.S.C. § 78s(e)(1)(A) (providing after finding a violation the Commission shall "affirm the sanction imposed by the self-regulatory organization, modify the sanction . . . , or remand to the self-regulatory organization for further proceedings"); *id.* § 78s(e)(1)(B) (providing if the Commission does not find a violation it shall "set aside the sanction imposed by

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[17] The Firm's opening brief makes a representation concerning an alleged conversation between Mr. Korth and Enforcement's counsel, Mr. Burky. Opening Br. at 7. Not only is this irrelevant hearsay, it is also completely unsupported by the record and should carry no weight with the Commission.

the self-regulatory organization and, if appropriate, remand to the self-regulatory organization for further proceedings"); *see also MFS Sec. Corp*, Exchange Act Release No. 47626, 2003 SEC LEXIS 3158 (Apr. 3, 2003) ("MFS asks for damages, but we do not have the power to make such an award.").

3. Lack of Customer Harm is Not Relevant

The Firm also maintains that its customers "benefited handsomely from [its] work and received no harm whatsoever." Opening Br. at. p. 3. However, the customers were harmed—they were forced to pay excessive markups and markdowns, making their investments less profitable. In any event, the argument that customers' investments were successful and were not harmed by Korth's actions is not a defense to charging markups. As the Commission has stated, "[t]he absence of . . . customer harm is not mitigating, "as our public interest analysis focus[es] . . . on the welfare of investors generally." *Howard Braff*, Exchange Act Release No. 66467, 2012 SEC LEXIS 620, at *26 (Feb. 24, 2012).

C. The Sanctions Imposed Are Neither Excessive Nor Oppressive

The Commission should affirm that NAC's sanctions, which are well-supported by the record and are neither excessive nor oppressive. Section 19(e)(2) of the Exchange Act guides the Commission's review of FINRA's sanctions, and provides that the Commission may eliminate, reduce, or alter a sanction if it finds that the sanction is excessive, oppressive, or imposes a burden on competition unnecessary or appropriate to further the purposes of the Exchange Act. 15 U.S.C. § 78s(e)(2).[18] In considering whether sanctions are excessive or oppressive, the

[18] The Firm argues that bond market liquidity has suffered as a result of "FINRA's lack of clarity regarding its markup policies. . .." Opening Br. at p. 4. However, issues surrounding market liquidity and FINRA's markup policies in general are not at issue in this appeal. In any event, the record does not support the Firm's claims, nor has the Firm shown that the sanction imposes a burden on competition.

Commission gives significant weight to whether the sanctions are within the allowable range of sanctions under FINRA's Sanction Guidelines ("Guidelines"). *See Vincent M. Uberti*, Exchange Act Release No. 58917, 2008 SEC LEXIS 3140, at *22 (Nov. 7, 2008) (noting that Guidelines serve as "benchmark" in Commission's review of sanctions).

The sanctions the NAC imposed on the Firm are neither excessive nor oppressive and serve to protect investors, market integrity, and the public interest. The sanctions imposed are specifically tailored to address the type and severity of the violations at issue, are consistent with FINRA's Sanction Guidelines, and will serve to deter future misconduct. The Commission should therefore affirm the sanctions imposed in their entirety.

In determining sanctions, the NAC considered the Guidelines, including the Principal Considerations in Determining Sanctions set forth therein and any other case-specific factors, and censured the Firm, ordered it to pay restitution in the amount of $29,268 to affected customers, and ordered that it retain an independent consultant.[19] RP 2844-2846.

The sanctions imposed against Korth are appropriately tailored to prevent future misconduct. For excessive markups and/or markdowns, the Guidelines recommend a fine of $5,000 to $73,000 plus, if restitution is not ordered, the gross amount of the excessive markups or markdowns.[20] In addition, in cases of negligent misconduct, the Guidelines recommend suspending the respondent in any or all capacities for a period of 10 to 30 business days and requiring demonstrated corrective action with respect to the firm's markup/markdown policy

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19 *See FINRA Sanction Guidelines* (2017), http://www.finra.org/sites/default/files/2017_April_Sanction_Guidelines.pdf.

20 *Id.* at 91.

or commission policy.[21] In egregious cases, adjudicators should consider imposing a suspension in any or all capacities for up to two years or a bar.[22]

The NAC concluded that there were several factors that supported a sanction lower than that recommended by the Guidelines. The evidence suggested that the Firm's misconduct was aberrant and did not exhibit a pattern of charging excessive markups[23] and that the Firm's misconduct was not intentional or reckless, but rather the Firm attempted, albeit unsuccessfully in some instances, to calculate fair markups.[24] Therefore, it is clear that the sanction was neither excessive nor oppressive and served solely a remedial purpose and should be affirmed by the Commission.

Korth argues that they should not have to pay restitution to the affected customers, arguing that they "did extraordinary work for which we charged fairly." Opening Br. at 11. However, because the Firm charged its customers excessive markups and markdowns, the NAC properly followed the Guidelines which instruct adjudicators to order restitution where it is appropriate to remediate misconduct and necessary to "restore the status quo ante for victims who would otherwise unjustly suffer loss."[25] The Firm unfairly marked up or marked down bond transactions, thereby reducing the yield to its customers. Because the customers suffered

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21 *Id.*

22 *Id.*

23 *Id.* at 8 (Principal Considerations in Determining Sanctions No. 15).

24 *Id.* (Principal Considerations in Determining Sanctions No. 13).

25 *Id.* at 4 (General Principles Applicable to All Sanction Determinations No. 5); 91.

a quantifiable loss, proximately caused by the Firm's unfair markups and markdowns, restitution was appropriately awarded and should be affirmed by the Commission.

Finally, Korth takes issue with the requirement that it retain an independent consultant. First, the relevant Guidelines direct the adjudicator to consider an independent consultant. In this case, both the Hearing Panel and the NAC determined that in light of the Firm's issues with appropriately pricing the markups, albeit in some – not all circumstances, a consultant would be appropriate for the very limited purpose of reviewing the Firm's pricing procedures. This requirement is narrowly tailored to respond to the violations at issue here, is neither excessive nor oppressive, and should be affirmed by the Commission.[26]

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[26] The Firm notes that its policies and procedures have "evolved" and it has "essentially" ended its small trade research business and in most cases doesn't charge markups in excess of 2.5 percent and it has institutional/accredited customers. Thus, argues the Firm, there is no need for an independent consultant. Opening Br. at p 12. Even assuming these representations are accurate, they don't negate the need for an independent consultant to review the Firm's pricing to its customers. Furthermore, as noted in this brief, markups of 2.5 percent can still be considered excessive.

V. CONCLUSION

The NAC's findings that Korth engaged in violations are fully supported by the record, and the sanctions imposed for the violations are appropriate to deter the Firm from engaging in future misconduct. The Commission should sustain the NAC's decision in all respects.

Respectfully submitted,

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September 23, 2019

CERTIFICATE OF SERVICE

I, Colleen Durbin, certify that on September 23, 2019, I caused the original and three copies of the FINRA's Brief in Opposition to Application for Review – in the matter of Application for Review of J.W. Korth & Company, Administrative Proceeding No. 3-19206, to be served by messenger on:

Vanessa A. Countryman, Secretary
Securities and Exchange Commission
100 F Street, N.E.
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On this date, I also caused one copy of FINRA's Brief in Opposition to Application for Review to be served via overnight FedEx and electronic mail on:

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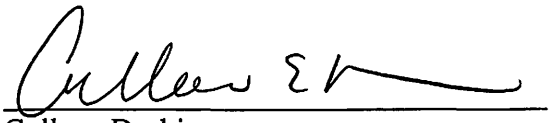
Different methods of service were used because courier service could not be provided to the applicant's counsel.

Respectfully submitted,



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