This is a reproduction of a library book that was digitized by Google as part of an ongoing effort to preserve the information in books and make it universally accessible.

Google™ books

https://books.google.com

LIBRARY OF THE
UNIVERSITY OF ILLINOIS
AT URBANA-CHAMPAIGN

332.6
Un34d
v. 44

The person charging this material is responsible for its return to the library from which it was withdrawn on or before the **Latest Date** stamped below.

Theft, mutilation, and underlining of books are reasons for disciplinary action and may result in dismissal from the University.

UNIVERSITY OF ILLINOIS LIBRARY AT URBANA-CHAMPAIGN

JAN 4 [illegible]

DEC 15 1975

MAY 24 1976

MAY 12 1976

DEC 20 1975

DEC 13 1976

MAY 23 1977

MAY 23 1977

L161—O-1096

SECU

D

SECURITIES AND EXCHANGE COMMISSION

DECISION AND REPORTS

VOLUME 44

July 1, 1969 to June 30, 1972

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON:

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402 - Price $11.95 (paper cover)
Stock Number 4600-00096

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

HAMER H. BUDGE, *Chairman.*[1]
Took oath of office on July 8, 1964, and became chairman on February 22, 1969.

WILLIAM J. CASEY, *Chairman.*
Took oath of office on April 14, 1971, and became chairman on April 14, 1971.

HUGH F. OWENS, *Commissioner.*
Took oath of office on March 23, 1964.

FRANCIS M. WHEAT, *Commissioner.*
Took oath of office on October 2, 1964.[2]

RICHARD B. SMITH, *Commissioner.*
Took oath of office on May 1, 1967.[2]

JAMES J. NEEDHAM, *Commissioner.*
Took oath of office on July 10, 1969.

ALBERT SYDNEY HERLONG, *Commissioner.*
Took oath of office on October 29, 1969.

PHILIP A. LOOMIS, JR., *Commissioner.*
Took oath of office on August 13, 1971.

ORVAL DUBOIS, *Secretary*

[1] Chairman Budge resigned on January 2, 1971.

[2] Commissioner Wheat resigned on September 30, 1969.

[2] Commissioner Smith resigned on July 30, 1971.

332.6
Un34d
v.44

CONTENTS

	Page
Members of the Securities and Exchange Commission	II
involved	V
Decisions and Reports of the Commission	915
Index	
Securities Act of 1933	916
Securities Exchange Act of 1934	919
Public Utility Holding Company Act of 1935	940
Investment Company Act of 1940	942
Investment Advisers Act of 1940	944

TABLE OF REPORTS

Embassy Construction Company, Inc.	821
Four Seasons Equity Corporation	821
Four Seasons Franchise Centers, Inc.	821
Four Seasons Nursing Centers of America, Inc.	821
Four Seasons Overseas, N.V.	821
FSN Corporation	821
Great Lakes Gas Corporation	56
Jade Oil & Gas Corporation	56
National Medical Supply, Inc.	821
Yale Express System, Inc.	772
Do	866

25Mr75 recd Deposit

TABLE OF DECISIONS AND REPORTS
WITH SECTIONS INVOLVED

Title	Securities Act of 1933 and Trust Indenture Act of 1939	Securities Exchange Act of 1934	Public Utility Holding Company Act of 1935	Investment Company and Investment Advisers Act of 1940	Page herein
	Section involved	Section involved	Section involved	Section involved	
A					
A.V.C. Corporation				8	134
Do				6, 17	389
Abacus Fund, Ind				17	876
Abbett, Sommer & Company, Inc		15, 15A			104
Abbett, Sommer & Company Mortgage Corporation		15, 15A			104
Adam, David M., Jr		15, 15A, 19			481
Amann, Louis S		15, 15A, 19			481
American European Securities Company				6	889
Anderson, Richard Clark		15, 15A, 19			523
Arkansas-Missouri Power Company			11		792
Augion-Unipolar Corporation	8				438
Do	8				613
B					
Babcock & Co		15, 15A			350
Babcock, Louis W		15, 15A			350
Barraco and Co		15A			539
Barraco, Paul		15A			539
Basic Sciences Inc	8				893
Baskin, Harvey A		15, 15A, 19			481
Beck, Herbert		15, 15A			100
Benedict, Alfred		15A			805
Benson & Co., Inc., C.A.		15, 15A			8
Berkshire Industries, Inc.				17	126
Blair & Co., D. H		15, 15A, 19			320
Blimpie Corporation of America	8				558

TABLE OF DECISIONS AND REPORTS—Continued

With Sections Involved—Continued

Title	Securities Act of 1933 and Trust Indenture Act of 1939	Securities Exchange Act of 1934	Public Utility Holding Company Act of 1935	Investment Company and Investment Advisers Act of 1940	Page herein
	Section involved	Section involved	Section involved	Section involved	
Boesel, Richard E., Jr		15, 15A			579
Bohn, Ray G		15, 19			709
Bohn-Williams Securities Corporation		15, 19			709
Breslin & Associates, Daniel		15, 15A			596
Breslin, Daniel J		15, 15A			596
Burden Investors Services, Inc		15, 15A, 19		*203	633
Burden & Co., William A. M		15, 15A, 19		*203	633
Burwell, Dean Russell		15, 15A, 19		*203	810
Butcher & Sherrerd				6, 17	389
C					
Cambridge Housing, Inc			9, 10		422
Cantor, Melvin		15, 15A, 19			45
Carr, W. Lyles, Jr		15, 15A, 19			481
Carter Group, Inc., The				3	904
Castle, Joseph L				6, 17	389
Cea, Richard N		15, 15A			8
Columbia Gas of Pennsylvania, Inc			6, 7, 9, 10		28
Columbia Gas System, Inc., The			6, 7, 9, 10		28
Commonwealth Securities Corporation		15, 15A			100
Competitive Capital Corporation		15, 15A			579
Conklin, James C		15, 15A			8
Conrad & Company, Inc		15			725
Conrad, Margaret J		15			725
Conrad, Thomas D., Jr		15			725
Conston, Leo L		15A			805
Cortlandt Investing Corporation		15, 15A, 19			45
Coughenour, John F		15, 15A			666

*Investment Advisers Act of 1940.

TABLE OF DECISIONS AND REPORTS—Continued

With Sections Involved—Continued

Title	Securities Act of 1933 and Trust Indenture Act of 1939	Securities Exchange Act of 1934	Public Utility Holding Company Act of 1935	Investment Company and Investment Advisers Act of 1940	Page herein
	Section involved	Section nvolved	Section involved	Section involved	
D					
Dackerman and Company, Inc., Harry C.		15, 15A, 19		*203	442
Dackerman, Harry C.		15, 15A, 19		*203	442
Danais Investment Co., Inc., R.		15A			801
Danais, Romeo		15A			801
Davis, Homer E.		15, 15A, 19			481
Davis & Co., Inc., M. G.		15			153
Doctor Dolittle Animal Fairs, Inc	8				310
Dornacker, John		15, 15A, 19			461
Dunhill Securities Corporation		15			1
Do		15, 15A			472
E					
Eastern Gas and Fuel Associates			10		282
Embassy Construction Company, Inc. (Report)					821
Equity Corporation, The.				8	235
Do				8	428
F					
FSN Corporation (Report)					821
Fairfield Partners		15, 15A, 19		*203	633
Federated Purchaser, Inc		15			260
Filtrol Corporation		15			860
First Multifund Advisory Corp				17	680
First Multifund of America, Inc				17	680

*Investment Advisers Act of 1940.

TABLE OF DECISIONS AND REPORTS—Continued

With Sections Involved—Continued

Title	Securities Act of 1933 and Trust Indenture Act of 1939	Securities Exchange Act of 1934	Public Utility Holding Company Act of 1935	Investment Company and Investment Advisers Act of 1940	Page herein
	Section involved	Section involved	Section involved	Section nvolved	
Fisher, Kenneth E		15, 15A			8
Fleschner Becker Associates		15, 15A, 19		*203	633
Four Seasons Equity Corporation (Report)					821
Four Seasons Franchise Centers, Inc. (Report)					821
Four Seasons Nursing Centers of America, Inc. (Report)					821
Four Seasons Overseas, N.V. (Report)					821
Frances, Ltd., L. A		15			588
G					
General Electric Company				6, 16, 32	87
Gonzales, Roland L., Jr		15			725
Goodbody & Co		15, 15A, 19			320
Gray Investments, Inc., M. V		15, 15A			567
Gray Line Corporation				3	314
Gray, Maxel V		15, 15A			567
Great Lakes Gas Corporation (Report)					56
Great Northern Management Co., Inc		15			266
Gregory & Sons		15, 15A, 19			630
Gregory, William H., III		15, 15A, 19			630
Greene & Company		15, 15A, 19			285
Greene, Irving A		15, 15A, 19			285
Guiducci, Louis		15A			129
H					
Hafen, Darrell G				*203	347
Hagen, Edward J		15A			701
Hagen Investments, Inc		15A			701

*Investment Advisers Act of 1940.

TABLE OF DECISIONS AND REPORTS—Continued

With Sections Involved—Continued

Title	Securities Act of 1933 and Trust Indenture Act of 1939	Securities Exchange Act of 1934	Public Utility Holding Company Act of 1935	Investment Company and Investment Advisers Act of 1940	Page herein
	Section involved	Section involved	Section involved	Section involved	
Hagopian, Robert R		15, 15A, 19		*203	810
Haight & Co., Inc		15, 15A, 19			481
Haight, James F		15, 15A, 19			481
Hardy, John		15, 15A, 19			523
Harper, James W., III		15, 15A, 19			481
Harrison, Benjamin A		15, 19			336
Hartwell & Co., J. M		15, 15A, 19		*203	633
Hartwell Associates		15, 15A, 19		*203	633
Hodgdon, A. Dana		15, 15A, 19			481
Horn, Bernard		15, 15A, 19			285
Hawaiian Electric Company, Inc			9, 10		189
I					
Illinois Power Company			6, 10		140
Intercontinental Industries, Inc		12			273
International Aerospace Associates, Inc	3, Reg. A				432
Investors Management Co., Inc		15, 15A, 19		*203	633
Isaacs, Edgar F		15, 15A, 19			45
Ivy Fund, Inc				17	560
J					
Jackpot Exploration Corp	3, Reg. A				303
Jade Oil & Gas Co. (Report)					56
Jaffee & Company		15, 15A, 19			285
Jaffee, Wilton L., Jr		15, 15A, 19			285
Jamieson, Henry L		15, 15A, 19		*203	810
Jones & Co., A. W		15, 15A, 19		*203	633
Jones Associates, A. W		15, 15A, 19		*203	633
K					
Kane, David Paul		15			216

*Investment Advisers Act of 1940.

TABLE OF DECISIONS AND REPORTS—Continued

With Sections Involved—Continued

Title	Securities Act of 1933 and Trust Indenture Act of 1939	Securities Exchange Act of 1934	Public Utility Holding Company Act of 1935	Investment Company and Investment Advisers Act of 1940	Page herein
	Section involved	Section involved	Section involved	Section involved	
Katz, Seymour		15, 15A, 19			320
Kaufman, Paul M**					374
Kennedy, Cabot & Co., Inc		15			216
Keystone State Investment Securities, Inc		15, 15A			8
Kibler, Robert F		15, 15A, 19			481
Kitain, Burton		15, 15A, 19			481
Kivitz, Murray A**					600
Kness, Robert E		15, 15A			8
Kopel, Morris		15			153
Kuehner, Hanns E		15, 15A, 19			45
L					
Laird, Bissell & Meeds		15, 15A, 19			45
LaSalle Street Capital Corporation				6, 17	655
Laser Nucleonics, Inc	8				206
Lautsbaugh, Jack S		15, 15A, 19		*203	442
Lee & Co., Inc., M. L		15, 15A, 19			285
Lee Motor Products, Inc		12			33
Levine, Lawrence		15			153
Levy, Martin L		15, 15A, 19			285
Loeb, Rhoades & Co		15, 15A, 19			202
Do				9	320
Loeb, Rhoades Management Co., Inc				9	202
Lomasney & Company		15, 15A			453
Lomasney, Myron A		15, 15A			453
Louisiana Power & Light Company			6, 7		457
Mc					
McKay, Henry L		15, 15A, 19		*203	442

*Investment Advisers Act of 1940.

**Rule 2(e)—Rules of Practice.

TABLE OF DECISIONS AND REPORTS—Continued

With Sections Involved—Continued

Title	Securities Act of 1933 and Trust Indenture Act of 1939	Securities Exchange Act of 1934	Public Utility Holding Company Act of 1935	Investment Company and Investment Advisers Act of 1940	Page herein
	Section involved	Section involved	Section involved	Section involved	
M					
Madison Fund, Inc		15, 15A, 19		*203	633
Magnuson, Harry F		15, 19			336
Maine Yankee Atomic Power Company et al			6, 9, 10		396
Major Realty Corporation		15			535
Mann and Company, Inc		15, 15A			585
Martire, Lawrence		15			588
Massachusetts Gas System			11		756
Mates Financial Services		15		*203	246
Mates, Frederic S		15		*203	246
Mates Management Company		15		*203	246
May & Co., Inc		15A			412
Meadows, Louis Benjamin		15			588
Meid, David H		15, 15A, 19		*203	810
Meyerson & Co., Inc		15, 15A, 19		*203	810
Meyerson, Harry		15, 15A, 19		*203	810
Michigan Consolidated Gas Company			9, 10		361
Do			10		409
Do			6		425
Michigan Consolidated Homes Corporation			9, 10		361
Do			10		409
Do			6		425
Middle South Utilities, Inc			19		532
Do			6, 7, 9, 10		548
Do			11		792
Miller, Charles J		15, 15A, 19			320
Miller, Richard V		15, 15A, 19			320
Miller, Robert W		15, 15A, 19			320
Mississippi Power & Light Company			9, 10		406

*Investment Advisers Act of 1940.

TABLE OF DECISIONS AND REPORTS—Continued

With Sections Involved—Continued

Title	Securities Act of 1933 and Trust Indenture Act of 1939	Securities Exchange Act of 1934	Public Utility Holding Company Act of 1935	Investment Company and Investment Advisers Act of 1940	Page herein
	Section involved	Section involved	Section involved	Section involved	
Monmouth Capital Corporation	8				626
Mutual Funds Advisory, Inc				6, 17, 22	761
N					
National Association of Securities Dealers, Inc.		15A			129
Do		15A			212
Do		15A			412
Do		15A			539
Do		15A			622
Do		15A			701
Do		15A			801
Do		15A			805
Do		15A			896
National Fuel Gas Company			6, 7, 9, 10, 12		115
National Medical Supply, Inc. (Report)					821
Neumark, Ronald		15, 15A, 19			320
New England Electric System			11		227
Do			11		756
Newburger and Company		15, 15A, 19		*203	442
Newburger, Frank L., Jr		15, 15A, 19		*203	442
Newburger, Richard L.		15, 15A, 19		*203	442
Norris Grain Company				6, 17	699
O					
Ohio Power Company			9, 10		340
Do			9, 10		422
Olympic Insurance & Securities Agency		15A			212

*Investment Advisers Act of 1940.

TABLE OF DECISIONS AND REPORTS—Continued

With Sections Involved—Continued

Titie	Securities Act of 1933 and Trust Indenture Act of 1939	Securities Exchange Act of 1934	Public Utility Holding Company Act of 1935	Investment Company and Investment Advisers Act of 1940	Page herein
	Section involved	Section involved	Section involved	Section involved	
P					
Park Westlake Associates		15, 15A, 19		*203	633
Pathe Industries, Inc				17	879
Pennaluna & Company, Inc		15, 19			336
Pennzoil United, Inc			11		75
Performance Systems, Inc	8	15			750
Polarad Electronics Corporation		12			734
Porteous and Company, Inc		15, 15A, 19		*203	442
Porteous, Douglas K		15, 15A, 19		*203	442
Provident Fund for Income, Inc	8				442
Provident Management Corporation		15, 15A, 19		*203	442
Q					
Quinn and Company, Inc		15, 15A, 19			461
R					
Rau, Harold J		15, 15A, 19			45
Reiter, Max		15, 15A, 19			45
Reynaud, Patrick R		15			1
Do		15, 15A			472
Reynaud de Saint Oyant, Ltd., Patrick R		15, 15A			472
Reynaud de Saint Oyant, Patrick Rene (a/k/a Patrick R. Reynaud)		15, 15A			472
Rosenberg, Harold R		15			153
Rosenblatt, Burton J		15, 15A			585
Do		15, 15A			910

*Investment Advisers Act of 1940.

TABLE OF DECISIONS AND REPORTS—Continued

With Sections Involved—Continued

Title	Securities Act of 1933 and Trust Indenture Act of 1939	Securities Exchange Act of 1934	Public Utility Holding Company Act of 1935	Investment Company and Investment Advisers Act of 1940	Page herein
	Section involved	Section involved	Section involved	Section involved	
S					
Schwabacher & Co		15, 15A, 19			39
Schwabacher, Albert E., Jr		15, 15A, 19			39
Security Planners Associates, Inc		15, 15A			738
Security Savings and Loan		12			675
Sideris, Spiro		15A			212
Sidoti, A. Frank		15			588
Sinclair, Edward		15, 15A, 19			523
Slater, Peter J		15, 15A, 19			230
Smolar, Howard		15, 15A			738
Solomon, Herman M		15, 15A			585
Do		15, 15A			910
Sommer, Charles W., III		15, 15A			104
Southern California First National Bank of San Diego		15, 15A, 19			652
Sprinkel, Robert L., III		15, 15A			579
Stead, Robert T		15, 15A			350
Studley, Shupert and Co., Inc. of Boston				17	560
Sunset Plaza Apartments, Inc			9, 10		406
Susquehanna Corporation, The		15			379
T					
Tallen, Linda D		15			216
Talley Industries, Inc				17	165
Tallman, Alfred Bryant, Jr		15, 15A, 19			230
Topol, Robert		15, 15A, 19			285
Transmittal Securities Corporation		15A			805
Trapani, Ralph J		15, 15A, 19			320
Troster, Singer & Co		15, 15A, 19			320

TABLE OF DECISIONS AND REPORTS—Continued

With Sections Involved—Continued

Title	Securities Act of 1933 and Trust Indenture Act of 1939	Securities Exchange Act of 1934	Public Utility Holding Company Act of 1935	Investment Company and Investment Advisers Act of 1940	Page herein
	Section involved	Section involved	Section involved	Section involved	
U					
U.S. Communications Corporation				6, 17	389
Utilities & Industries Corp				3	904
V					
Van Strum & Towne, Inc		15, 15A, 19		*203	633
Vermont Yankee Nuclear Power Corporation et al			6, 9, 10		396
W					
Waber, Morris		15, 15A, 19		*203	442
Washington Gas Light Company			11		515
Wax, Walter		15			153
Wayhart, Frank P		15, 15A			8
Werner, Benjamin		15, 15A			622
Do		15			745
Do		15, 15A			886
Werner & Co., Benjamin		15			622
Western Securities Co				*203	347
Weston and Company, Inc		15, 15A, 19			692
Weston, Walter David		15, 15A, 19			692
Whitaker, Alfred A. S		15, 15A, 19		*203	442
Williams, Donald J		15, 19			709
Williams Securities Corporation, Bohn-		15, 19			709
Winfield & Co., Inc		15, 15A, 19		*203	810
Winfield Distributors, Inc		15, 15A, 19		*203	810
Winfield Underwriters, Inc		15, 15A, 19		*203	810

*Investment Advisers Act of 1940.

TABLE OF DECISIONS AND REPORTS—Continued

With Sections Involved—Continued

Title	Securities Act of 1933 and Trust Indenture Act of 1939	Securities Exchange Act of 1934	Public Utility Holding Company Act of 1935	Investment Company and Investment Advisers Act of 1940	Page herein
	Section involved	Section involved	Section involved	Section involved	
Wittow & Company		15, 15A			666
Wittow, Herbert L		15, 15A			666
Woolwich, Sidney		15, 15A, 19			320
Wunsch, George J		15			95
Y					
Yale Express System, Inc. (Report)					772
Do					866
Z					
Zenoff, Ben Company, Inc., The		15			719
Zenoff, Gertrude		15			719

In the Matter of

DUNHILL SECURITIES CORPORATION

PATRICK R. REYNAUD

File No. 3-1961. Promulgated July 14, 1969

Securities Exchange Act of 1934—Section 15(b)

BROKER-DEALER PROCEEDINGS

Suspension of Registration

Where record shows that registered broker-dealer or its president have been permanently or preliminarily enjoined from violations of the registration, anti-fraud, net capital and record-keeping provisions of the securities acts, and evidence in the record indicates that registrant violated registration and anti-fruad provisions, that subsequently to injunction against violations of net capital and record-keeping requirements, registrant and its president also violated those provisions, and that registrant failed reasonably to exercise supervision to prevent violations, *held*, sufficient showing made to require in the public interest and for protection of investors suspension of broker-dealer registration pending final determination of whether registration should be revoked.

APPEARANCES:

Michael L. Blane, *William Nortman* and *Thomas Beirne*, of the New York Regional Office, for the Division of Trading and Markets of the Commission.

Philip C. Schiffman, for Dunhill Securities Corporation and *Patrick R. Reynaud.*

FINDINGS, OPINION AND ORDER

The issue now before us in these proceedings under the Securities Exchange Act of 1934 is whether it is necessary or appropriate in the public interest or for the protection of investors to suspend the registration as a broker-dealer of Dunhill Securities Corporation ("registrant") pending determination of whether such registration should be revoked. These proceedings were instituted on April 21, 1969, pursuant to Section 15(b) of the Exchange Act, and evidentiary hearings on the suspension issue were held for 10 days during the period May 5 through May 20, 1969. The hearing examiner filed an initial decision June 2, 1969 in which he concluded that suspension was required in the public interest and for the protection of investors. Registrant and Patrick R. Reynaud, its president and sole stockholder, filed a petition for review, which we granted. Briefs were filed on behalf of respondents and our Division of Trading and Markets. Respondents also requested oral argument, which was scheduled for July 1, 1969 but was not held due to the failure of counsel for respondents to appear.

After consideration of the briefs and an independent review of the record, we agree with the findings and conclusions of the hearing examiner and we adopt the detailed findings set forth in his initial decision. As the examiner found, the evidence in the record indicates that during the period February through May 1968, registrant violated the registration and anti-fraud provisions in connection with a large-scale distribution of unregistered shares of stock of Lynbar Mining Corporation, Ltd. A substantial number of the sales of these shares were made through registrant's own trading account and an account in the name of Panamerican Bank and Trust Company, a Panama firm of which Reynaud is president, for which Reynaud made the decisions and which the record suggests Reynaud treated as his own personal trading account. Reynaud also participated in certain of registrant's sales to customers whose accounts he brought to registrant when he joined it in 1967.

The record further indicates, as the examiner found, that notwithstanding an injunction in June 1968 enjoining registrant and Reynaud from violations of the bookkeeping and net capital requirements, registrant again violated those requirements in 1969. The record indicates that registrant's books were in various stages of incompleteness during the period from January 31, 1969 to April 21, 1969, the date of the order for proceedings, and that as of March 31, 1969, registrant had a net capital deficiency of $140,967. Finally, as the examiner also found, the record indicates that registrant failed reasonably to supervise employees with a view to preventing the Lynbar and record-keeping violations.

As the examiner also found, the record shows that registrant and Reynaud were the subjects of a total of four injunctions issued by the United States District Court for the Southern District of New York between May 1967 and February 1969. Thus, on May 10, 1967, Reynaud and Panamerican were permanently enjoined on consent from selling unregistered securities of Panamerican in violation of Section 5 of the Securities

Act of 1933. On February 20, 1968, registrant, with others, was preliminarily enjoined from violations of the registration and anti-fraud provisions of the Securities Act and of the Exchange Act in connection with the offer and sale of stock of the North American Research and Development Corporation. On June 18, 1968, as noted above, registrant and Reynaud were preliminarily enjoined from violating the net capital and record-keeping provisions of the Exchange Act and rules thereunder.[1] And on February 20, 1969, registrant was permanently enjoined on consent from violating the registration and anti-fraud provisions in connection with sales of stock of Lynbar or any other securities.[2]

Respondents do not deny the existence of the injunctions against them. They argue, however, that their "constitutional rights" were violated by the introduction and use of a certified copy of the consent injunction against Reynaud and Panamerican. The final judgment of permanent injunction in that case noted that the defendants (Reynaud and Panamerican), without admitting the substantive allegations of the complaint, consented to the entry of a permanent injunction "without this Final Judgment constituting evidence against, or an admission by said defendants." [3]

As the examiner pointed out, Section 15(b)(5)(c) of the Exchange Act specifically provides that the existence of an injunction relating to securities activities against a person associated with a registered broker-dealer is a basis for disciplinary action, including revocation, against that broker-dealer if such disciplinary action is in the public interest. We have consistently held that under these provisions of the Exchange Act a consent injunction, no less than one issued after trial, furnishes a basis for denial or revocation of a broker-dealer registration if such action is in the public interest,[4] even where the consent is accompanied by a denial of the allegations in the injunction complaint.[5] As we have stated before, "The recitals in the decree regarding the nature and

[1] In this matter the Court on June 6, 1969 signed a judgment of permanent injunction, on default, against registrant and Reynaud. *S.E.C. vDunhill Securities Corporation*, U.S.D.C., S.D.N.Y., 68 Civil Action File No. 2152.

[2] *S.E.C.* v. *Lynbar Mining Corporation, Ltd.*, S.D.N.Y., Civil Action File No. 68 Civ. 4493.

[3] *S.E.C.* v. *Panamerican Bank & Trust Co. and Patrick Reynaud*, U.S.D.C., S.D.N.Y., 67 Civil Action File No. 1825, May 9, 1967.

[4] *Balbrook Securities Corporation*, 42 S.E.C. 496, 497 (1965) and cases there cited.

[5] *Securities Distributors, Inc.*, 40 S.E.C. 482, 485 (1961); *Kimball Securities, Inc.*, 39 S.E.C. 921, 923 (1960).

purpose of the consent are all part of the affirmation that the consent did not constitute an admission of the allegations." [6]

In the instant case, the consents in the Panamerican injunction action did not deny the allegations of the complaint, they stated that no promise of any kind had been made by any representative of the Commission in consideration for the consents, and the court's final judgment did not state that the injunction could not be used in administrative proceedings.[7] Moreover, the Panamerican injunction is only one of four injunctions entered against registrant and Reynaud. Even if it were disregarded, any of the other injunctions together with the other evidence in the record would amply support the examiner's conclusion that suspension pending final determination of the revocation issue is in the public interest.

We have considered various other contentions of the respondents, including that they were deprived of due process, that the examiner acted in an arbitrary manner and that there is no substantial evidence to support his initial decision, and we find all such contentions to be without merit.

Among other things, respondents argue that the examiner erred in granting the Division's motion made during the hearings to amend the order for proceedings so as to add the allegation of a net capital violation as of March 31, 1969, claiming that such motion was untimely and that granting it was prejudicial to them. However, we are of the opinion that the examiner acted reasonably within his discretion in concluding that the Division presented an adequate justification for the failure to include the allegation earlier, and no showing of prejudice in their ability to present a defense has been made by respondents. In fact, respondents do not appear to deny the existence of a substantial net capital deficiency as of March 31, 1969, and registrant's own accountant called as a witness by respondents did not attempt to deny such a deficiency but only sought to establish that any such deficiency had been corrected by registrant and Reynaud as of April 30, 1969.[8]

[6] *Balbrook Securities Corporation, supra*, p. 497.

[7] Respondents also complain that the examiner refused to direct the Division to produce as a witness the staff attorney assigned to the Panamerican matter. However, as the examiner advised respondents on the first day of the hearings, respondents could have appealed the examiner's ruling to us and requested a subpoena or order requiring the attendance of the witness but they did not do so.

[8] We agree with the examiner's finding that the record is inconclusive as to whether registrant had been brought into compliance by April 30, 1969. In the accountant's calculations upon which he based his testimony of compliance the accountant included as current assets all customer debit balances, totalling $111,000, which he assumed without verifying were fully secured, although he conceded that such asset figure would have to be reduced to the extent such balances were not secured. He also accepted as a current asset an item of over $16,000 listed as money of registrant on deposit with Panamerican, on the verification only of Reynaud himself who was president both of registrant and of Panamerican. In addition, the accountant's calculations included as an asset a loan of $125,000 from Reynaud only $100,000 of which was shown to be subordinated to claims of other creditors.

Respondents have not denied the record-keeping violations, arguing only that such violations were not willful and that they were corrected by the time of the hearings. It is well established, however, that a finding of willfulness under Section 15(b) of the Exchange Act does not require an intent to violate the law and that it is sufficient that a respondent intentionally engagee in conduct which constitutes a violation.[9] Reynaud as the president and sole stockholder was in active management of registrant in 1969 and was aware of the state of registrant's records. Moreover, at this stage, on the issue of an interim suspension, it is not necessary to and we do not find that willful violations have been established,[10] only that there is a prima facie showing that willful violations have occurred.

The order for proceeeings originally included as a respondent one Edward Flinn, a former salesman of registrant who testified at the hearings as a witness. On the basis of his consent, in which he neither admitted nor denied the charges as to him, an order was issued on May 9, 1969 barring him from association with any broker or dealer.[11] We reject respondents' contention or implication that the examiner's reference, which was in a footnote, to the bar order against Flinn, was or could be used to "inflame" us into a prejudicial state of mind against respondents and create a "guilt by association." Any reading of the examiner's initial decision demonstrates that the reference to the Flinn order, which is a matter of public record, was merely a factual explanation of what had happenee to one of the original respondents in the proceedings and did not affect the findings as to registrant and Reynaud in any way.

Upon a review of the record, we also reject respondents' contentions that the examiner improperly relied on matters not in the record and improperly admitted into evidence certain documents in connection with the charges based on sales of Lynbar stock. These contentions relate to the evidence submitted by the Division, in the form of summaries and "flow charts" prepared by a staff investigator, to show the sale of large blocks of Lynbar shares by control persons in Canada and to trace these shares to registrant and other broker-dealers in this country. The investigator testified that the charts and summaries accurately reflected the basic underlying records which he had examined. All the material he

[9] *E.g., Tager* v. *S.E.C.*, 344 F.2d 5,8 (C.A. 2, 1965); *Gilligan, Will & Co.*, 38 S.E.C. 388, 395 (1958), *aff'd sub. nom. Gilligan, Will & Co.* v. *S.E.C.*, 267 F.2d 461, 468 (C.A. 2, 1959), *cert. denied* 361 U.S. 896 (1959).

[10] *A.G. Bellin Securities Corp.*, 39 S.E.C. 178, 185 (1959).

[11] Securities Exchange Act Release No. 8604.

referred to in the preparation of his charts and summaries was either introduced into testimony or otherwise made available in the hearing room to respondents' counsel, and the investigator was subjected to cross-examination. Respondents have not pointed out any discrepancies between the underlying records and the summaries and charts.[12] It is permissible for a summary of material contained in a large number of documents to be admitted into evidence, even if all the documents themselves are not introduced into evidence provided the documents are made available to opposing counsel and he has an opportunity to cross-examine.[13]

Moreover, it may be noted that respondents do not dispute the examiner's findings that during the period February through May 1968, registrant purchased over 150,000 shares of stock of Lynbar, a Canadian corporation, and resold about 140,000 of those shares to purchasers in this country, that no registration statement under the Securities Act had been filed or was in effect with respect to such shares, and that prior to February 1968 there was no market for such stock in this country. Respondents have neither asserted nor attempted to establish that any exemption from registration was available for such sales.[14]

The purpose of a suspension proceeeing under the Exchange Act is to determine, where it is preliminarily shown that a registered broker-dealer has engaged in misconduct, whether the proper protection of investors and the securities markets requires that the statutory permission to engage in the securities business should be withdrawn pending final determination whether it should be revoked.[15] In this case any of the several injunctions and the other conduct described above, including failure to comply with record-keeping and net capital requirements after the entry of a court decree enjoining such conduct, together establish a prima facie case sufficient to require a

[12] The only specific "discrepancy" alleged by respondents relates to the blotters of another broker-dealer, which had been used in preparation of the summaries. After a set of such blotters was introduced into evidence as an exhibit, it was discovered that it was incomplete, after which the remainder of such blotters were produced and admitted into evidence.

[13] *Ward* v. *United States*, 356 F.2d 938 (C.A. 5, 1966); *In Re Shelley Furniture, Inc.*, 283 F.2d 540, 543 (C.A. 7, 1960); *Gross* v. *United States*, 201 F.2d 780, 787 (C.A. 9, 1953); 4 Wigmore, Evidence §1230 (3d ed. 1940).

[14] It is well recognized that the burden of establishing the availability of an exemption from the registration requirements of the Securities Act is on the person who claims such exemption. See, e.g., *S.E.C.* v. *Ralston Purina Company*, 346 U.S. 119 (1953); *S.E.C.* v. *Culpepper*, 270 F.2d 241, 246 (C.A. 2, 1959).

[15] *A. G. Bellin Securities Corp.*, 39 S.E.C. 178, 185 (1959); *Biltmore Securities Corp.*, 40 S.E.C. 273, 276–7 (1960).

suspension in the public interest and for the protection of investors.

Our conclusion herein is not to be construed as a determination on the issue whether registration should be revoked; that issue is not now before us.

Accordingly, IT IS ORDERED that the registration as a broker and dealer of Dunhill Securities Corporation be, and it hereby is, suspended pending final determination of whether such registration should be revoked.

By the Commission (Chairman BUDGE and Commissioners OWENS and SMITH), Commissioners WHEAT and NEEDHAM absent and not participating.

IN THE MATTER OF

RICHARD N. CEA ET AL.*

File No. 3–785. Promulgated August 6, 1969

Securities Exchange Act of 1934—Sections 15(b) and 15A

BROKER-DEALER PROCEEDINGS

Grounds for Remedial Sanctions

Fraud in Offer and Sale of Securities

Excessive Trading

Where salesmen of registered broker-dealer, in offer and sale of security, made false and misleading representations and predictions concerning, among other things, financial condition and prospects of issuer and prospective rise in market price of its stock, and certain of such salesmen fraudulently represented that highly speculative securities they recommended to customers met investment objectives disclosed by such customers, or induced excessive trading in customers' accounts, *held*, willful violations of anti-fraud provisions of securities acts, and in public interest to bar salesmen from association with broker-dealer, and to revoke registration of broker-dealer controlling and controlled by certain of the salesmen and expel it from membership in registered securities association.

APPEARANCES:

Alexander J. Brown, Jr., Paul F. Leonard, Herbert E. Milstein, and *Burton H. Finkelstein,* of the Washington Regional Office of the Commission, for the Division of Trading and Markets.

Floyd L. Arbogast, Jr., for Richard N. Cea, James C. Conklin, Kenneth E. Fisher, and Keystone State Investment Securities, Inc.

Norman H. Rea, of Reding, Blackstone, Rea & Sell, for Robert E. Kness and Frank P. Wayhart.

FINDINGS AND OPINION OF THE COMMISSION

Following hearings in these proceedings pursuant to Sections 15(b) and 15A of the Securities Exchange Act of 1934

*James C. Conklin; Kenneth E. Fisher; Robert E. Kness; Frank P. Wayhart; C. A. Benson & Co., Inc., and Keystone State Investment Securities, Inc.

("Exchange Act"), the hearing examiner filed an initial decision in which he concluded that Kenneth E. Fisher, who was sales manager, and Richard N. Cea, James C. Conklin, Robert E. Kness and Frank P. Wayhart, who were salesmen for C. A. Benson & Co., Inc. ("registrant"), then a registered broker-dealer,[1] should be barred from association with any broker or dealer. The examiner further concluded that the broker-dealer registration of Keystone State Investment Securities, Inc. ("Keystone"), which is controlled by Fisher and Conklin and employs Cea,[2] should be revoked, and that Keystone should be expelled from membership in the National Association of Securities Dealers, Inc. ("NASD"). We granted petitions for review filed by respondents, they and our Division of Trading and Markets ("Division") filed briefs, and we heard oral argument. Our findings are based upon an independent review of the record.

FRAUD IN OFFER AND SALE OF SECURITIES

Between January 1963 and October 1964, the individual respondents, while in registrant's employ, willfully violated the anti-fraud provisions of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Exchange Act and Rule 10b–5 thereunder in the offer and sale of certain securities.

Substantial amounts of the stock of Home Makers Savings Corporation ("HMS") were sold by each of the individual respondents to public investors during the period in question and false and misleading representations and predictions were made by them with respect to the company and its stock.

HMS, a Pennsylvania corporation, had been organized in February 1961 to sell household appliances. Shortly thereafter it marketed vitamin products, but by January 1963 it was solely engaged in marketing an antacid tablet called "Mr. Enzyme," which was manufactured for it by another company. HMS supplied the tablets in packaged form to The Norwich Pharmacal Company ("Norwich"), which by agreement with HMS in December 1962 became the exclusive distributor of Mr. Enzyme in the United States.

On May 29, 1963, the State of Pennsylvania imposed an embargo upon HMS's entire inventory of Mr. Enzyme for

[1] Registrant's broker-dealer registration was revoked and it was expelled from membership in the National Association of Securities Dealers, Inc. *C. A. Benson & Co., Inc.*, 42 S.E.C. 952 (1966) and Securities and Exchange Act Release No. 7857 (April 8, 1966).

[2] Keystone's broker-dealer registration became effective in January 1965. Fisher owns 65 percent of its stock and is president and treasurer, and Conklin owns the remaining 35 percent of the stock except for one share owned by Fisher's wife, and is vice-president and secretary.

alleged misbranding in violation of state law. A few days later, on June 3, the State lifted its embargo and the United States immediately seized the inventory. The United States had alleged in a condemnation proceeding instituted on May 28, 1963 that the name of the product and the company's advertising material were false and misleading and violated the Federal Food, Drug and Cosmetic Act.[3] At about the same time, the manufacturer of Mr. Enzyme notified HMS that it had ceased production, and on June 17, 1963, Norwich informed HMS that it was discontinuing its distribution of Mr. Enzyme. Following the seizure, no new products were handled by HMS. It could no longer pay all of its bills and it dismissed most of its employees. A bank which had previously extended credit to the corporation refused to make any further loans. In May 1964, HMS vacated its offices owing back rent which it never paid.

HMS never operated at a profit. Its brief history was marked by continual losses and increasing deficits. It sustained net losses of $17,240 in 1961, and $100,060 in 1962. The company had a net operating loss in every single month of 1963. By March 1963, its current liabilities exceeded current assets, and by April 1963, its accumulated operating deficit was approaching $200,000 and it had a net worth deficit of $27,000. Thereafter both deficits steadily increased. HMS's net loss for 1963 was $110,231, and its net loss for 1964 was $18,732, with an accumulated operating deficit at the end of that year of $246,264.

Registrant received copies of all HMS financial statements for the years 1961–1963 shortly after the periods covered. It was also supplied with copies of statements prepared by HMS's accountants for each month of 1963. All HMS financial statements received by registrant were made available or distributed to registrant's salesmen. Moreover, the financial reports were discussed with the salesmen who were specifically told that HMS was unable to pay its bills and had a net worth deficit, and that the situation was deteriorating to the point where HMS faced possible bankruptcy. In addition, the salesmen were kept informed concerning the federal seizure of Mr. Enzyme, and they were told that the manufacturer would no longer ship and Norwich would no longer distribute the product, and that, as a result of the seizure, HMS sales had suffered a sharp drop. In the latter part of 1963, the salesmen

[3] Civil Action No. 63–427 (D.C.W.D. Pa.). In December 1965, a jury sustained the seizure.

were informed that efforts to reach a settlement with the United States had been unsuccessful up to that time.

Registrant was the principal market-maker in HMS stock and entered bid and ask, or ask, quotations for the stock in the daily sheets published by the National Quotation Bureau, Inc. almost continuously from January to June 1963 and, after the federal seizure, from August 1963 to July 1964 when it ceased entering quotations. Between the federal seizure in June 1963 and October 1964, only two numerical bids for HMS stock were placed in the sheets by dealers other than registrant. For most of such period, as all of the salesmen were aware, registrant maintained a "work-out" market for HMS stock in which it would not buy stock offered to it by customers and other brokers unless purchasers were available.[4] Salesmen were kept informed at all times as to whether registrant would buy stock from their customers and, if so, in what amounts. At times, they were required to keep individual records of their purchases and sales of HMS stock, which were constantly reviewed by registrant's management, and told to stay as close as possible to "a zero balance."

HMS stock, which was sold by the individual respondents during the period at prices ranging from $1^{1}/_{8}$ to $2^{1}/_{8}$, was recommended to customers both before and after the state embargo and federal seizure in late May and early June of 1963.

Cea sold 44,111 shares of HMS stock to customers in 127 transactions in 1963 and 1964. Of those shares, over 60 percent or 27,241 shares were sold after June 1, 1963. Prior to the embargo, Cea persuaded a customer, who told him she was interested primarily in long-term investments, to sell a stock listed on the New York Stock Exchange in order to buy HMS stock. He failed to disclose to this customer and to other customers to whom he recommended HMS stock adverse facts with respect to HMS's financial condition. Following the federal seizure, a customer who purchased 4,750 shares of HMS stock in four separate transactions between August 1963 and January 1964 questioned Cea concerning the federal action and was told that "there was nothing to worry about," that the price of HMS stock would recover from its decline, and that HMS would merge with Norwich. Cea stated to another customer, who purchased 400 shares of HMS stock in May 1964, that HMS was "going good" that the company had had "a little

[4] Registrant nevertheless entered bid as well as ask quotations in the sheets from August to mid-November 1963 during the "work-out" market.

trouble" with the Government but "everything was settled," and that the customer would triple his money within 6 months. Another customer was told that there was no truth in the federal charges, and that there was "nothing to worry about" since HMS would "win" the case. Certain of the customers who purchased HMS stock after the federal seizure following optimistic representations or recommendations by Cea were not told about the seizure or its substantial adverse impact on HMS's business, or about the company's precarious financial condition or registrant's "work-out" market under which the customers might be unable to sell their stock and thus be locked into the stock for the duration of such market.

Conklin effected 221 sales of a total of 64,170 shares of HMS stock during the period. Of such shares, over 53 percent or 34,430 shares were sold after June 1, 1963. Three customers, to whom Conklin sold HMS stock after the seizure, variously testified that he represented that there was no doubt that HMS would "win" the federal lawsuit within 40 to 60 days, that the lawsuit was "just a matter of routine," that the price of HMS stock was bound to go up and that purchasing it would be a good way to save money to send the customer's children to college, that HMS was a very good investment the value of which would "go much higher" than the price paid, and that with the money saved on HMS an investor might be able to retire early. One investor, who told Conklin he was purchasing stock with a view to early retirement, redeemed United States Savings Bonds in order to obtain cash to purchase HMS stock. It does not appear that Conklin induced him to redeem the bonds, but Conklin told him that he thought this was a good idea since the customer probably would do better with HMS. Conklin failed to disclose to the above customers and to a fourth customer to whom he recommended the stock HMS's deteriorating financial condition or, following the seizure, the impact of such seizure on its business, and registrant's "work-out" market. In fact, throughout 1963 Conklin continued to send to customers copies of HMS's 1962 annual report which, among other things, predicted substantial sales and profits in 1963 and annual sales of Mr. Enzyme of $7 to $10 million.

Fisher sold 38,493 shares of HMS stock to customers in 145 transactions during the period. Of those shares, over 65 percent or 25,038 shares were sold after June 1, 1963. Fisher persuaded a customer, who effected purchases before and after the seizure, to sell three listed securities to pay for the purchases. He represented prior to the seizure that the customer would "do a lot better . . . financially" with HMS smock, that he "expected great things" from the company which would make more money for the customer, and, in August 1963, about two months after the federal seizure, that HMS stock was preferable to the listed stock the customer was selling because that stock "had not been doing anything at all for the last year or so." Fisher also stated to this customer that HMS would "win" the federal "lawsuit" and that the company would then make money and its stock rise in price. Fisher failed to disclose to him material facts concerning the company's financial condition or the existence of registrant's "work-out" market. Following the federal seizure, Fisher represented to a second customer that HMS was a "good company" and a "good investment," without disclosing to him or to another customer to whom he recommended the stock, the seizure, material financial facts, or the "work-out" market.

Kness, who left registrant's employ in December 1963, effected 47 sales to 25 customers of a total of 19,182 shares of HMS stock in that year. Of those shares, about 77 percent or 14,802 shares were sold subsequent to June 1. He told one customer in May 1963 that HMS was "rolling along" well and that she should buy more HMS stock before the price went any higher. No disclosure of the company's adverse financial condition was made to her. Kness had previously advised the same customer that, with an investment in HMS, she could probably double her money in about a year and she then purchased 100 shares. He represented to another customer, who made 11 purchases of HMS stock totalling 10,300 shares between April 30 and September 3, 1963, that HMS was a good stock that would make money. However, he failed to inform this customer and others to whom he recommended the stock of material facts concerning HMS's financial condition or, in connection with their purchases after June 3, of the federal seizure and registrant's "work-out" market in the stock.

Wayhart, who left registrant's employ in November 1963, sold 19,705 shares of HMS stock to 47 customers in 78 transactions in that year. About 43 percent or 8,490 shares were sold after June 1. Wayhart represented to one customer in March 1963 that HMS was making money. He told another customer, who purchased 200 shares of HMS at 2$^1/_8$ in May 1963, that the stock should go up at least another dollar in the near future. The customer purchased an additional 100 shares in September 1963 at 1$^1/_2$ based on Wayhart's representations that it was a good time to purchase more HMS stock since the price had gone down, and that the customer should have her money back by Christmas by which time the federal action should be settled. No disclosure was made of the company's deteriorating financial condition or of registrant's "work-out" market. Wayhart sold a third customer 250 shares of HMS stock at $1^3/_8$ in August 1963 on the representation that the stock "had a possibility of going up to 9 [although] . . . he personally didn't think it would go higher than 7." Subsequent to this purchase, Wayhart sent the customer a copy of the company's 1962 annual report which, as noted above, made extravagant predictions as to future sales and profits. The same customer made another purchase of HMS stock in September 1963 after Wayhart told him he did not have to worry about HMS's finances since the company had Norwich's backing. When the customer asked him how HMS's business was going, Wayhart stated that "it was really not important information at the time [since] . . . the company's money was being spent for research and development and also to arrange distribution of [its] product in markets such as California." No disclosure was made of material adverse facts relating to HMS's financial condition, or of registrant's "work-out" market. Wayhart variously represented to other customer in September 1963 that he was sure HMS stock would go up a couple of points and make "good money," that a favorable conclusion to the federal litigation was imminent, and that the price of HMS would thereafter "greatly appreciate." Wayhart omitted to tell certain other customers to whom he recommended the stock before or after June 3, 1963, material facts concerning HMS's financial condition, the federal seizure, or the "work-out" market.

It is clear that the representations and predictions made to customers by the individual respondents were without a reasonable basis. Moreover, we have repeatedly held that predictions of specific and substantial increases in the price of a speculative and unseasoned security are inherently fraudulent and cannot be justified. Not only were optimistic representations and recommendations made to customers by respondents without disclosure of known or reasonably ascertainable adverse information which rendered them materially misleading,[5] but affirmative misstatements were variously made by

[5] See *Richard J. Buck & Co.*, 43 S.E.C. 998, 1005 (1968), *aff'd sub nom. Hanly* v. *S.E.C.*, 415 F.2d 589 (C.A. 2, 1969); *MacRobbins & Co., Inc.*, 41 S.E.C. 116, 120, 126 (1962), *aff'd sub nom. Berko S.E.C.*, 316 F.2d 137 (C.A. 2, 1963); *R.A. Holman & Co., Inc.*, 42 S.E.C. 866, 871 (1965), *aff'd* F.2d 446 (C.A. 2, 1966); *Van Alstyne Noel & Company*, 33 S.E.C. 311, 321 (1952).

Cea, Conklin, Kness, and Wayhart concerning the federal condemnation proceedings or the financial condition or operations of HMS.

Cea, Conklin and Fisher argue that certain of their customers were experienced investors who wished to speculate and did not rely on them in making their investment decisions, and that they themselves purchased HMS stock and still held such stock at the time of the hearings. They also assert that various customer-witnesses and registrant's president who testified as a staff witness were prejudiced against them, and that, in general, customers' memories were faulty so that they failed to recall much of the information concerning HMS supplied to them. Finally, they assert that, being "young and inexperienced," they relied on optimistic statements concerning HMS's prospects in the federal proceedings and otherwise which were made to them by registrant, HMS, and the attorneys for that company and Norwich. Along with Kness and Wayhart, they further contend that they did not intend to defraud the customers and that any violations committed by them were not willful.

The fact that a customer is experienced or wishes to speculate cannot excuse fraudulent representations made to him, nor is it necessary to show that he relied on such representations in order to establish violations of the anti-fraud provisions.[6] A Salesman's willingness to speculate with his own funds despite his knowledge of adverse factors cannot justify sales of a stock to customers through misrepresentations and a failure to disclose such factors.[7]

While certain customer-witnesses understandably may have been displeased by their monetary losses on HMS, and their memories may not have been as sharp as they might have been immediately following the events about which they testified, no sufficient basis has been shown for rejecting their testimony, especially since the representations made by several of the salesmen to their various customers bear a striking similarity.[8] The testimony of registrant's president as to the information furnished respondents concerning HMS's adverse financial condition, the seizure of its inventory, the effects of such seizure, and registrant's "work-out" market was not only corroborated by the testimony of registrant's secretary but by the individual respondents' own admissions. Moreover, the

[6] See *R. Baruch and Company*, 43 S.E.C. 13, 19 (1966), and cases there cited.

[7] See *Richard J. Buck & Co., supra*, at p. 1008.

[8] See *R. Baruch and Company, supra*.

hearing examiner, who heard the witnesses and observed their demeanor, credited the testimony of the customers and registrant's president, while concluding that contrary testimony by respondents "strain[ed] credulity."

In the light of the knowledge they possessed concerning HMS's affairs and deteriorating condition, respondents' claims of reliance on any optimistic statements made to them by others are frivolous. Irrespective of their training and experience, they should have been aware that representations should not be made to customers without a reasonable basis.[9] And any optimistic statements made to them by registrant, HMS, Norwich or their attorneys as to the outcome of the federal condemnation proceeding were hardly a reasonable basis for representing to customers that the action was simply a routine matter, had been already settled, or that victory for HMS was assured. Finally, it is well established that a finding of willfulness under Section 15(b) of the Exchange Act does not require an intent to violate the law; it is sufficient that the person charged with the duty knows what he is doing.[10]

Additional violations of the anti-fraud provisions were committed by Cea, Conklin and Wayhart in connection with their sales to certain customers of HMS stock as well as the unseasoned and highly speculative stocks of Copter Skyways, Inc. ("Copter"), Mr. Hot Cup, Inc. ("Hot Cup"), and Wyoming Nuclear Corporation ("Wyoming"). Those companies, like HMS, had operating losses, and information concerning such losses was supplied to registrant's sales staff.[11] The customers in question disclosed their financial situations and needs and investment objectives to the salesmen who falsely represented, expressly or impliedly, that the securities they recommended met those needs and objectives.

[9] Cf. *Thomas Brown III*, 43 S.E.C. 285, 287 (1967).

[10] *Gearhart & Otis, Inc.* v. *S.E.C.*, 348 F.2d 798, 802–3 (C.A.D.C. 1965); *Tager* v. *S.E.C.*, 344 F.2d 5, 8 (C.A. 2, 1965).

[11] Copter was organized in 1960 to transport persons and property by helicopter. For the year 1962, it had a net operating loss of $99,773 which increased its deficit to $119,316. For the nine months ended September 30, 1963, it had a further operating loss of $43,501 and a deficit on that date of $162,817. Recognizing that Copter was failing, and anticipating that it would discontinue operations, registrant ceased trading in the stock in October 1963. In November 1963, Copter's stockholders voted to dissolve the company.

Hot Cup was incorporated in February 1963 to engage in selling and granting franchises for hot drink dispensers and ingredients. In March of that year, registrant was the principal underwriter of an intrastate offering of the stock. By September 30, 1963, Hot Cup had incurred a net loss of $40,813, and for the fiscal year ended September 30, 1964 had a net loss of $99,083, which increased its deficit to $139,896.

Wyoming was organized in 1959 to engage in mining, particularly of uranium. Its minimg claims apparently remained undeveloped throughout most of the period in question. During the period January 1 to November 30, 1963, Wyoming had a net operating loss of $20,573 and at November 30 had a deficit of $19,399 in retained earnings.

During the period in question, Cea recommended and sold stock of Hot Cup and Wyoming as well as HMS to one of his customers who had had little experience in the purchase of securities. The customer informed Cea that he needed about $1,500 to pay for his daughter's training as a nurse, did not wish to take any "wild chances" since he could not afford any loss, and was relying on Cea's judgment because he did not know anything about stocks and trusted him. Cea assured the customer that he did not have to worry, and that on Cea's recommendations he would make three times the amount he needed. During the same period, a widow in her late fifties who earned about $50 a week take-home pay and supported a grandchild was induced by Conklin to purchase the stocks of HMS, Wyoming, Hot Cup and Copter. The customer informed Conklin of her circumstances, and told him that she wished to make enough money to purchase a homestead which she occupied and which had previously been in her family for over 100 years. On Conklin's representation that she would do better, the customer was persuadee to sell listed securities in order to finance her purchases, and she told Conklin that she was borrowing money to make some of the purchases he recommended. In 1963, Wayhart recommended and sold shares of HMS, Copter and Hot Cup to a divorcee who earned about $350 per month, had savings of about $2,500, and was the sole support of her daughter who attended college. The customer informed Wayhart that she did not know anything about buying stocks and was primarily interested in purchasing shares of a mutual fund because she felt that such an investment would not be too risky and, in the long run, pay a better return on her money. Although Wayhart was admittedly amazed that anyone with this customer's limited income and assets wished to buy stock, he recommended purchase of the above securities and stated that, if they "paid off," the customer could then invest the proceeds in a mutual fund. The customer testified that she relied completely on Wayhart.

Cea and Conklin assert that their customers wished to speculate and were fully aware of the risks they were taking. The record shows, however, that the customers in question neither desired to speculate nor were told or knew of the risks involved. And, contrary to the contention of Cea, Conklin and Wayhart, it is not necessary to show a fiduciary relationship with their customers to hold them accountable for the recommendations made,[12] although it would appear that such a

[12] See *Anderson* v. *Knox*, 297 F.2d 702, 706 (C.A. 9, 1961), *cert. den.* 370 U.S. 915.

relationship existed under the circumstances. Wayhart's asserted inexperience and unawareness of the impropriety of his recommendations are negated by his admitted amazement that his customer even wished to buy stock in view of her limited means. Although the customers described their financial situations and objectives to these respondent salesmen, the salesmen recommended purchases of securities that were far from commensurate with the investment objectives disclosed by such customers. It was incumbent on the salesmen in these circumstances, as part of their basic obligation to deal fairly with the investing public, to make only such recommendations as they had reasonable grounds to believe met the customers' expressed needs and objectives. The recommendations they made clearly did not meet their responsibilities under that obligation.[13]

EXCESSIVE TRADING

We also find that Kness, from February 1962 through December 1963, and Conklin, from March 1960 through December 1964, willfully violated the above designated anti-fraud provisions in that they each induced a customer to engage in securities transactions which were excessive in size and frequency in light of the character of the customer's account.

Kness handled the account of a customer who earned about $9,000 a year as comptroller for a conference of churches. The money invested by him came from his wife's savings and from funds supplied by his mother-in-law. Prior to dealing with Kness, the customer had made only one small purchase of stock. He testified that he trusted and relied on Kness and that he never rejected any of Kness's recommendations or suggestions. Kness recommended purchases or sales about twice a week throughout the period, including a three-month period during which the customer, as Kness was aware, was confined to his home following a nervous breakdown. At Kness's suggestion, the customer left his stock certificates with registrant and signed and sent to Kness about eight blank stock powers which Kness told him would save time if stock had to be sold quickly. Kness admitted that the customer relied on him "to a degree" and "generally" followed his recommendations. He further conceded that "on occasion" it was his idea to turn over the customer's portfolio quickly.

The customer had an average monthly investment of $25,257 during the 23-month period in question and in that time made

[13] See *Mac Robbins & Co., Inc., supra*, 41 S.E.C. at 117–19. Cf. *Anderson v. Knox, supra.*

67 purchases totalling $95,061 and 26 sales totalling $47,038. The securities purchased in 27 transactions were held for less than 6 months, in 10 for less than 4 months, and in one for less than 2 months. His average monthly investment was turned over 3.76 times, or about once every 6 months. At the end of the period, the customer had a realized net loss of $1,849 and an unrealized loss in excess of $10,000. Kness earned $7,013 in commissions on sales to this customer, which accounted for 55 percent of his income from registrant in 1962, and 51 percent in 1963.

Conklin's customer was an engineer in his early forties who testified he earned about $8,400 per year, supported his elderly parents and had savings of about $17,000. Prior to dealing with Conklin, the customer had made only a single purchase of stock for about $200, and he received shares of his employer's stock, which was listed on the New York Stock Exchange, through a payroll plan. The customer testified that he trusted Conklin and always followed his recommendations which included selling his listed stock to purchase securities recommended by Conklin. The customer told Conklin to invest his "hard earned money" for him carefully since he was anxious not to lose it, and Conklin told him not to worry. Conklin testified that the customer informed him that he had annual earnings of about $12,000 but that Conklin "felt" that the customer had a lot of money. He admitted that the customer purchased only stocks which he recommended and almost never sold a stock except on his recommendation, and he knew the customer trusted him and was relying on his investment judgment. He also recalled the customer's remark about not wanting to lose money.

During the 58-month period, the customer had an average monthly investment of $27,772. He made 137 purchases of securities totalling $103,560 and 88 sales totalling $71,301. The securities acquired in 68 purchases were held in his account for less than 6 months, in 52 purchases for less than 4 months, and in 17 purchases for less than 2 months. His average monthly investment was turned over about 3.73 times, or about once every 15½ months. At the end of the period, the customer had a net realized loss of $21,089 and held securities which had been purchased from Conklin at a cost of $14,618 but had a market value of only about $1,615. Conklin earned a total of $8,603 in commissions on the account.

Kness and Conklin argue that they had no discretionary power over the accounts, that the customers exercised independent judgment with respect to their purchases and sales, and that they thought that the customers, who would not furnish financial information to them, were wealthy. Kness states that his customer was "a trained accountant" while he himself was inexperienced, and that the customer instructed him to call "any time there was a market movement in the securities" he had purchased. Kness concedes, however, that the transactions in the customer's account "were abnormally high." Conklin testified that his customer told him he did not care how often his account was traded so long as he made money, and he asserts that he was not aware that trading in a customer's non-discretionary account may be considered excessive notwithstanding the customer's approval of each transaction.

It has long been established that a broker-dealer or salesman who uses his relationship of trust and confidence to a customer to cause an excessive number of transactions in the customer's account commits a fraud upon the customer, whether or not the account is a discretionary one.[14] In light of their customers' complete reliance on their judgment, the assertions that the two customers exercised "independent judgment" and that Kness's customer was "a trained accountant" are frivolous. Kness and Conklin had no reasonable basis for concluding that their customers were wealthy and Conklin knew that his customer had a modest income. In any event, that the customer may be of substantial means is no defense to a charge of excessive trading. Kness's customer denied that he told Kness to call him. Conklin's customer denied that he ever gave Conklin instructions to sell a stock if it did not go up in price or went down, and testified that he simply told Conklin to do whatever Conklin thought best. It is clear that Kness and Conklin, for their own benefit and contrary to their customers' best interests, induced excessive trading in their customers' accounts.

OTHER MATTERS

Respondents argue that they were not afforded an opportunity, as required by Section 9(b) of the Administrative Procedure Act of 1946 ("A.P.A."),[15] to achieve compliance with legal requirements prior to the institution of these proceedings. They further contend, pointing to our earlier administrative

[14] *E. H. Rollins & Sons, Incorporated*, 18 S.E.C. 347, 380 (1945); *R. H. Johnson & Company*, 36 S.E.C. 467 (1955), *aff'd* 231 *F.2d 523* (C.A.D.C. 1956); *J. Logan & Co.*, 41 S.E.C. 88, 98–99 (1962); *Samuel B. Franklin & Company*, 42 S.E.C. 325, 330 (1964).

[15] Now 5 U.S.C. 558(c) (1966).

action against registrant and its president based on fraud violations in the sale of HMS stock, that there was an undue delay in instituting the present proceedings. It is urged that such delay prejudiced respondents and requires that these proceedings be dismissed for laches. Kness and Wayhart additionally argue that the proceedings against them were barred by Pennsylvania's two-year statute of limitations applicable to forfeiture actions.

We find no merit in these contentions. There proceedings clearly fall within the exceptions expressly provided in Section 9(b) of the A.P.A. for "cases of willfulness or those in which [the] public . . . interest . . . requires otherwise." [16] Even assuming that our staff was aware of any violations by respondents when, upon its recommendation, we instituted proceedings against registrant and its president in May 1965,[17] the law is clear that the doctrine of laches or estoppel cannot be invoked against the Government acting in a sovereign capacity to protect the public interest.[18] In any event, respondents have failed to show any prejudice by virtue of the fact that the instant proceedings were not commenced until September 1966. Conklin and Fisher assert that they invested $25,000 in Keystone, and Cea states that, after leaving registrant, his new employer required him to take an expensive course of instruction. However, at the time respondents made these payments, they had no reasonable basis for assuming that proceedings would not be institutee against them. The payments were made prior to commencement of the May 1965 proceedings against registrant and its president and only a relatively short time after the period of the violations we found were committed by these respondents. Keystone became registered with us as a broker-dealer in January 1965, and Cea left registrant in November 1964 and began working for his new employer in December of that year.[19] The fact that Kness and Wayhart have remained in the securities business hardly

[16] See *Dlugash* v. *S.E.C.*, 373 F.2d 107, 110 (C.A. 2, 1967); *Sterling Securities Company*, 37 S.E.C. 837, 838–39 (1957).

[17] The allegations in those proceedings charged only fraudulent representations in the sale of HMS stock during the period May 28 to December 31, 1963, and failure to file a financial report.

[18] See *Utah Power & Light Co.* v. *U.S.*, 243 U.S. 389, 409 (1917); *Guaranty Trust Co.* v. *U.S.*, 304 U.S. 126, 132 (1938); *S.E.C.* v. *Morgan, Lewis & Bockius*, 209 F.2d 44, 49 (C.A. 3, 1953); *U.S.* v. *Vulcanized Rubber and Plastics Co.*, 178 F. Supp 722, 726 (E.D. Pa. 1959); *N. Sims Organ & Co., Inc.*, 40 S.E.C. 573, 577 (1961), *aff'd* 293 F.2d 78 (C.A. 2, 1961), *cert. denied* 368 U.S. 968.

[19] The individual respondents also argue that our staff should have been alerted to their activities by two additional prior proceedings against registrant. However, neither of those proceedings involved violations similar to those at issue here, and the first related to a period of time before *Cea, Kness and Wayhart* were even employed by registrant. See *C.A. Benson & Co., Inc.*, 41 S.E.C. 427 (1963), and *C.A. Benson & Co., Inc.*, 42 S.E.C. 952 (1966) (review of NASD proceedings).

constitutes a showing of prejudice as to them.[20] Cea, Conklin and Fisher also claim that certain of registrant's records became lost by the time of the hearings, but the record fails to show that the absence of any such records prejudiced their defense. And the Pennsylvania Statute of Limitations does not apply to our proceedings under Section 15(b) of the Exchange Act.[21]

Cea, Conklin, Fisher, and Keystone further assert that they were prejudiced in a number of additional respects, including the manner in which the hearings were conducted. They urge that they should have been given the names of prospective customer-witnesses and allowed to examine the staff's documentary evidence well in advance, that customer-witnesses were unfairly permitted, in advance of their testimony, to refresh their recollections by reading assertedly biased statements they had previously been induced to give to our staff, and that respondents should have been allowed to cross-examine staff counsel as to the circumstances surrounding the taking of such statements. They further assert that investor-witnesses were influenced by reading newspaper accounts of the prior disciplinary action taken against registrant, that respondents' testimony at the hearings in the prior proceedings was improperly received in evidence, that a printer should have been permitted to testify as to the number of the various pieces of literature he printed for registrant, and that respondents were unfairly singled out from all of registrant's salesmen as subjects for disciplinary proceedings.

These contentions and assertions are similarly lacking in merit. The Division gave respondents one day's notice of the names of witnesses it intended to call, although it was under no obligation to do so.[22] Certainly it was not required to furnish respondents with a list of the witnesses as well as exhibits it intended to present "well in advance" of the hearings. The requested information was in the nature of evidence which need not be disclosed to a respondent before its introduction at the appropriate time during the course of the

[20] *Cf. Russell L. Irish*, 42 S.E.C. 735, 742 (1965) *aff'd* 367 F.2d 637, 639 (C.A. 9, 1966), *cert. denied* 386 U.S. 911.

[21] See *Board of County Commissioners* v. *U.S.*, 308 U.S. 343, 351 (1939).

Nor are Sections 9(b) and 10(e) (now 5 U.S.C. 706) of the A.P.A., cited by respondents, applicable to the complained-of delay. The former Section requires the agency, where an application is made for a license, to hear and decide the case "with reasonable dispatch"; the latter, in defining the scope of judicial review, authorizes the reviewing court to "compel *agency action* unlawfully withheld or unreasonably delayed." See *Russell L. Irish* v. *S.E.C.*, 367 F.2d 637, 638–9 (C.A. 9, 1966), *cert. denied* 386 U.S. 911.

[22] *Dlugash* v. *S.E.C.*, 373 F.2d 107, 110 (C.A. 2, 1967), *aff'g F. S. Johns & Company, Inc.*, 43 S.E.C. 124, 141 (1966).

hearings.[23] The record does not show any impropriety by the Division in obtaining statements from customers, and those statements could be used to refresh their recollections.[24] Respondents were of course free to cross-examine customer-witnesses as to the manner in which staff investigators obtained statements from them. Absent some indication of irregularity, however, they were not entitled to examine staff counsel on that subject. Nevertheless, contrary to respondents' assertion, the examiner in fact permitted such examination. Further, the fact that a customer-witness may have read a newspaper account describing the outcome of our 1965 proceedings against registrant was not a basis for rejecting his testimony, but only a factor in weighing it. Nor were respondents harmed because the record of their testimony in those proceedings, introduced herein as admissions against interest, assertedly included "highly prejudicial" comments by the examiner and counsel in those proceedings. It does not appear that the hearing examiner in the instant proceedings, who is legally trained and judicially oriented, gave such extraneous matter any weight; and we have not done so.[25] Contrary to respondents' assertion, registrant's printer was not prevented from testifying as to the number of the various pieces of literature he prepared for registrant. His work orders containing that information were in fact received in evidence except for certain ones which were withdrawn or excluded as being outside the scope of the allegations of the order for proceedings. And there is no basis for respondents' charge that they were "singled out" from registrant's salesman "as some kind of punishment" for having testified on behalf of registrant and its president in the prior disciplinary proceedings. The misconduct alleged in the order for proceedings was the sole basis for their being named as respondents in these proceedings.

Kness and Wayhart complain of the examiner's rulings re-

[23] *F. S. Johns & Company, Inc., supra.*

[24] *Nees* v. *S.E.C.*, 414 F.2d 211 (C.A. 9, 1969), *aff'd Century Securities Company*, 43 S.E.C. 371 (1967); *David T. Fleischman*, 43 S.E.C. 518, 520 (1967); III Wigmore, Evidence (3d ed. 1940), Sections 758–62.

[25] See *R. Baruch and Company*, 43 S.E.C. 13, 23 (1966). The same conclusion is applicable with respect to the initial decision in the prior proceedings which the examiner in the present proceedings assertedly consulted.

Respondents also claim that the transcripts of their prior testimony, which are in evidence in these proceedings, were not available to them when they were preparing their brief and could only have been obtained at "great expense". The division states, however, that it supplied respondents at their request with photostatic copies of about 30 exhibits, and knows of no request for copies of exhibits or to inspect exhibits which was denied or abridged in any way.

Kness and Wayhart contend that their prior testimony was a "form of entrapment" by the Division, which is difficult to understand since such testimony was given on behalf of registrant and its president. Moreover, Conklin and Fisher testified to the staff's conduct of interviews with them during its investigation and each stated that he was fully apprised of his constitutional rights.

jecting their efforts to call as witnesses customers who would have testified that no misrepresentations were made to them, and to recall all of the customer-witnesses for further cross-examination. We think the examiner was clearly correct. The credibility of the customers who testified in these proceedings and the validity of our findings based on their testimony would not be impaired even assuming that no fraudulent representations were made to other customers.[26] And the statement of respondents' counsel that he believed that three of the twenty-nine customer-witnesses, whom he did not identify, were "known racketeers" was hardly a sufficient basis for recalling all of such witnesses after they had already been cross-examined extensively and excused.[27]

Subsequent to our taking this case under advisement, respondents filed a motion, on which they asked for oral argument, requesting that the proceedings be stayed and our decision withheld pending disposition of an indictment returned on October 7, 1968 against the individual respondents for violation of anti-fraud provisions of the Securities Act, and the mail fraud and conspiracy statutes, in connection with the offer and sale of HMS stock.[28] The Division filed a memorandum in opposition to the motion.

Respondents assert that we or our staff caused to be brought before the grand jury the allegations which resulted in the indictment and which were derived from the hearings in the instant administrative proceedings. They argue that such action constituted an election to present the essence of the issues raised in these proceedings in the criminal action and that it "preempted" the instant proceedings since a guilty verdict would preclude respondents from selling securities without our approval and an acquittal would be *res judicata* "in great part" as to the issues raised herein. Respondents further assert that our issuance of an adverse decision against them prior to a jury verdict would be prejudicial to them because of the additional publicity and also in their defense to the criminal action. They also state that the delay would not injure the public since there were no allegations, nor has it been shown,

[26] *Alexander Reid & Co., Inc.*, 40 S.E.C. 986, 993 (1962). See also *Crow, Brourman & Chatkin, Inc.*, 42 S.E.C. 938, 944 (1966). Cf. *Allstate Securities, Inc.*, 40 S.E.C. 567, 571 (1961).

[27] Kness and Wayhart further assert that this Commission is in the "anomalous position" of trying to make them "causes" of our previous order revoking registrant's broker-dealer registration. Respondents overlook Section 15(b)(7) of the Exchange Act, added in 1964, which enables us to proceed directly against associated persons and makes "cause" findings unnecessary.

[28] No. 68–202 Criminal (W.D. Pa.).

that they violated the securities acts subsequent to the period specified in the order for proceedings.

After due consideration, we conclude that oral argument on the motion for a stay would serve no useful purpose and that such motion should be denied.

As previously indicated, the indictment relates to only a portion of the allegations in the instant proceedings. Moreover, the Exchange Act provides several parallel and compatible procedures for the achievement of that Act's objectives, and the use of more than one avenue at the same time is permissible.[29] The specified administrative and criminal remedies are designed to serve different purposes, one to determine whether respondents should be barred or suspended from association with a broker-dealer or censured, and the other to determine whether they should be fined or imprisoned. A criminal conviction of a securities offense, rather than being a reason for withholding administrative action, is an express ground for remedial action under Sections 15(b)(5)(B) and 15(b)(7) of the Exchange Act.

Contrary to respondents' assertions, awaiting the outcome of the criminal action would not accomplish the same remedial purposes as a decision on the present administrative record. A conviction would not automatically exclude them from the securities business, although it would provide a ground for administrative remedial action if, after a hearing, it was determined that such action was in the public interest. Respondents would be free to engage in the securities business not only until final disposition of the criminal proceeding but also of an administrative proceeding based on such a conviction. An acquittal of respondents clearly would have no bearing on the charges in the instant proceedings unrelated to those involved in the criminal action, and indeed would have no effect on any of the charges since administrative allegations of willful violations need be proven only by a preponderance of the evidence and not beyond a reasonable doubt as in a criminal trial.[30] The fact that the period of time covered by the fraud charges against the individual respondents in the instant proceedings did not extend beyond December 31, 1964 is not controlling on the issue of whether the public interest would require respondents' immediate exclusion from the secu-

[29] See *Kamen & Company* 43 S.E.C. 97, 108, n317 (1966); *Clinton Engines Corporation*, 40 S.E.C. 408, 413 (1963); *Security Forecaster Co., Inc.*, 39 S.E.C. 188, 192–93 (1959); *A.G. Bellin Securities Corporation*, 39 S.E.C. 178, 185–86 (1959).

[30] *Norman Pollisky*, 43 S.E.C. 852, 860 (1968).

rities business. Any violations subsequent to that date were not in issue and no showing in that respect was legally permissible. Finally, as to the claimed prejudicial effect of an adverse decision issued by us before the criminal trial, we are of the opinion that the judicial safeguards including the jury selection process and the court's instructions to the jury can be relied upon to assure an impartial verdict.

PUBLIC INTEREST

Respondents contend that the public interest does not warrant the sanctions imposed by the examiner. Cea, Conklin and Fisher assert, among other things, that they have not previously been the subject of disciplinary action, that they were young and inexperienced at the time of the alleged violations,[31] that they have already suffered from adverse publicity, that we have assessed lesser sanctions in comparable cases, that their exclusion from the securities business would deprive them of property without due process of law, and that Keystone's business consists mainly of the sale of mutual funds. Kness and Wayhart state, among other things, that they have no prior history of securities violations and have been employed by broker-dealers in supervised capacities for four years since the period covered by these proceedings.

We conclude that the various mitigative factors cited are insufficient to overcome the serious fraud of the individual respondents, and that as held by the examiner it is in the public interest to bar them from association with any broker or dealer. Since Keystone is owned and controlled by two of the wrongdoers, Conklin and Fisher, and employs a third, Cea, we think that, under all the circumstances, pursuant to Section 15(b) of the Exchange Act, it is appropriate in the public interest to revoke its broker-dealer registration and expel it from NASD membership.[32] The public should not be exposee to further risk of fraudulent conduct by those who have demonstrated their gross indifference to the basic duty of fair dealing required of persons in the securities business.[33]

[31] Conklin was in his late twenties and Fisher in his early thirties. Cea, whose age does not appear in the record, was married and, as of October 1965, had 3 children. Cea and Conklin had been employed by registrant about 16 months, and Fisher had been in the securities business over 3½ years, prior to the respective periods of their alleged violations.

[32] See *R. H. Johnson & Company, supra*, 36 S.E.C. at 487-88; *Atlantic Equities Company*, 43 S.E.C. 354, 367 (1967), *aff'd sub nom. Hansen* v. *S.E.C.*, 396 F.2d 694 (C.A.D.C. 1968), *cert. denied* 393 U.S. 847.

[33] The exceptions to the initial decision of the hearing examiner are overruled or sustained to the extent that they are inconsistent or in accord with our decision.

An appropriate order will issue.

By the Commission (Chairman BUDGE and Commissioners OWENS, WHEAT and SMITH), Commissioner NEEDHAM not participating.

In the Matter of

COLUMBIA GAS OF PENNSYLVANIA, INC.

THE COLUMBIA GAS SYSTEM, INC.

File No. 3-1860. Promulgated August 20, 1969

Public Utility Holding Company Act of 1935—Sections 6(a), 6(b), 7, 9(a) and 10.

MEMORANDUM OPINION AND ORDER

ACQUISITION OF GAS UTILITY ASSETS

Aplication-declaration by registered holding company and subsidiary gas utility company regarding the acquisition of assets of nonassociate gas utility company, *granted and permitted to become effective*, no adverse findings being required under applicable provisions of the Public Utility Holding Company Act of 1935.

The Columbia Gas System, Inc. ("Columbia"), a registered holding company, and its gas utility subsidiary company, Columbia Gas of Pennsylvania, Inc. ("Pennsylvania"), have filed an application-declaration and amendments thereto with this Commission pursuant to Sections 6(a), 6(b), 7, 9(a), and 10 of the Public Utility Holding Company Act of 1935 ("Act") in respect of Pennsylvania's proposal to acquire all of the assets and to assume substantially all of the liabilities of York County Gas Company ("York"), a nonassociate gas utility company.[1]

The Columbia holding-company system is composed of Columbia, twenty operating subsidiary companies, including Pennsylvania, and a subsidiary service company. The operating subsidiary companies are primarily engaged in the production, purchase, storage, transmission, and distribution of natural gas. Retail natural gas service is rendered to approximately 1,651,000 customers in the states of Ohio, Pennsylvania, West Virginia, New York, Maryland, and Virginia. The Columbia system also sells natural gas to nonaffiliated public-utility companies for resale. As of September 30, 1968, Columbia's consolidated gross property, plant, and equipment, at original cost, was $2,091,121,000, with an accumulated reserve for de-

[1] The notice of filing, issued March 26, 1969 (Holding Company Act Release No. 16326), afforded interested persons an opportunity to request a hearing. None has been requested.

preciation and depletion of $600,577,000. For the twelve months then ended, consolidated operating revenues were $705,302,000, consolidated operating income was $103,627,000, and consolidated net income was $76,571,000. At that same date, Columbia had outstanding 30,409,722 shares of common stock, listed and traded on the New York Stock Exchange.

Pennsylvania distributes natural gas at retail to approximately 265,000 customers in the Commonwalth of Pennsylvania, and its service area includes Adams County and other areas in the immediate vicinity of the areas served by York. As of September 30, 1968, Pennsylvania's gross property, plant, and equipment, at original cost, was $122,018,000, with a related reserve for depreciation and depletion of $29,560,000. For the twelve months then ended, its operating revenues were $90,720,000, its operating income was $7,254,000, and its net income was $5,000,000.

York distributes gas, at retail, to approximately 52,000 customers in most of York County, Pennsylvania, including the cities of York, Red Lion, and Hanover, and in a small portion of Adams County, which lies immediately to the west of York County. York purchases the bulk of its gas requirements from the Manufacturers Light and Heat Company, a wholly-owned subsidiary company of Columbia. The service areas of Pennsylvania and York are contiguous. The customers in Adams County who are not served by York are served by Pennsylvania, and Pennsylvania also serves customers in a portion of York County. As of September 30, 1968, gross property, plant, and equipment of York was recorded at original cost in the amount of $23,066,000, with a related reserve for depreciation and depletion of $4,795,000. For the 12 months ended September 30, 1968, York's operating revenues were $11,675,783, operating income was $1,191,043, and net income was $681,628. York has outstanding 217,856 shares of common stock which is traded in the over-the-counter market.

Columbia and Pennsylvania have entered into a Reorganization Agreement dated September 12, 1968, providing for the acquisition by Pennsylvania of all of the net assets of York. The purchase price is to be 2.85 shares of Columbia stock for each share of York and was arrived at by arm's-length bargaining. The sale by York was approved by the holders of 86 percent of the outstanding shares of the common stock of York.

Pennsylvania will assume substantially all of the liabilities of York on the closing date, including first mortgage bonds and notes payable to banks which amounted to $8,668,000 and

$1,870,000, respectively, as of September 30, 1968. To enable Pennsylvania to make the proposed acquisition, Columbia will deliver 620,890 of its shares of common stock to Pennsylvania. In exchange, Pennsylvania will issue its common stock, par value $25 per share, to Columbia in an aggregate par amount equal to the book value of the net assets of York to be acquired.[2] As of September 30, 1968, a total of 296,074 shares of Pennsylvania's common stock, having an aggregate par value of $7,401,850, would be delivered to Columbia. Pennsylvania will deliver to York such 620,890 shares of the common stock of Columbia in exchange for the equity of the common stockholders in the net assets of York. York will then dissolve and distribute to its stockholders the shares of common stock of Columbia.

The mean of the high and low prices of the Columbia common stock on the New York Stock Exchange for the first six months of 1969 was $29.81 per share. At this price, less an estimated 3 percent allowance for selling costs, the shares being given in exchange for the equity of the common stockholders of York have an aggregate value of approximately $18,000,000. This amount, plus the $8,668,000 principal amount of first mortgage bonds and $1,870,000 of notes payable to be assumed, aggregates $28,538,000 and may be considered to be an estimate of the total purchase price to be paid for the assets of York. Such assets, when acquired, and the liabilities, when assumed, will be recorded on the books of Pennsylvania at amounts at which they are recorded on the books of York. Columbia will record its investment in the additional common stock of Pennsylvania at underlying book value, which was $7,401,850 as of September 30, 1968.

The high and low sales prices per share of Columbia's common stock on the New York Stock Exchange for the years 1966 and 1967 and for the period January 1, 1968, through September 30, 1968, and the reported high and low bid quotations for York common stock in the over-the-counter market for the same periods were as follows:

TABLE I

	COLUMBIA				YORK		
Period	High	Low	Mean	2.85 times Mean	High	Low	Mean
1966	$30 5/8	$24 1/8	$27 3/8	$78.02	$68	$64	$66
1967	28 3/4	23 7/8	26 1/4	74.81	79	68	73 1/2
1968 (through September 30)	30 1/4	25 3/8	27 7/8	79.44	80	79	79 1/2

[2] Pennsylvania will pay cash to Columbia in lieu of issuing fractional shares.

While the 2.85 shares of Columbia offered for each share of York are about equal in terms of mean market price, the immediate effect of the exchange gives the York stockholders some advantages in other respects. The following table presents comparative net income, dividends, and book values for the Columbia and York common stocks for the twelve months ended and as of September 30, 1968.

TABLE II

	Columbia per share*	Columbia per 2.85 shares*	York per share
Net Income	$ 2.49	$ 7.10	$ 3.13
Dividends	1.50	4.27	2.20
Book Value	21.08	60.08	33.98

*For comparative purposes, net income and book values of the Columbia shares are set forth in the table on a pro forma basis, after giving effect to the acquisition of York. Actual net income for Columbia for the period shown was $2.52 per share, and the actual book value was $21.27 per share. For 2.85 shares of Columbia the actual net income and book value were $7.18 and $60.62 respectively.

On the basis of the mean price for the first nine months of 1968 (27^{7}/_{8}$), after allowing for selling costs, Columbia is paying 24.6 times earnings for the common stock equity of York and 2.3 times the book value of such stock equity. As a result of the purchase, the consolidated earnings of the Columbia common stock will be diluted 3 ¢ per share, or approximately 1 percent from the reported earnings of $2.52 per share for the 12 months ended September 30, 1968.

Columbia has cited a number of savings which will come about through merging York's operations into those of Pennsylvania. Among them are the elimination of officer personnel, reduction in operating and maintenance personnel related to supervisory forces, and the substitution of Columbia's centralized customer accounting and collection activities for those of York. As a result of these economies, Columbia estimates that, for the first year's operation after acquisition, net income attributable to the York properties would increase to $914,000. This would reduce the dilution per share of Columbia stock to 2 ¢ per share. It is represented that the York service area is one of the most rapidly expanding areas in the United States and that this growth trend will continue at a faster rate than that of Pennsylvania. It is estimated that, in approximately six years, the earnings applicable to the York properties will exceed the current earnings of the Columbia shares exchanged therefor.

At September 30, 1968, long-term debt of York amounted to

$10,538,000, or 58.7 percent of total capitalization and surplus, and common stock equity amounted to $7,402,000, or 41.3 percent thereof. For Columbia, pro forma, as of the same date, consolidated long-term debt was $762,733,000, or 53.8 percent, and common stock equity was $654,125,000, or 46.2 percent. Interest requirements of York for the 12-months ended September 30, 1968, were earned 2.36 times, after taxes; the corresponding figure for Columbia, pro forma, was 3.09 times.

The Pennsylvania Public Utility Commission has authorized the acquisition of York's assets and the issuance of common stock by Pennsylvania. It is stated that Pennsylvania will adopt the rates of York in effect at the time of acquisition.

The fees and expenses to be incurred by Columbia in connection with the proposed transactions are estimated to be $9,100, including $5,000 for accountants' fees and $3,500 for service company charges, at cost. The fees and expenses to be incurred by Pennsylvania are estimated at $11,703, including $4,000 for service company charges, at cost, and $3,500 for counsel's fees.

We find that the proposed acquisitions will not result in any anticompetitive effects and that in all respects the standards of Sections 9 and 10 are satisfied. The issue of the common stock by Pennsylvania meets the standards of Section 6(b), and the issue of the Columbia common stock and the assumption by Pennsylvania of the first mortgage bonds and notes of York satisfy the standards of Section 7 of the Act.

IT IS ORDERED, accordingly, pursuant to the applicable provisions of the Act and the rules thereunder, that the application-declaration, as amended, be, and it hereby is, granted and permitted to become effective forthwith, subject to the terms and conditions prescribed in Rule 24 under the Act.

By the Commission (Chairman BUDGE and Commissioners OWENS, WHEAT, SMITH and NEEDHAM).

In the Matter of

LEE MOTOR PRODUCTS, INC.

File No. 1-4441. Promulgated August 25, 1969

Securities Exchange Act of 1934—Section 12(d)

STRIKING OF SECURITY FROM LISTING AND REGISTRATION

Net Losses

Where issuer failed to meet revised guidelines of exchange for continued listing of its security in that its net tangible assets were below specified minimums and it had sustained net losses in last two fiscal years and in three of last four fiscal years, application by exchange to delist security *granted*, and issuer's request for hearing by Commission, *denied*, the Commission finding that application conformed to exchange's rules, exchange properly acted on basis of established facts rather than on pro forma situation assuming consummation of proposed acquisitions by issuer, and exchange's consideration of losses incurred prior to date of guideline revision was not improper.

APPEARANCES:

Bernard H. Maas, Vice-President, for American Stock Exchange.

Stuart A. Jackson and *William J. O'Brien, II*, of Royall, Koegel & Wells, for Lee Motor Products, Inc.

FINDINGS, OPINION AND ORDER

The American Stock Exchange has filed an application, pursuant to Section 12(d) of the Securities Exchange Act of 1934 and Rule 12d2-2(c) thereunder, to strike from listing and registration on the Exchange, effective September 4, 1969, the Class A common stock, $1 par value, of Lee Motor Products, Inc. ("Lee").[1] Following a hearing before a committee of the Exchange, the Exchange suspended trading in the stock on May 16, 1969. Lee filed a memorandum in opposition to the application and the Exchange filed a reply.

The application is based on a "policy" of the Exchange, as amended in February 1968, which provides that the Exchange

[1] Section 12(d) of the Act and Rule 12d2-2(c) provide in pertinent part that upon application by a national securities exchange, a security registered with such exchange may be delisted in accordance with the rules of the exchange upon such terms as we may deem necessary to impose for the protection of investors.

will consider the delisting of a security when, in its opinion, "the financial condition and/or operating results of the issuer appear to be unsatisfactory and do not warrant continuation of the security on the list," [2] and on related guidelines which specify, as amended, that delisting will be considered where an issuer which has net tangible assets of less than $1 million has sustained net losses in each of its two most recent fiscal years, or, if such assets amount to less than $3 million, has sustained net losses in three of its four most recent fiscal years.[3]

The application states that as of December 31, 1968, Lee had net tangible assets of only $426,787 and that it had net losses in three of the four fiscal years ended on that date, including 1967 and 1968. These losses amounted to $45,444 in 1965, $250,133 in 1967 and $124,771 in 1968. In 1966, Lee had a net income of $70,000. The application further states that at a formal hearing before an Exchange committee, Lee submitted information concerning acquisitions which it proposed to make in order to improve its financial condition and operating results; that the committee concluded that this and other information submitted by Lee did not warrant continuation of the listing; and that the Board of Governors concurred in the committee's recommendation that delisting be sought.

Lee urges that we should deny the application, or order a hearing to determine the reasonableness of the Exchange's rules and the manner in which they were applied in this case. It does not question the asset or earnings figures recited in the application, but contends that the application was not made in accordance with the published rules and policies of the Exchange, in that the Exchange did not find or assert that Lee falls within the delisting standards that are specified in Section 1001 of the Exchange's Company Guide. Lee further contends that the Exchange is improperly applying retroactively the amended guidelines which assertedly were intended to have only prospective application. In addition, Lee argues that the Exchange's decision to recommend the delisting of its stock was arbitrary and discriminatory. We find no adequate basis in Lee's arguments for disturbing the Exchange's determination that the company's stock should be delisted at this time.

Section 1001 of the Company Guide, which is the first section of that part of the guide dealing with delisting and is captioned

[2] American Stock Exchange Company Guide, § 1002.

[3] *Id.*, § 1003.

"General," states that many factors are weighed in determining whether a security warrants continued listing, among them the degree of investor interest in the company, its prospects for growth and the degree of commercial acceptance of its products, and any developments which substantially reduce the size of a company or the nature and scope of its operations. Lee argues that the Exchange did not find a substantial reduction of the nature contemplated by these provisions, and that, on the contrary, Lee had demonstrated to the Exchange, through submission of pro forma consolidated financial statements for 1968, that assuming an actual acquisition as of the end of that year of certain companies which Lee proposed to acquire, it had a net worth of $2.8 million, net income of $101,354 for 1968 and projected income of $423,500 for 1969.

We agree with the position of the Exchange that Section 1001 is merely an introduction in very general terms, with illustrations of categories of situations in which delisting may be considered, and does not supersede and is not inconsistent with the terms of its more specific delisting policies and guidelines. Moreover, it would appear that Lee's losses and reduced net worth[4] did substantially reduce its prospects for growth within the intent of the introductory section. And Lee's proposed acquisitions did not operate to take it out of that area or to require the Exchange to withhold its decision to seek delisting. Lee states that it submitted to the Exchange financial material, supported by "agreements in principle" with three companies and an acquisition agreement with a fourth,[5] showing that those acquisitions would effect substantial compliance with the Exchange's guidelines. The Exchange points out, however, that none of the proposed acquisitions had been consummated [6] and states that its committee considered all material presented. The Exchange was warranted in proceeding on the basis of the established facts before it rather than on the basis of possible future developments.[7]

[4] According to Lee's financial statements filed with us pursuant to the periodic reporting requirements of the Securities Act, its net worth declined from $788,420 at December 31, 1964 to $445,160 as of December 31, 1968.

[5] According to unaudited financial figures, the last company had total net assets of $448,380 at December 31, 1968 and a net income of $95,660 for the 9 months ended on that date.

[6] The Exchange also states that several acquisition proposals of which Lee informed the Exchange after the latter halted trading in Lee stock prior to its suspension had been abandoned and others had been initiated. Lee's memorandum filed with us on June 4 indicates that none of the proposed acquisitions had been consummated as of that time.

[7] Cf. *American Electronics, Inc.*, 43 S.E.C. 687 (1968); *Magic Marker Corporation*, 43 S.E.C. 500 (1967); *Fifth Avenue Industries Corporation*, 43 S.E.C. 146 (1966).

We also find no merit in Lee's argument that it would be unfair and improper to give the Exchange rules what it argues is a retroactive application.[8] Whether or not application of the revised guidelines to Lee in this case represents retroactive action merely because some of the facts deemed pertinent relate to a time preceding adoption of those guidelines,[9] the issue raised by Lee's argument was resolved in the *Atlas Tack* and *Exchange Buffet* cases.[10] In affirming orders by us granting exchange applications to delist securities pursuant to delisting standards adopted in 1955 which were based in part on earnings for 3 years, the courts in those cases rejected the companies' contentions that it was improper and unfair for the exchange to apply the new standards to them so as to take into consideration their earnings preceding adoption of the standards. In the *Exchange Buffet* case, the court, after pointing out that listed companies were on notice that an exchange's rules are subject to constant revision in light of the changing economy, stated that

> "One of the main purposes of the Act was the protection of investors and prospective investors. Future purchasers of securities are those peculiarly in need of the sort of protection which is afforded by delisting. If new standards could be made effective only after a lapse of years or even months, such protection might turn out to be illusory and of the too-late variety." [11]

And in *Atlas Tack*, the court quoted with approval the statement in our opinion[12] that

> "Corporations whose stock is listed, and the holders of such stock, are bound to recognize that listing is not a vested right which may not be terminated despite changes in the importance of the company and its stock in the investment community. Past earnings performance is one of the factors affecting investment standing, and we cannot find that its use by the Exchange, which has the primary responsibility for the determination of appropriate standards for appraising the suitability of securities for continued listing, as one of the tests of the need for continued access to the Exchange's market is inappropriate or affords any basis for not granting unconditional approval of the applications."

[8] Prior to the 1968 revision, the corresponding guidelines (then denoted "criteria") provided that delisting would be considered where the issuer had not operated at a net profit in at least one of the last three fiscal years. We held in *American Electronics, Inc., supra*, that the criteria did not preclude the Exchange from considering the suitability of continued listing in light of the broader standards of its "policy" with respect to financial condition and operating results.

[9] Cf. *Atlas Tack Corporation* v. *New York Stock Exchange*, 246 F.2d 311, 318 (C.A. 1, 1957). There is clearly no retroactivity in the consideration of net assets as of December 31, 1968, more than 10 months after the revised policies and guidelines were adopted.

[10] *Atlas Tack Corporation* v. *New York Stock Exchange, supra; Exchange Buffet Corporation* v. *New York Stock Exchange*, 244 F.2d 507 (C.A. 2, 1957).

[11] 244 F.2d at 510.

[12] 37 S.E.C. 362, 365 (1956).

The court added that any retroactive effect of the rule should be weighed against the protection afforded present and potential investors by delisting securities not suitable for exchange trading.[13]

Lee's attempt to distinguish those cases is unconvincing. It asserts that the companies there involved had been advised when their securities were first listed that a reduction in size and performance might call for delisting, and that their size and earnings had "dramatically" declined from previous levels which had exceeded the standards set in 1955. However, it does not appear that either *Atlas Tack* or *Exchange Buffet* was specifically advised that a reduction in size and performance might lead to delisting, and as noted above Lee has also sustained a significant decline in performance. It is clear that Lee, like those companies, was aware that delisting standards are subject to periodic revision. Since 1961, when Lee's common stock became listed and registered, there have been several revisions of those standards in the direction of stricter requirements. These revisions have accompanied or closely followed upward revisions of standards for original listing. It is apparent that an exchange cannot "live up to the expectation created by its image" [14] if it maintains listings that are substantially below original listing standards.[15] And it may be further noted that Lee had the opportunity for more than 10 months to bring its net assets to a level above that specified in the delisting guidelines.

We find unpersuasive the further argument made by Lee that the language of the Company Guide contemplates that, in applying the revised standards, only earnings beginning with 1968 were intended to be considered. The language states that the revised delisting policies and guidelines were to apply "in all respect to each company with securities listed . . . on the Exchange on the date that its annual report for its first fiscal year ending on or after December 31, 1967, is furnished to shareholders, but in no event later than four months after the end of such fiscal year." We agree with the Exchange's interpretation of this provision as merely specifying an effective date keyed to the fiscal year-ends of listed companies as of which the revised policies are to apply "in all respects." [16]

[13] 246 F.2d at 318.

[14] Report of Special Study of Securities Markets, House Doc. No. 95, Part 2 (88th Cong., 1st Sess.), p. 835.

[15] Under amended listing standards adopted by the Exchange shortly before the delisting standards were revised, a company must have net tangible assets of at least $3 million and net earings of at least $300,000 for its most recent fiscal year.

[16] In addition to its action here, the Exchange has taken delisting action with respect to several other companies on the basis of this interpretation. See, e.g., *The Stephan Co.*, 43 S.E.C. 929 (1968).

We cannot agree with Lee's contention that the Exchange acted in an arbitrary and discriminatory manner. Lee points to the fact that, as recited in the Exchange's application, trading in Lee's stock was originally halted in January 1969 because of a proposed acquisition by Lee of Palm Beach Investment Properties, Inc., which was subsequently abandoned after the Exchange advised Lee that such acquisition might call into question the continued listing of Lee's stock.[17] Lee notes that even though it voluntarily deprived itself of what it asserts would have been a profitable relationship which would have brought it into compliance with the tangible net assets requirement, the Exchange continued the trading halt and took steps to delist Lee's stock. The Exchange states that after its inquiry into Lee's situation in connection with the Palm Beach proposal, it considered that on the facts concerning Lee's condition that had been presented dealings in Lee stock should not be resumed pending a determination under the delisting policies with respect to earnings. We find nothing arbitrary or otherwise improper in this procedure. Nor is the asserted fact that the Exchange has not acted to delist the securities of other companies which also appear to fall within the delisting guidelines relating to financial condition and operating results, a reason for denying the instant application.[18]

In light of our discussion above, we conclude that no useful purpose would be served by a hearing before us, and that it is appropriate to grant the application for delisting. We also find no basis for Lee's request that we institute a proceeding under Section 19(b) of the Act to determine the reasonableness or propriety of the Exchange's delisting rules.

Accordingly, IT IS ORDERED that the application of the American Stock Exchange to strike from listing and registration the Class A common stock of Lee Motor Products, Inc. be, and it hereby is, granted, effective at the opening of trading on September 4, 1969.

By the Commission (Chairman BUDGE and Commissioners OWENS, WHEAT, SMITH and NEEDHAM).

[17] Lee was advised, among other things, that because of the substantial amount of Lee stock to be issued to the owners of Palm Beach, which was engaged in installment sales of subdivided land, the acquisition of Palm Beach would result in a material change in the nature of Lee's business and would represent a "back-door" listing for Palm Beach.

[18] See *Fotochrome, Inc.*, 43 S.E.C. 151 (1966); *General Contracting Corporation*, 43 S.E.C. 571 (1967).

In the Matter of

SCHWABACHER & COMPANY

ALBERT E. SCHWABACHER, JR.

File No. 3-1635. Promulgated August 28, 1969

Securities Exchange Act of 1934—Sections 15(b), 15A and 19(a)(3)

FINDINGS, OPINION AND ORDER

In these proceedings pursuant to Sections 15(b), 15A and 19(a)(3) of the Securities Exchange Act of 1934 ("Act"), an offer of settlement was submitted by Schwabacher & Co. ("registrant"), a partnership registered as a broker-dealer, and Albert E. Schwabacher, Jr., the senior general partner and chief executive of registrant. Under the terms of the offer, respondents waived a hearing and post-hearing procedures, and, without admitting the allegations of the order for proceedings, consented to findings of willful violations of the record-keeping, hypothecation, and reporting provisions of the Act and rules thereunder as alleged in such order. Respondents further consented to the entry of an order censuring them, prohibiting Schwabacher from undertaking certain supervisory functions, and imposing various terms and conditions.[1]

After due consideration of the offer of settlement and upon the recommendation of our staff, we have determined to accept such offer. On the basis of the order for proceedings, the offer of settlement, and certain materials attached to the offer, we make the findings set forth below.

Violations of Record-Keeping, Hypothecation, and Reporting Provisions

Between January 1, 1966 and July 11, 1968, when we issued our order for proceedings, registrant, willfully aided and abetted by Schwabacher, willfully violated Section 17(a) of the Act and Rule 17a-3 thereunder in that registrant failed to make or

[1] Respondents' offer of settlement recited that no fact stated therein constitutes an admission by them in any other proceeding except to the extent that it may lawfully be considered by the Commission as to them in any subsequent administrative proceeding pursuant to Sections 15(b), 15A and 19(a)(3) of the Act and Section 203(d) of the Investment Advisers Act of 1940.

keep current a large number of the books and records relating to its business.[2] During the same period, registrant, willfully aided and abetted by Schwabacher, willfully violated Section 8(c) of the Act and Rule 8c–1(a)(2) thereunder in that it hypothecated and permitted the hypothecation of securities carried for the accounts of customers under circumstances permitting such securities to be commingled with securities carried for the accounts of persons other than bona fide customers under liens for loans made to registrant. In addition, registrant, willfully aided and abetted by Schwabacher, willfully violated Section 17(a) of the Act and Rule 17a–5 thereunder in that it failed to file timely reports of its financial condition for the years 1966 and 1967, and those reports, when filed, were not duly certified.

In January 1966, registrant converted its bookkeeping operations to the Midwest Service Bureau's computerized accounting system. In April 1966 it was reported to the New York Stock Exchange, of which registrant was a member, that the conversion was not as smooth as registrant would have liked. An audit by the Exchange disclosed in October 1966 that short security differences were almost $14,000,000, indicating a substantial failure to keep accurate records. This figure was reduced within about 11 days to $3,700,000 and substantial capital was contributed to assure compliance with the Exchange's minimum capital requirements. Because of the differences, completion of the audit was delayed and answers to a regular financial questionnaire were not received until March 1967 and showed differences of $2,376,757 and securities not properly segregated of $6,866,910.

Despite special efforts over the two next years to correct past differences and prevent new ones, there continued to be a failure to maintain current records that were in balance and reasonably accurate. Thus, an Exchange examiner who visited registrant in September 1967 submitted a report listing a large

[2] The books and records that were not made or maintained consisted of blotters of other records of original entry; records reflecting all assets and liabilities, income and expenses and capital accounts; records itemizing separately, as to each cash and margin account of customers and of registrant and its partners, all purchases, sales, receipts, and deliveries of securities and commodities for such account, and all other debits and credits; records reflecting securities in transfer, dividends and interest received, securities borrowed or loaned, monies borrowed or loaned and the collateral therefor, and securities failed to receive or deliver; a record reflecting separately for each security as of the clearance dates all "long" or "short" positions (including securites in safekeeping) carried by registrant for its account or for the account of its customers or partners and showing the location of all securites long and the offsetting position to all securities short and in all cases the name or designation of the account in which each position is carried; and records in respect of each cash and margin account containing the name and address of the beneficial owner of such account and, in the case of a margin account, the signature of such owner.

number of record-keeping deficiencies.[3] A further examination by the Exchange in November 1968 disclosed approximately 31,000 record-keeping errors, more than $7½ million of fails, and inaccuracies by as much as $6 or $7 million in monthly fail figures reported to the Exchange. In addition, dividend condition could not be determined, record-keeping control over a major bank account had been lost, and ten suspense accounts in registrant's New York Office were similarly out of control.

Beginning in February 1968, the Exchange placed various restrictions on registrant because of its "inability to handle its business on an operationally sound basis." Additional restrictions were imposed at the suggestion of our staff in July and August 1968, and restraints were also voluntarily adopted by registrant in response to Exchange inquiries or to assure compliance with the restrictions. Included were prohibitions against the opening of new branch offices, advertising, and the conducting of investment classes, as well as restrictions on new registered representatives, new accounts, margin accounts and required margin, trading activity, underwriting originations, bidding commitments and participations, lending of securities, and partnership withdrawals.

In October 1968, the Exchange determined that registrant's business had to be further reduced, and in early December placed a December 15 deadline for registrant's decision either to merge with another firm or sell a number of branch offices. By that date, arrangements for a merger with Blair & Co., Inc., a registered broker-dealer, were completed, and since February 28, 1969, operations of registrant have been under the supervision of Blair executives.[4] Pursuant to a settlement in April 1969 of disciplinary proceedings brought by the Exchange in which registrant and its general partners, for the

[3] The deficiencies consisted of out-of-balance conditions, errors in submitting financial questionnaires, commingling of partner and customer securities in registrant's safekeeping box and in bank loans, excessive "edits," representing errors disclosed by the Midwest system's computer, inadequate attention to customers' unsecured debits and short positions, inordinate delays in COD deliveries and payment of customers, laxity in transfer in cases of sales of non-negotiable securities, security count differences, undersegregation in margin accounts, failure to segregate fully paid-for securities in cash accounts, deficiencies in accomplishing shipping instructions, delays in margin department release of transfer instructions and cage processing of transfer instructions and segregation instructions, unauthorized release of segregated securities, lack of control of excessive fails, unreconciled clearing house accounts and broker accounts, a breakdown in new accounts procedures resulting in loss of control of commingling of customer securities without consent in bank loans, unreconciled suspense accounts, and loss of control of the dividend department.

[4] At about that time, according to the Exchange, registrant had 15 branch offices, 33 general partners, 13 limited partners, 193 registered representatives, 612 operational and other personnel, and approximately 24,260 active customers' accounts, of which 4,239 were margin accounts.

On May 6, 1969 the Exchange determined, on the basis of improvements in operation conditions of registrant, to modify the restriction against approval of new registered representatives and to rescind the restriction on underwriting activities.

purpose of settlement only, admitted violations of rules of the Exchange and this Commission with respect to books and records, segregation and hypothecation, supervision and control, good business practice, and audits, registrant was fined $50,000, and Schwabacher was fined $25,000 and censured. In addition, Schwabacher agreed that he would not undertake any supervisory duties with respect to back-office operations of any Exchange member for five years without prior approval of the Exchange.

PUBLIC INTEREST

A firm's obligation to investors to conduct its securities business on a sound basis requires that it be sensitive to any back-office problem as soon as it arises, and take prompt and effective steps to bring itself into compliance with applicable rules and, if necessary to prevent further delinquencies, to curtail activities not essential to providing service to existing customers. The maintenance of the back-office mechanisms and their relation to the firm's overall operations must be the subject of constant close attention, in order to insure that customers' interests are being served and protected. A failure to effect prompt handling of all record and delivery requirements not only imposes substantial risks on the firm's own customers but also on those of the broker-dealers with whom its transactions are entered into. It tends to have a chain effect which can compound the delays and risk of injury and adversely affect investor confidence in the securities market. The increasingly severe restrictions imposed to correct registrant's continuing back-office deficiencies, even to the extent of requiring the firm either to merge with another firm better prepared to deal with them or to reduce the number of its branch offices, reflect the serious concern with which such deficiencies are viewed and the importance of a broker-dealer firm's recognition of the full magnitude of the problem.

The offer of settlement in the instant proceedings provides that we may censure respondents; require registrant, as a division of Blair, to continue making its weekly report of condition to our San Francisco Regional Office and to the Exchange (such reports may be consolidated); continue the existing restrictions upon registrant;[5] reserve the right to

[5] Registrant or Blair may apply to us at any time for removal of modification of the restrictions. Respondents represent that while the restrictions were of material assistance in the resolution of the operational difficulties which resulted in the instant proceedings, they believe that such restrictions are no longer necessary.

reinstitute these proceedings, upon five days' written notice, in the event of a breach by registrant of any of such restrictions which has not been corrected within the notice period, provided that the occurrence of the breach shall be an issue to be determined at a hearing; and prohibit Schwabacher from undertaking any duties with respect to supervision of back-office operations of any broker-dealer without prior Commission approval. The offer further states that while Schwabacher, for the year beginning March 1, 1969, may be a vice-president of Blair, as one of 12 or 13 members of its Corporate Finance Department, his duties would not be of a supervisory nature.[6]

Respondents urged in mitigation that registrant's accounting problems began with its conversion in January 1966 to the Midwest system during a period of unprecedented increases in the volume of market activity, and were compounded by the difficulty in locating and engaging competent operations personnel experienced in that system; that in December 1968, six of registrant's partners obtained a bank loan of $3 million which they loaned to registrant as new capital on a subordinated basis; and that the acquisition of registrant by Blair resulted in the loss of registrant's independence and autonomy and terminated a 50-year-old firm that had played a responsible financial role in the West. They further stated that the totals of fails to deliver and fails to receive have shown substantial improvement over the last seven months;[7] that progress has been made in the suspense account arising from the August 30, 1968 audit;[8] that the cashier department has been completely reorganized and, among other things, processes customer complaints on a current basis; that the number of Midwest system "edits," reflecting both current errors and historical errors which have not been completely corrected, has shown improvement over the past several months;[9] and

[6] Respondents represented it was their understanding that Blair, as registrant's successor, would make appropriate representations or undertakings to the Commission necessary to continue the jurisdiction of the Commission with respect to registrant, including undertakings requiring the submission of weekly reports and permitting the reinstitution of proceedings in the event that the operations or books and records of the Schwabacher division of Blair materially deteriorate. Blair has submitted a statement to the Commission in conformance with respondents' understanding.

[7] Fails to deliver were $28,665,000 for the week ending August 30, 1968, compared to $7,106,000 for the week ending April 3, 1969. The corresponding figures for fails to receive were $18,096,000 and $7,522,000.

[8] Suspense items were long $9,578,000 and short $8,580,000 for the week ending September 13, 1968, compared to $1,681,771 long and $1,040,511 short for the week ending April 3, 1969.

[9] There were 30,153 "edits" for the week ending October 18, 1968, compared to 15,340 "edits" for the week ending April 3, 1969. Registrant, acknowledging that "edits" should number less than 10,000 per week, states that in view of certain projects that are planned, reductions in the number of "edits" are expected to continue.

that control of current operations has been achieved by implementing procedures which monitor problem areas and by taking action to correct any errors thus revealed.[10]

Under all the circumstances, including the disciplinary action already taken against respondents by the Exchange, and giving due consideration to the recommendations of our staff, we think it appropriate in the public interest to dispose of the proceedings in accordance with the offer submitted and impose the sanctions permitted by such offer.

Accordingly, IT IS ORDERED that respondents be and they hereby are, censured, that Albert W. Schwabacher, Jr. be, and he hereby is, prohibited from undertaking any supervisory duties with respect to back-office operations of any broker-dealer without prior approval of the Commission, and that the other terms and conditions specified in the offer of settlement be, and they hereby are, imposed.

By the Commission (Chairman BUDGE and Commissioners OWENS, WHEAT and SMITH), Commiosioner NEEDHAM not participating.

[10] Cited by respondents as among the most significant of the programs installed to assure current control of operations are a procedure assuring the current balance and control of trading activities on all exchanges and the over-the-counter market; the daily processing of the basic "edit" used to maintain control of cash and securities entries to the computer records; a weekly box count of all securities in the active box in both the San Francisco and New York offices; and a daily reconciliation of bank balances in both the cashier's and the accounting department's records.

In the Matter of

CORTLANDT INVESTING CORPORATION ET.AL.*

File No. 3-133. Promulgated August 29, 1969

Securities Exchange Act of 1934—Sections 15(b), 15A and 19(a)(3)

BROKER-DEALER PROCEEDINGS

Grounds for Revocation of Registration

Grounds for Bar from Association with Broker-Dealer

Fraud in Offer and Sale of Securities

Injunction

Where, in connection with offer and sale of securites, registered broker-dealer and salesmen made fraudulent representations and predictions and distributed market letters containing misrepresentations concerning, among other things, increases in price of stock, issuer's financial condition, past and projected sales and earnings, and future dividend payments, and salesman's own purchase of stock, and registered broker-dealer together with its president are subject to permanent injunction with respect to hypothecation and net capital rules, *held*, in public interest to revoke broker-dealer's registration and bar salesmen from association with any broker-dealer without prejudice to application by certain of them for supervised association after period of time.

APPEARANCES:

Joseph C. Daley, *Lawrence M. Levy*, *Jack Becker*, *Roberta S. Karmel*, and *Judith G. Shepard*, for the Division of Trading and Markets of the Commission.

Arthur M. Sommerfield, of Sommerfield & James, for Max Reiter.

Edward R. Sullivan, for Cortlandt Investing Corporation and Melvin Cantor.

Lester Kissel, *Eugene R. Souther*, and *Edward W. Beuchert*, of Seward & Kissel, for Harold J. Rau.

Daniel J. McCauley, Jr., of Blank, Rudenko, Klaus & Rome, for Edgar F. Isaacs.

*Melvin Cantor; Max Reiter; Edgar F. Isaacs; Harold J. Rau; Hanns E. Kuehner; Laird, Bissell & Meeds.

FINDINGS AND OPINION OF THE COMMISSION

Following extensive hearings in these proceedings pursuant to Sections 15(b), 15A and 19(a)(3) of the Securities Exchange

Act of 1934 ("Exchange Act"), the hearing examiner issued an initial decision in which he concluded, among other things, that the registration as a broker and dealer of Cortlandt Investing Corporation ("Cortlandt") should be revoked; and that Melvin Cantor, president and sole stockholder of Cortlandt, Max Reiter, a salesman for Cortlandt, and Edgar F. Isaacs and Harold J. Rau, co-managers of the Dover, Delaware, branch office of Laird, Bissell & Meeds ("Laird"), a registered broker-dealer[1] should be barred from association with any broker or dealer.[2]

Petitions for review of the initial decision filed by Cortlandt, Cantor, Reiter, Isaacs and Rau ("respondents") were granted by us.[3] Respondents and our Division of Trading and Markets ("Division") filed briefs, and we heard oral argument. On the basis of an independent review of the record, and for the reasons set forth herein and in the initial decision, we make the following findings.

FRAUD IN OFFER AND SALE OF SECURITIES

The record establishes, as found by the hearing examiner, that respondents willfully violated and willfully aided and abetted violations of the antifraud provisions of Section 17(a) of the Securities Act of 1933 and Sections 10(b) and 15(c)(1) of the Exchange Act and Rules 10b–5 and 15c1–2 thereunder in connection with the offer and sale of securities of Old Empire, Inc. ("Empire").[4] Empire had prior to 1960 been primarily a contract manufacturer and packager of toiletries, cosmetics and household specialties for other companies. In that year Empire began acquiring a number of firms engaged in the pharmaceutical business, following which it encountered operational and financial difficulties. It had very tight working capital and cash positions when it embarked on those acquisitions, and the attendant relocation and consolidation of manufacturing facilities, inventory accumulations, and product pro-

[1] Laird and a partner, Louis J. Sneed, were also named as respondents in the instant proceedings, and remedial action was heretofore taken against them pursuant to an offer of settlement (Securities Exchange Act Release No. 8231 (January 17, 1968) which is discussed below under public interest.

[2] The examiner also concluded that respondent Hanns E. Kuehner, a Laird employee, should be barred from association with any broker or dealer. Kuehner died after the issuance of the initial decision and, accordingly, the proceedings will be discontinued as to him.

[3] The examiner's order in these proceedings barring two other salesmen of Cortlandt from association with any broker or dealer was declared effective by us on January 18, 1968, following their failure to file petitions for review as provided in our Rules of Practice. Securities Exchange Act Release No. 8232.

[4] It was charged in the order for proceedings, and the hearing examiner found, that all the respondents there named, including those as to whom the issues have already been disposed of, acted singly and in concert. However, we make no finding with respect to a concert of action as between the remaining respondents now before us.

motions produced significant changes in the nature and extent of the operations previously conducted by Empire and entailed added costs and problems.[5] The removal in 1961 and 1962 of the operations of Empire's newly acquired out-of-state subsidiaries to its main plant, the resulting loss of key personnel, and a shortage of raw materials because of a lack of funds disrupted Empire's operations. Empire was unable to meet delivery schedules for the large number of vitamin orders that were obtained beginning around April 1961 and post-seasonal deliveries resulted in a large number of returns in the spring and summer of 1962, and it stopped taking orders for vitamins because of difficulties encountered by it. By April 1962 Empire had built up an inventory of generic drugs at a substantial cost and it began a major sales effort with respect to such drugs. Because its inventory was unbalanced, however, it was unable to deliver more than 35 percent to 40 percent of the generic drugs ordered in 1962.

Empire's consolidated net income declined from $41,604 for the fiscal year ending January 31, 1960 to $17,359 for the following fiscal year. Its annual report covering the year ending January 31, 1962, which was published around July 1962, contained certified financial statements which showed net income of $160,297, or 17 ¢ per share. Those figures were subsequently revised downward, in a restated financial statement contained in Empire's annual report for the following fiscal year, to show a loss of $47,744, or 5 ¢ per share, for the 1962 period principally as a result of "retroactive" adjustments for substantial accounts receivable that had proven uncollectible. In fiscal 1963 sales amounted to $3,343,944, and Empire sustained a loss for that year of $955,727 or 97 ¢ per share. Its financial situation became so desperate that between December 1962 and April 1963 a Laird partner personally loaned it about $112,000 and guaranteed payment to a supplier primarily to keep Empire functioning until either financing or a merger could be negotiated.[6] No cash dividends were ever paid by Empire.

Isaacs, who sold Empire stock to four customer-witnesses at $3\frac{3}{4}$ to $7\frac{1}{4}$ from April 1961 through February 1962, represented that Empire stock had the potential easily to go to 20 and that

[5] In an April 1961 letter Laird was advised by Empire that its cash balances would be virtually eliminated by the end of June, and that it required at least $200,000 by the end of April in order to implement its moving and vitamin promotion plans before its "peak production period". Enclosed with the letter was a cash flow chart showing projected cash deficits of between $47,153 and $175,502 at the end of each month from July through December 1961.

[6] In 1964 the company filed a petition for an arrangement under Chapter XI of the Bankruptcy Act.

the price of the stock was apt to rise to around 20 in about a year; that Empire was an "up and coming company . . . bound to do good"; and that in his opinion the stock had good potential for growth in about a year and if the price did not go up he "would have to leave town". In November 1962 he advised a customer not to sell his Empire stock, stating that a very favorable earnings report and some improvement in the price of the stock was expected.

Rau sold Empire securities between May 1961 and March 1962 to three customer-witnesses at from 5¹/₄ to 7. Around March 1962 he told one customer that the stock was "a good buy with a good future" and that its price would possibly increase to around 20 before long. He informed that customer that he had personally purchased Empire stock, without disclosing his sale in September 1961 of all of his holdings amounting to 1,000 shares. In March 1962 he told a customer that a decline that had taken place in the price of the stock was due to packaging and distribution problems which had been corrected, and that he thought the price could very easily reach 16 in six months and if it did not he would have to go "over the hill". And in March 1963 he told a customer, who had previously purchased stock through him at 7, that the stock, which was then quoted at 1 bid and 1¹/₂ ask, had been sold in good faith as a speculation because sales and earnings per share had tripled each year from 1959 through 1961.

Cortlandt offered and sold Empire securities between July 1962 and August 1963 through Cantor and Reiter and other salesmen. Two salesmen who were respondents in these proceedings recommended to customers the purchase of Empire stock on representations that Empire was an "old established company", that the Empire stock would increase in price, and that a customer would be able to make a profit on it.

Four customers testified as to their dealings with Cantor. In July 1962 he stated that Empire's earnings were expected to double in that year, and that it expected to pay dividends in the following year. He told a customer who purchased shares in December 1962 at 2⁵/₈, that the stock was a good investment, and represented to another customer, who had previously bought stock at 3¹/₂, that he expected its price to reach 6 in the near future.

Three customers, who purchased shares from Reiter at prices from 1 to 3¹/₂ between July 1962 and August 1963, testified as to representations by him. Reiter told customers that he thought the price of Empire stock should double within a year, or would go to 10 in several months; and that he expected the company to pay dividends in a short time. In August 1963 he represented to a customer that Empire was in good shape and should have good earnings, and stated that the price of its stock would go to 7.[7]

Respondents' customers were also sent a market letter concerning Empire dated February 1962, which was prepared by Laird. The letter estimated that the company's "well-planned and promptly successful" vitamin program would produce sales of $1,200,000 to $1,500,000 per year, and that its generic drug program would add a minimum of $1,500,000 to gross sales. Sales of $5,000,000 to $6,000,000 were projected for 1962, with estimated earnings of 15 ¢ to 20 ¢ per share for the fiscal year ended January 31, 1962, and a "conservative estimate" of earnings of 40 ¢ to 45 ¢ per share for fiscal 1963. In addition, Cortlandt sent customers a letter dated August 1962, prepared by Laird in response to Cantor's request for more copies of the February letter, which contained representations similar in most respects to those in the February letter.

The highly optimistic representations and predictions concerning Empire and its stock were not warranted by the facts, nor were the representations concerning Empire's sales and earnings from 1959 through 1961, its financial condition, and Rau's purchases of Empire stock.

Isaacs and Rau assert that they relied in good faith on the optimistic information and material furnished by Laird, which had acted as underwriter in connection with a 1960 offering of Empire common stock and co-underwriter of an offering of Empire convertible debentures commencing in December 1961, and had a representative on Empire's board of directors. Such information and material included the February 1962 market letter and a highly favorable memorandum on Empire that an analyst in a prominent investment banking firm had prepared for his firm around December 1960 when it was considering participating with Laird in a sale of Empire securities. That memorandum stated that Empire's management projected a rise in sales from $1,174,000 to $4,125,000 and in earnings per share from 6 ¢ to 23 ¢ during the three-year period ending January 31, 1962. Reference is also made to the fact that a widely-circulated financial publication carried an article, in

[7] Although various of the respondents have challenged the credibility of a number of the customer-witnesses and denied respresentations attributed to them by the witnesses, we see no basis for disagreeing with the hearing examiner who credited the customers' testimony. Nor do we find any basis for the contention that the hearing examiner exhibited a lack of impartiality with respect to certain respondents.

May 1962, commenting favorably on Empire and its prospects. These respondents further point to their own personal investment in Empire securities, on which they realized losses, as evidence of their belief in Empire's growth potential. And they state that they sold the Empire stock only to known customers.

Isaacs further urges that his representation that the price of the stock might rise to 20 in about a year reasonably reflected Laird's "bullish" views concerning Empire and was made to only one customer, and that any statement by him that if the price did not go up he would have to leave town constituted mere sales puffing. Rau asserts that he sold Empire stock to customers who sought speculative securities, and that his representation that Empire's sales and earnings per share had tripled each year from 1959 through 1961 was based on his "imperfect recollection" of the investment banking firm memorandum, and his statement that if the stock did not go to 16 he would have to go "over the hill" was made jokingly; and he claims that he sold his holdings of Empire stock for personal reasons unrelated to his evaluation of such stock and he was not required to disclose such sales.

Whatever degree of reliance may have been warranted by the optimistic information furnished by Laird, it is clear that at least the predictions of price rises made to customers by Isaacs and Rau and the misstatements by Rau concerning his own purchases and the increase in Empire's sales and earnings from 1959 through 1961 went beyond and cannot be justified by such information. In any event, as we have held, it is inherently fraudulent to predict specific and substantial increases in the price of a speculative security.[8] Moreover, the impact of the optimistic predictions was heightened by the statements of these respondents indicating that they staked their professional reputations on them. Those expressions of confidence cannot be excused, as these respondents urge, as "puffing" or as made in jest. We have held that the doctrine of *caveat emptor*, from which the concept of "puffing" is derived, can have little application under the antifraud provisions of the securities acts designed to protect investors.[9] And the statutory standards of fair dealing by those engaged in the securities business embrace all statements by them which are of a nature to induce investment action, whether or not the one making them considers some not to be seriously made.

[8] See, *e.g.*, *Crow, Brourman & Chatkin, Inc.*, 42 S.E.C. 938, 943 (1966).

[9] *Norman Pollisky*, 43 S.E.C. 852, 856 (1968); *Irving Friedman*, 43 S.E.C. 314, 319 (1967); *B. Fennekohl & Co.*, 41 S.E.C. 210, 215–216 (1962).

Rau's representation that he had purchased Empire stock and had thus himself assumed a risk position was also designed to emphasize his confidence in his recommendation. Such representation was rendered misleading by his failure to disclose the sale of stock, by which he had in fact removed himself from the risk position, irrespective of the reasons for such sale.[10] Nor was the respondents' responsibility to their customers lessened because they may have themselves believed in the prospects of Empire or were willing to speculate with their own funds,[11] or because the customer may have previously known or done business with the salesmen or knew that the Empire stock was speculative.[12]

Cortlandt, Cantor and Reiter also urge that they reasonably relied on the market letters obtained from Laird, and further state that they had made an independent investigation to confirm Laird's reports. Cantor and Reiter stated that they personally visited Empire's plant, and that Empire's president told them in June 1962 that representations and predictions made in Laird's February market letter were true and around August 1962 told Cantor that statements made in the August market letter were correct. Cantor testified that upon learning in October 1962 of certain problems encountered by Empire, Cortlandt stopped recommending Empire stock until May 1963 when he was advised that the company had obtained additional working funds through a factoring loan.

We do not find these defenses adequate. While in an appropriate case an employee may be entitled to rely upon his own employer for information respecting a security he undertakes to sell, a higher standard of care is required of those engaged in the securities business who would place reliance upon market letters or other materials or information respecting a security which was prepared or supplied by another broker-dealer. The inquiry made by these respondents with respect to the stock they were actively recommending was less than sufficient under the circumstances. Cantor knew in June 1962 that Empire lost personnel when it moved its operations, in October 1962 of production difficulties, and in early 1963 of

[10] *Cf. The S. T. Jackson & Co., Inc.*, 36 S.E.C. 631, 655-6 (1950). Rau states that following his sale in September 1961 he purchased Empire stock in January 1963 at 3/4 to 1 per share. Such purchases, of course, afford no justification for his statement around March 1962 concerning his prior purchases, which he had liquidated.

[11] *Cf. Richard J. Buck & Co.*, 43 S.E.C. 998, 1008 (1968); *Shearson, Hammill & Co.*, 42 S.E.C. 811, 834 (1965); *A. J. Caradean & Co., Inc.*, 41 S.E.C. 234, 238 (1962).

[12] *Cf. Norman Pollisky, supra* at p. 856; *James De Mammos;* 43 S.E.C. (333–335 (1967); *aff'd* as to De Mammos, Docket No. 31469 (C.A. 2, October 13, 1967); *Billings Associates, Inc.* 43 S.E.C. 641, 646 (1967).

serious financial problems and unprofitable operations. He testified that he did not check out "every single item" in the market letter but relied on Laird's statements, that his "questioning" of the letter was limited to checking with Empire's president as to the prospects for the company, and that the latter was optimistic that Empire would make money, which "was good enough" for Cantor. Cantor obtained Empire's annual report for the fiscal year ending January 31, 1962, which was issued around July 1962, and in May 1963 he asked Empire's president for current financial data but he did not obtain the annual report for the fiscal year ending January 31, 1963 until the following September. Neither Cantor nor Reiter was furnished with reliable current financial data and in the absence of such data they were not warranted in accepting the self-serving statements of the issuer as an adequate verification of the representations and predictions in the Laird letters.[13] Moreover, these respondents' predictions of price rises and dividend payments went beyond the information contained in the Laird letters.

Reiter was informed by Cantor around November 1962 of problems involving production and deliveries, prior to May 1963 of working capital difficulties, and in May 1963 of the factoring loan as well as the prediction made by Empire's president that such loan should put Empire "on the road to recovery". But notwithstanding his awareness of Empire's problems and his lack of current financial information Reiter thereafter solicited the purchase of Empire stock by means of optimistic predictions including a rise in the price of such stock.

INJUNCTION

Cortlandt and Cantor are subject to a permanent injunction entered on February 4, 1966 by the United States District Court for the Southern District of New York upon the complaint of this Commission.[14] The Court prohibited them from effecting securities transactions while Cortlandt failed to comply with net capital requirements of our Rule 15c3–1 under Section 15(c)(3) of the Exchange Act and hypothecated customers' securities in violation of our Rule 15c2–1(a)(3) under Section 15(c)(2) of the Exchange Act.

Cortlandt and Cantor urge that the hearing examiner im-

[13] *Cf. Shearson, Hammill & Co., supra* at p. 830.

[14] 66 Civil Action File No. 361. The Court, upon our request and with the consent of those respondents, appointed a receiver for Cortlandt.

properly granted a motion by the Division to amend the order for proceedings to include the injunction as a ground for adverse action. In this connection they point out that the injunction was entered with their consent and without a judicial determination of the allegations, which were denied by them, and that it involves activities which are unrelated to and occurred long after those involved in these proceedings with respect to Empire stock.

We see no basis for overruling the examiner or disregarding the injunction. Rule 6(d) of our Rules of Practice authorizes the examiner in the course of the hearing to amend the order for proceedings for cause shown. Since Cortlandt and Cantor were already respondents in these proceedings, which were instituted prior to the issuance of the injunction, it was appropriate to amend the order for proceedings to include the charge relating to the injunction following its issuance. Under the terms of the Exchange Act a consent injunction in which the allegations are denied, no less than one issued after trial upon a determination of the allegations, may furnish the sole basis for remedial action under Section 15(b) of the Exchange Act if such action is in the public interest.[15] It is clear that the lack of factual relationship between the conduct enjoined and the original charges involving Empire securities cannot affect the propriety of the amended charge or the statutory consequence of the injunction.

PUBLIC INTEREST

On the question of what remedial action is appropriate in the public interest, respondents have adverted to various factors. Isaacs asserts that he has already suffered hardship as a result of these proceedings and has conducted himself in an exemplary manner since the activities discussed above, and Rau and Reiter also state they have not been the subject of prior disciplinary proceedings. Isaacs and Rau point to their respective notable careers in police and military service. It is further pointed out that subsequent to the issuance of the examiner's initial decision, pursuant to an offer of settlement in these and other proceedings, Laird was suspended from membership in the National Association of Securities Dealers, Inc. ("NASD") for 40 days,[16] and Sneed, the Laird partner who

[15] See, *e.g.*, *Balbrook Securities Corporation*, 42 S.E.C. 496 (1965); *Kimball Securities, Inc.*, 39 S.E.C. 921, 923–4 (1960).

[16] Securities Exchange Act Release No. 8231 (January 17, 1968). The 40-day suspension was imposed on Laird, Bissell and Meeds, Inc., a corporation which succeeded to the broker-dealer business of Laird, a partnership, in October 1965.

was responsible for the market letters, was barred from association with any broker-dealer for 15 months. It is argued that imposition upon respondents of the revocation and bar sanctions recommended by the hearing examiner would be excessive and discriminatory because Laird and Sneed were responsible for the dissemination of false and misleading information upon which respondents relied and were also found to have violated provisions of the securities acts in other proceedings.

We have taken into account the factors presented. With respect to the argument involving the sanctions imposed on Laird and Sneed, we note that the remedial action which is appropriate in the public interest with respect to any particular respondent depends upon the facts and circumstances applicable to him and cannot be measured precisely on the basis of action taken against other respondents.[17] As noted, the sanctions as to Laird and Sneed were imposed in accordance with an offer of settlement which we deemed it appropriate to accept, whereas our present determination as to the respondents now before us is based upon a resolution of the issues as developed by the record.[18]

We agree with the hearing examiner that the violative conduct we have found in this case requires the imposition of substantial sanctions as a means of protecting investors against a repetition of such conduct. The hearing examiner concluded that it was in the public interest to bar all of the respondents now before us from engaging in the securities business. In the case of Cortlandt and its principal, Cantor, who in addition to the misconduct found here were subject to the injunction described above as well as prior disciplinary action by the NASD for violations involving the misuse of customers' securities, excessive mark-ups, net capital deficiencies and improper extension of credit,[19] we conclude there is no basis for providing that the bar be other than of indefinite duration. With respect to the other individual respondents, however, we are of the opinion, after a careful weighing of all the factors, that the bar as to them need not be an indefinite one but may appropriately be ordered without prejudice to their filing, after a period of nine months, an application that they be permitted to become associated with a broker-dealer in

[17] See *Dlugash* v. *S.E.C.* 373 F.2d 107 (C.A. 2, 1967); *Cf. Century Securities Company*, 43 S.E.C. 371, 384 (1967).

[18] Cf. Irving Friedman, supra at p. 323.

[19] Cortland was suspended from NASD membership for 30 days and Cantor was found a cause of such suspension. *Cortlandt Investing Corporation*, 42 S.E.C. 709 (1965).

a non-supervisory capacity upon an appropriate showing that they will be adequately supervised.

In reaching this conclusion, we have assessed the nature and extent of the various misrepresentations made by each of the individuals as well as the assertedly mitigative factors and circumstances presented to us. We have considered, among other factors, respondents' activities in the light of the optimistic analysis of Empire and its prospects made by Laird, which had acted as underwriter in connection with offerings of Empire securities and had a representative on Empire's board of directors, and in the memorandum prepared for a prominent investment banker by its own analyst; the optimistic financial information for fiscal 1962 originally presented in Empire's annual report; and the favorable article that was published concerning Empire. And we have taken into account also the absence of any other prior disciplinary action against Isaacs, Rau and Reiter and their individual backgrounds.

By noting and considering these factors, we do not mean to suggest that there was any justification for respondents' fraudulent conduct. Rather, we note that the record as a whole supports the imposition of a bar, and that the above factors enable us to indicate a time period after which application for re-entry into the securities business under the conditions specified would not be inappropriate.

An appropriate order will issue.[20]

By the Commission (Chairman BUDGE, Commissioners OWENS, WHEATand SMITH), Commissioner NEEDHAM not participating.

[20] We have considered the initial decision of the hearing examiner and the exceptions thereto, and to whatever extent such exceptions involve issues which are relevant and material to the decision of the case, we have by our Findings and Opinion herein ruled upon them. We hereby expressly sustain such exceptions to the extent that they are in accord with the views set forth herein, and we expressly overrule them to the extent that they are inconsistent with such views.

In the Matters of

JADE OIL & GAS COMPANY

GREAT LAKES GAS CORPORATION

Debtors

Promulgated September 15, 1969

ADVISORY REPORT ON PROPOSED PLANS OF REORGANIZATION

The Trustee in reorganization has filed a plan for the reorganization of the two Debtors involved in these proceedings (sometimes hereinafter referred to collectively as "Jade"). The Court has found the plan "worthy of consideration" and has referred it to the Securities and Exchange Commission ("Commission") for an advisory report, pursuant to Section 173 of the Bankruptcy Act (11 U.S.C. § 573).

For reasons hereinafter discussed we conclude that the plan is unfair and inequitable to Jade's unsecured creditors. We believe, however, that the plan can be made fair and equitable, if amended in accordance with the suggestions made herein. The plan can be found feasible although this is not free from doubt.

THE DEBTOR

The principal Debtor was incorporated in California in 1908 as the Jade Oil Company, and in 1962 its name was changed to Jade Oil & Gas Co. Originally, activities were largely confined to the drilling and exploration of oil wells on a 76-acre tract near the city of Taft in the Midway Sunset Oil Field in Kern County, California. During the 1920's, Jade was successful, and its shares were listed on the Pacific Coast Stock Exchange. However, as production from the Taft property declined, no new properties of value were acquired. Jade thus became inactive with a small royalty income from wells on the Taft property and no assets of any consequence. It remained in this dormant state for many years.

In 1958, Harry M. Frank and H. L. Leach acquired control of the company and embarked on an expansion program. The first step was the acquisition of eight producing leases in

Texas owned by Frank, Leach and J. Roy Derrick in exchange for common stock of the company. Since their principal business experience had been in fields other than oil, Frank and Leach asked one Johnny Mitchell of Houston, Texas, to serve as president of the company. After Mitchell's election as president in December 1959, exploration and acquisition activities were greatly intensified. In addition to purchasing leases on the Texas Gulf Coast, the company acquired working interests in the Salt Lake area of California. These Salt Lake interests are now the company's principal asset. It also has a 50 percent leasehold interest in some significant gas-producing property in the San Francisco Bay Area, oil and gas properties in New York, Pennsylvania, Ohio, Tennessee and Texas,[1] and some mining claims in land near Tonopah, Nevada, on which there is believed to be a deposit of barite.

Jade's operations have been unsuccessful. It has had a history of heavy losses. By the end of 1966, it had a retained earnings deficit of more than $4 million.

According to the Trustee, the Debtor was inadequately capitalized for the ambitious program of expansion undertaken. The lack of equity capital led to undue reliance on borrowed funds, and the resultant financial problems were also aggravated by haphazard administration and control. The maintenance of two administrative offices, one in Los Angeles and another in Houston, was in itself a heavy burden for a small oil producing company, and the staff was larger than was necessary. Much was spent on public relations efforts which bore little fruit. The company's president, Johnny Mitchell, was paid a salary of $50,000 per year and allowed $3,250 per month to cover expenses for which no accounting was required.

Jade's financial problems were accentuated by its disagreements with its banker, the Union Bank of Los Angeles, and these disagreements led Union Bank to declare a default in June of 1966. The Union Bank is the largest secured creditor, having as its security virtually all of the Debtor's producing properties. The Union Bank's secured claim against Jade amounts to about $4.7 million. This is a little less than half of Jade's total liabilities, which, according to the Trustee's unaudited balance sheet, amounted to about $9.6 million on Febru-

[1] The New York, Pennsylvania and Ohio properties belong to Great Lakes Gas Corp. In 1964, Jade acquired all of the stock of Great Lakes. As a practical matter, Great Lakes is simply a division of Jade.

ary 28, 1969, including about $2 million in publicly held debentures, as set forth in the table below:

TABLE I

JADE'S LIABILITIES AS OF FEBRUARY 28, 1969

Notes payable:	
Long-term debt, payable within one year	$ 1,429.36
Banks	4,984,892.55
Others	869,904.81
Accounts payable	1,250,493.08
Accrued expenses	438,081.06
Other accrued expense	115,512.80
Long-term debt, less payment due within one year	16,864.91
Subordinated debentures	1,959,000.00
Total Liabilities	$9,636,178.57

Junior to debt are 3,587,602 shares of common stock. Most of this stock was originally issued in exchange for property and to creditors who converted their claims against Jade into stock. The amount of new cash raised through the sale of stock was relatively small.

More than 1,000,000 shares were issued after The Union Bank had declared its loan in default. These shares were issued under valid permits obtained from the California Commissioner of Corporations, but were not registered with the Commission under the Securities Act of 1933. Recipients of a substantial number of these shares subsequently resold them to the public on the open market. This meant that those persons were "underwriters" for Jade within the meaning of the term "underwriter" as used in the Securities Act of 1933;[2] that Jade had made an unregistered public offering of the shares in question through those underwriters in violation of the Securities Act of 1933[3] and that public purchasers of those shares had a right of rescission.[4] Such rescission claims have been filed in the approximate aggregate amount of $800,000.

Jade's violations came to the Commission's attention and led directly to the initiation of these proceedings. On June 7, 1967, the Commission brought an action in this Court against Jade, Johnny Mitchell, and one Benjamin Balos in which it alleged that the defendants had offered and sold Jade shares on the

[2] Section 2(11) of that statute (15 U.S.C. § 77b(11)) provides in pertinent part that: "the term 'underwriter' means any person who has purchased from an issuer with a view to . . . the distribution of any security . . ."

[3] See Section 5 of the Securities Act of 1933 (15 U.S.C. § 77e).

[4] Section 12(1) of the 1933 Act (15 U.S.C. § 771) provides that "any person who — offers or sells a security in violation of section 5 . . . shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon . . ., upon the tender of such security, or for damages if he no longer owns the security."

Pacific Coast Stock Exchange in violation of the registration requirements of the Securities Act of 1933 and sought to enjoin them from doing so in the future.[5] The defendants consented to the entry of a permanent injunction, which provided *inter alia* that ". . . the defendant Jade Oil & Gas Co. will file a voluntary petition for reorganization under Chapter X of the Bankruptcy Act."

THE PLAN

The Trustee's plan is based on a proposal presented by Johnny Mitchell. The plan calls for the infusion into the reorganized Debtor of $2,500,000 in new money to be supplied by a group of investors. These fresh funds are to be used to reduce secured indebtedness, pay administrative and priority expenses and provide working capital. The plan's salient features are as follows:

The reorganized company is to issue 250,000 shares of Series A preferred stock in exchange for the $2.5 million of new money. This series is to have a par value of $10 per share, and for five years after its issuance each share is to be convertible at the option of its holder into 10 shares of common stock, or at the rate of $1 per share of new common stock. The Series A preferred will be entitled to a cumulative annual dividend of 70c per share. This dividend need not be paid in cash, but may be paid in common stock. After two years, the Series A preferred will be redeemable, at Jade's option, at $10 per share plus accumulated dividends. The holder will be entitled to the same amount in the event of liquidation or dissolution. Each share of the Series A preferred is to be accompanied by two detachable purchase warrants. Each such warrant, which will expire at the end of 5 years, will entitle its holder to purchase one share of new common stock for one dollar per share.

Unsecured creditors (including stockholders who have valid claims for rescission) will receive Series B preferred stock at the rate of one Series B share for each $2 in claims. These Series B shares will have a par value of $2 and be convertible into common for five years from the date of issuance at the rate of $2 per share. Dividends on the Series B preferred will be noncumulative, payable if dividends are paid on the common. In that event each share of Series B preferred will receive 15 percent more than the per share dividend on the common stock. The Series B preferred is to be redeemable, at

[5] *S.E.C.* v. *Jade Oil & Gas Co.*, *et al.*, U.S.D.C. C.D. Calif., Civil Action No. 67–802–IH.

LIBRARY U. OF I.

Jade's option, at $2 per share plus declared but unpaid dividends, with this same amount payable on liquidation or dissolution.

The Debtor's present common stock is to be exchanged on a share-for-share basis for the new common stock of the reorganized company. Additional shares of the new common are to be issued to persons who have invested in certain of the Debtor's drilling programs at the rate of one common share for each $2 invested. Common stock may also be issued to pay administrative expenses.

The plan provides for substantial immediate payments to The Union Bank and for the subsequent amortization of Jade's indebtedness over an 8 or 10-year period. The bank's security will be unaffected. In general, holders of other valid secured claims will be repaid out of the proceeds of their security. To the extent that a secured claim exceeds the value of the property securing it, it will be treated as a general unsecured claim. No secured creditor has objected to the plan.

The first board of directors of the reorganized Debtor will consist of seven members, two to be designated by The Union Bank, two by the Series A preferred shareholders, two by the Trustee, and one by the Series B. Both Series A and B will have full voting rights, along with the common, for the election of directors and on other matters. The Trustee will be a nonvoting member of the board until the entry of a final order closing the estate. All of the stock to be owned by certain directors and officers and their associates is to be placed in a voting trust. The voting trustees, to be appointed by the Court, are to continue to act as such for 10 years. The trust relates only to the election of directors. With respect to other matters, the trustees are to vote as instructed by the beneficial owners.

VALUATION

1. INTRODUCTORY

To determine who is entitled to what in a reorganization proceeding one must appraise the enterprise in question. If creditors' claims exceed the value of the business, the shareholders have no further interest in the matter. Conversely, if the business is worth more than the aggregate amount to which the holders of senior interests are entitled, those who hold junior interests must be given appropriate participation in the reorganized enterprise. Accordingly, valuation is of central significance in corporate reorganization.[6]

The "value" of a business for corporate reorganization purposes usually turns on its earning capacity. As the late Judge Frank of the United States Court of Appeals for the Second Circuit observed, "Value is the present worth of *future* anticipated earnings. It is not directly dependent on *past* earnings; these latter are important only as a guide in the prediction of *future* earnings." [7] Since the application of this standard "requires a prediction as to what will occur in the future, an estimate as distinguished from mathematical certainty is all that can be made. But that estimate must be based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth, including, of course, the nature and condition of the properties, the past earnings record and all circumstances which indicate whether or not that record is a reliable criteria of future performances." [8]

The instant case does not involve an established industrial or commercial enterprise that makes a specific product or supplies a particular service. Jade is a small, independent oil company whose activities have been and probably will be largely speculative and promotional in character. Jade is more of an explorer and a developer than an established commercial producer. It looks for oil in unproven, unproductive areas that have been selected on the basis of preliminary geological or geophysical work. Since leases in such unproductive areas can normally be acquired at relatively low cost, the actual expenditure on a particular prospect may not be very large, but the risk of loss is high. Commercial deposits of oil and gas are found on only a few of the many exploratory wells drilled by a "wildcatter" like Jade. The purchase of proven producing property, while less risky, is much more costly.

An investment in a small, independent oil company, like Jade, thus involves substantial risks, as Jade's own history demonstrates. An investment in such an enterprise also offers the possibility of large rewards in the event of a major discovery, and investors looking for such possibilities tend to be

[6] See *Consolidated Rock Products Co.* v. *DuBois*, 312 U.S. 510, 524 (1941): ". . . [I]t is apparent that a determination of . . . value must be made so that criteria will be available to determine an appropriate allocation of new securities between bondholders and stockholders in case there is an equity remaining after the bondholers have been made whole."

[7] Frank, *Epithetical Jurisprudence and the Work of the Securities and Exchange Commission*, 18 N.Y.U.L.Q. Rev. 317, 342, n. 68 (1941) cited with approval in *Protective Committee v. Anderson*, 390 U.S. 414, 442, n. 20 (1968).

[8] *Consolidated Rock Products Co.* v. *DuBois*, *supra*, note 7, at p. 526 of 312 U.S.

motivated by hope for large capital gains rather than by desire for dividend income.

A substantial discovery (if such is ever made) will normally be preceded by many unsuccessful ventures. The exploration and drilling costs incident to these ventures are charged against income. Yet the life of the enterprise depends upon continued exploration and drilling. Because of this factor small oil companies do not necessarily behave in a conventional profit-maximizing way. A vigorous exploration program may be regarded as more important than net income. According to the Trustee, a petroleum engineer, the historical record indicates that small oil producers that succeed in growing into large ones usually owe their good fortune to a few happy substantial discoveries rather than to normal, steady growth.

Since non-cash charges, such as depletion, bulk so large and because exploration and development costs are so significant, the reported net earnings of most small oil companies are nominal. Indeed, quite a few of them report consistent book losses, and Jade itself has sustained consistent and substantial losses over the years. Hence small, independent, exploratory oil companies are often valued on the basis of projected "cash flow" rather than on the basis of probable "earnings" computed in accordance with generally accepted accounting principles.[9]

Cash flow is neither a synonym nor a substitute for income.[10] Hence the cash flow concept can be materially deceptive to investors unaware of its real nature.[11] It must be used with caution, particularly in case of a small oil company, because (1) oil and gas are wasting assets which will eventually be exhausted; and (2) by making no provision for depletion, cash flow analysis makes no allowance for the need to generate funds to finance the exploration and development, without which the enterprise is doomed to eventual extinction.

2. The Trustee's View

According to the Trustee, the total value of the reorganized Debtor would be from $21 million to $23 million.[12] He projects Jade's cash flow in accordance with the following table:

[9] See *Parker Petroleum Co.*, 39 S.E.C. 548, 559–590 (1959).

[10] See Paton, *The Cash Flow Illusion*, 38 Accounting Review (1963); Lese and Lee, *Cash Flow; Misleading Connotations of Dividend Distribution;* 13 Clev.-Mar. L. Rev. 267 (1964); Heath, *Calculation and Meaning of Cash Flow in Security Analysis*, Financial Analysts Journal, Sept.-Oct., 1962, p. 65.

[11] See *Franchard Corporation*, 42 S.E.C. 163, 178– 82 (1964); *Wolf Corporation*, 42 S.E.C. 1042, 1044–45 (1966).

[12] He arrives at this figure even though he regards Jade as insolvent on a liquidation approach. As previously noted, Jade's liabilities amount to about $9,636,000. For liquidation purposes, the Trustee values Jade at only $7.8 million, almost $2 million less than its liabilities.

TABLE II

TRUSTEE'S CASH FLOW PROJECTIONS

	1970	1971	1972	1973	1974
Gross Income:					
Sales From Present Properties	$1,009,000	$ 907,000	$ 810,000	$ 737,000	$ 661,000
Sales From New Properties	66,600	240,900	429,000	575,300	678,100
Other	264,400	258,900	284,400	303,300	310,500
Total	1,340,000	1,406,800	1,523,400	1,615,600	1,649,600
Expenses:					
Lease Operating	296,000	336,000	372,900	394,300	407,900
General & Administrative	350,000	375,000	375,000	375,000	375,000
Total	646,000	711,000	747,900	769,300	782,900
Operating Cash	694,000	695,800	775,500	846,300	866,700
Interest Expense	280,000	215,000	190,000	165,000	140,000
Net Cash Flow	$ 414,000	$ 480,800	$ 585,500	$ 681,300	$ 726,700
Five-year Average					$ 577,660

The foregoing projections assume that the reorganized Debtor will continue to operate its present properties and that it will also manage exploration programs in which it will have the right to participate. They also assume that there will be one significant discovery in 1970 and two such discoveries in each of the subsequent years.

Neither the substantial principal payments that the reorganized Debtor will have to make on its secured debt, nor capital expenditures incident to exploration and development, have been deducted from cash flow in the Trustee's projections. The Trustee indicates that the principal payments on secured debt will come from net cash flow, thus reducing the cash available for operations. He also testified that in his view this net cash flow will be sufficient to enable Jade to conduct the projected operations. He makes no allowance for the dividend on the Series A preferred prior to conversion. He points out that the reorganized Debtor probably would be unable to pay this cash dividend in the foreseeable future, and, moreover, the Debtor has the right to elect to pay the Series A dividend in common stock in lieu of cash.

The Trustee suggests that reorganized Jade's projected net cash flow (computed on his assumptions) be capitalized at 3 percent. In other words, he multiplies that projected average annual cash flow by 33 in order to arrive at Jade's imputed value as a going concern. This capitalization rate is based on stock price data, i.e., on the multiples that the stock market has assigned to companies the Trustee considers comparable to Jade.[13]

Assuming that all of the shares of the Series A and B preferred stocks are converted into common, Jade's common stock would sell at $2.12 per share on the basis of the Trustee's assumptions. His assumed figures are as follows:

NET CASH FLOW

	Thousandsof$/ year	$/per Share	Price of Stock $/Share	Ratio of Price to Cash Flow per Share
Reorganized Jade	$577	$.064	2.12	33

3. THE CMMISSION'S VIEW

We disagree with the Trustee's approach to the problem of valuation. For a small, wildcat oil company, a capitalized value bottomed on projected future cash flow, so much of which is to stem from unknown properties that the reorganized company hopes to be able to acquire or operate in the future, is far too conjectural for purposes of a plan of reorganization that is to bear the imprimatur of a court of equity. Basic to his projections in Table II at page 12, *supra*, is the premise that the inescapable decline in Jade's income from its present properties will be considerably more than offset by a rise in receipts from new and as yet unacquired properties. He anticipates a growth of more than tenfold in gross receipts from these purely hypothetical properties from 1970 to 1974, expecting reorganized Jade to increase such receipts from $66,600 in 1970 to $678,100 in 1974.

In arriving at a capitalization rate, the Trustee notes that in his sample of 15 comparable companies the average cash flow is on the average capitalized at 37 times. He concludes therefore that 3 percent is the appropriate rate at which to capitalize Jade's prospective cash flow, or 33 times the anticipated average cash flow of $577,660 for 1970–1974. We think it impossible to derive a capitalization'rate valid or acceptable for Chapter X purposes from a market in capitalized hope domi-

[13] For this purpose the Trustee analyzed 15 small oil and gas companies each with an annual net cash flow of less than $1 million.

nated by the pursuit of long shots. Market data based on investment values are highly significant and entitled to great weight. But market data that merely reflect composite assessments of the odds for or against lucky strikes and sensational finds—assessments shaped in large measure by extravagant intangibles—are much too shaky a foundation for judicial findings as to value and fairness.

Moreover, the Trustee's concept of striking and using some industry-wide "average" is extremely dubious. One of the Trustee's sample of 15 companies sells for 10 times cash flow, and, at the other extreme, another sells for 450 times cash flow. There is not even the semblance of a clue as to which rate is appropriate, and "averaging" such disparate numbers contributes nothing to a rational resolution of the issue. The Trustee himself recognizes that there is something questionable about averaging the odds. He notes that small oil and gas companies tend to sell at multiples much higher than larger ones, and therefore begins by looking for small oil and gas companies comparable to Jade. He finds 15, four of which he considers unrepresentative because the multiples at which they sell seem too high. For those very high multiples he substitutes the arbitrarily chosen multiple of 50. Of those the Trustee regards as acceptable, one sells at 10 times cash flow while another sells at 41 times. In the face of the vast range of multipliers, we consider market prices an unreliable guide to value and fairness.

In principle we agree with the Trustee that prospective cash flow is a key factor in a case such as this. But we look at that anticipated stream of revenue to see how much of it would be absorbed by the senior and other creditors whose claims are prior to the interest of Jade's present stockholders.

The claims of the secured creditors against the reorganized company will be about $3 million,[14] plus 8 percent interest.[15] If all cash generated from operations as projected by the Trustee were devoted to servicing the secured debt it would take about 4 years (1970–1973) to retire such debt. We assume $4.2 million

[14] At present net secured debt (after deducting the $700,000 Union Bank certificate of deposit that Jade holds) amonts to $4,106,171. The plan envisages the application of as much as $1 million of the new money toward the reduction of Jade's secured indebtedness to the Union Bank. Although the plan only obligates Jade to make a $500,000 principal payment to the Bank, we shall assume that Jade elects to exercise its option to make a second $500,000 principal payment to the Bank. Hence secured debt will decline to $3,106,171. For convenience, we use the lower and more favorable figure of $3 million.

[15] In view of present money market conditions we think it fair to assume that the secured creditors are entitled to an 8 percent. *Cf.* the provision in the plan under which the Union Bank, by far the largest secured creditor, will be entitled to interest at the prime rate plus 1 percent but in no event less than 7 percent per annum.

principal amount of unsecured claims.[16] This principal amount could be retired over a succeeding period of about five years if operating cash of $866,700 projected by the Trustee for 1974 were to continue undiminished thereafter and were to be applied entirely to the principal of the unsecured claims.

Such a debt retirement program is, of course, highly theoretical. It rests on the Trustee's projected cash flow which, considering Jade's history and the nature of its business, we regard as far too sanguine. It also rests on the assumption, which the Trustee does not make, that the high level of cash receipts projected for 1974 will continue after that date. It would in addition require the application of all operating cash to debt service, leaving no margin for the new investment on which the Trustee's projections of cash flow depend. Moreover, it makes no adjustment for the $2.5 million in new money, without which no reorganization is possible. To be sure, the new investors are seeking an equity position. But the equity position for which they ask is a preferred equity position, and under the plan these investors will get a 7 percent senior preferred stock with a preference on liquidation over the present unsecured creditors to whom the plan would give a junior preferred stock. The calculations we have made thus substantially underestimate the period of time actually required for debt retirement.

The present worth of the unsecured creditors' projected receipts is obviously a good deal less than the $4.2 million to which they are now entitled. If we applied a discount rate of 8 percent [17] to determine the present worth of the assumed receipts by these creditors over 1974–1979, those assumed receipts would have a present value of about $2.47 million. Of course, the retirement of Jade's unsecured debt would, absent reorganization, take a far longer period. Indeed, for the retirement of the secured debt alone the plan envisages a period as long as 10 years. Hence the present worth of the future

[16] Claims and interests for purposes of participation have not as yet been allowed by the court. Our $4.2 million figure estimate is based on the Trustee's analysis of claims and consists of:

"Valid" claims of debenture holders and other unsecured creditors	$3,425,625
"Questionable" unsecured claims	668,624
Estimated valid liabilities for which no claims have been filed	100,000
	$4,194,249

This total does include some claims which the Trustee has tentatively characterized as "invalid"; nor have we included stockholder claims for rescission, totaling $802,332, the status of which has not been clarified.

[17] This is the rate for the secured creditors. The unsecured creditors whose position is much riskier are certainly entitled to at least that same 8 percent rate.

receipts, though we cannot measure precisely, would be substantially below the calculated amount of $2.47 million.

Thus far we have been concerned with the proven reserves on the properties that Jade is now working and with the hypothetical oil and gas properties that the Trustee assumes Jade will acquire in order to offset the steady depletion and eventual exhaustion of the oil and gas on the present properties of Jade. Jade also has other assets which, though not now productive, are nevertheless real and valuable. The Trustee values these assets (exclusive of the tax losses) at $1,707,050, which we accept for purpose of analysis. The Trustee's valuation is:

TABLE III

TRUSTEE'S VALUATION OF JADE'S UNPRODUCTIVE ASSETS

Barite prospect (fair market value)	$ 235,000
Prospective oil & gas (fair market value)	631,300
Real estate (fair market value)	703,200
Escrow funds	137,550
Total	$1,707,050

This would just about cover the deficiency on the claims of the unsecured creditors if realistically we could, as we obviously cannot, assume a present worth of $2.47 million for future receipts as heretofore indicated.

The Trustee also assigns a present value of $1.4 million to the substantial tax loss carryover.[18] There is no support in the record for this valuation. A tax loss carryover is of value only if there are income tax liabilities against which to apply it. In this case the Trustee, according to his testimony, is ". . . confident that there will not be sufficient income, taxable income, to utilize even a small portion of the tax loss carry forward." The Trustee went on to allude to the use that could be made of the tax loss if Jade acquired or merged with other businesses which had income tax liabilities. We think this

[18] The losses from which that carryover stems are as follows:

Year	*Amount*
1963	$ 120,000
1964	744,000
1965	1,734,000
1966	1,679,000
1967	1,500,000*

*estimated

possibility too conjectural to permit the assignment of a dollar value to Jade's tax loss carryover.

Assuming the full conversion of all of the preferred stock called for by the plan, the division of the equity interest in the reorganized debtor would be as follows under the present plan:

TABLE IV

Class	Number of Shares	Percentage Interest in Aggregate Equity
Unsecured creditors	2,100,000	25.7
New money—plan proponents	2,500,000	30.5
Old common stockholders	3,587,602	43.8
Total	8,187,602	100.0

The plan is unduly generous to the old common stockholders at the unsecured creditors' expense. As noted, the unsecured creditors' present claims total $4.2 million in exchange for which the plan would give them 25.7 percent of the common stock, while the present common stockholders whose interest is marginal at best would get 43.8 percent of the new common.

True, prior to conversion the unsecured creditors will receive Series B preferred stock, which is to be preferred over the common in two respects. The first, the Series B's $2 per share liquidation preference is of little significance since the unsecured creditors now have a legally enforcible present claim to payment, which is superior to and more meaningful than a preferred position, as stockholders, on liquidation. Of even less moment is the Series B's right to a dividend 15 percent higher than the dividend paid on the common. As the Trustee points out, the severely straitened cash position in which Jade is likely to find itself will almost certainly preclude payment of cash dividends even on the senior Series A preferred (to be issued to the new money group), let alone on the common. The Series B's dividend preference is therefore illusory.

The plan's treatment of the new money group is also objectionable in certain respects. The provision for a 7 percent cumulative dividend on the Series A preferred to be issued to them is deceptive. There is no intention of paying any cash dividends, and the record shows that the dividend on the Series A is almost certain to be paid in stock. Secondly, the cumulative feature of the proposed Series A is inappropriate in the case of an enterprise, like reorganized Jade, which will be promotional and speculative in character and oriented to the hope of capital gains rather than to dividend income. Thirdly, the contemplated payment of stock dividends on the Series A will lead to a steady rise in the new money group's share of the equity, without any fresh investment on its part, and to a correspondingly steady fall in the equity of others.

Under the plan the new investors will be paying $1 for each share of the new common that they will get, while the unsecured creditors will be surrendering $2 in claims for each of their shares of the new common. However, the new investors will be supplying indispensable fresh capital and will be assuming a high degree of risk. Accordingly, there can be no valid objection to giving them a stock position at what appears to be a bargain price when compared to the price per share to the unsecured creditors. But the detachable common stock purchase warrants that would continue the bargain price for five years into the future are another matter. Those warrants are unlikely to be exercised unless the market price is above the exercise price and thus constitute an opportunity for gain unaccompanied by any risk of loss. This riskless opportunity for gain on the new investors part is necessarily at the expense of the other stockholders and will in some degree accentuate the speculative character of what is bound to be a highly speculative security in any event. We therefore deem the proposed warrants inequitable. We recognize, however, that the new investors seek and are entitled to a measure of incentive that will compensate them for the risk they are taking. We recommend that such incentives be provided as we indicate below.

We also view as objectionable a capital structure under which (aside from the warrants) more than 8,000,000 shares of common stock will be issued and reserved for issuance. (See Table IV, *supra.*) Even on the Trustee's highly optimistic cash flow projections, he concludes that reorganized Jade will have a cash flow of 6.4 ¢ per share. In the Trustee's opinion the stock should be worth about $2 a share in the market if, as he assumes, investors decide to value Jade at 33 times its projected cash flow. We do not undertake to forecast the market performance of reorganized Jade's new common stock, but we think it clear that it will be a highly volatile issue subject to sharp fluctuations. Some of this volatility will stem from the nature of the enterprise, but this unavoidable risk factor should not be magnified by the issuance of more than 8,000,000 shares.

In view of the foregoing, we recommend that reorganized Jade's capitalization consist basically of common stock, but that the stock to be issued to the new investors carry with it a liquidation preference equal to the proposed aggregate purchase price of $2.5 million, as the plan now provides. To that end we suggest that the new investors receive 250,000 shares of Class A common, which shall differ from the balance of the common stock only by reason of its $10 per share liquidation preference. The remainder of the capitalization should consist of ordinary common stock, most of which should go to the unsecured creditors with a modest participation for the old common stockholders.

We think such participation consistent with the standards of Chapter X. The financial reorganization of Jade will leave the essential character of its business unaltered. It will continue as a small independent oil company, and success or failure will turn on the same kind of uncertainties and contingencies as heretofore. The present common stockholders chose to invest in this venture, and that choice need not be treated as though it were a wholly lost bet—especially since investors want to put substantial new equity capital into the very same business. However, in passing on the extent to which minimal participation by the present common can be permitted due regard must, of course, be given to the prior rights of creditors whom the plan would reduce to stockholder status. In our view a participation of about 5 percent for the present common can be found consistent with the prior rights of creditors.

Accordingly, we recommend that the plan be amended so as to allocate the equity interest in the proportions set forth below.

TABLE V

COMMISSION'S RECOMMENDED
ALLOCATION OF THE EQUITY INTEREST

Class	Number of Shares to be Received		Percentage Interest
New money group	250,000	(Class A entitled to $10 per share liquidation preference)	35.4
Unsecured creditors	420,000		59.5
Old common stockholders	36,000		5.1

The 35.4 percent interest that we suggest for the new money group is appreciably larger than the 30.5 percent interest for which they ask. Thus our recommendation would substitute an

increased equity for the warrants and the cumulative dividend proposed by the plan. The unsecured creditors, although they would become stockholders, would have almost 60 percent of the stock and control of the reorganized company. The old common stockholders would retain a small residual interest in the enterprise on the basis of one share of new common for each 100 shares of the old.[19]

In addition to being fair and equitable a plan of reorganization must be "feasible", which relates, among other things, to the reorganized company's ability to meet its obligations. It is clear that the Debtor will have sufficient funds on hand to pay its immediate obligations under the plan. The question therefore is whether the reorganized company can service the balance of $3 million in secured debt. As we have noted previously, the reorganized company will be able to spread the repayment of this sum over 10 years, and on that basis will have to disburse approximately $300,000 a year to amortize its secured debt.

The Trustee's cash flow projections reproduced in Table II at page 12, *supra,* show that he anticipates a 1970 cash flow of $414,000 after interest, but makes no allowance for repayment of principal. The Trustee also anticipates a growth of more than tenfold in gross receipts from new properties, beginning with $66,600 in 1970 to $678,100 in 1974. In view of the uncertainties and the conjectures inherent in any attempt to forecast the results of the reorganized Debtor's exploratory efforts,[20] we deem it more prudent to assume that the hypothetical new properties will yield just enough to offset the post-1970 decline in Jade's income from its present properties.

In view of the many imponderables involved, it is not possible to explore the question of feasibility over the long run. For the shorter period following reorganization feasibility presents a problem. As the Trustee himself has said, "Jade would have to operate on a very economical basis to service its debt." The margin for the new investment on which the continued life of an enterprise like Jade depends will be extremely slim. How-

[19] 3,587,602 shares of the old common are now outstanding. Any of the present common stockholders whose rescission ultimately upheld would, of course, be treated as an unsecured creditor and hence fare far better than the other stockholders.

[20] It s hoped that the O'Brien group with which Jade's future is to be linked will be skillful enough—and lucky enough— to keep Jade's history from repeating itself. But this is no more than a hope. As the Securities Act prospectus for the "1969 O'Brien Oil and Gas Exploration Program" (Securities and Exchange Commission File No. 2–31839) states at its very outset:

"THE PROGRAM IS A SPECULATIVE ACTIVITY"

"Oil and gas exploration is a speculative activity and its results cannot be forecast . . ."

We note that the Trustee himself has testified that "In this business you are never sure of anything."

LIBRARY U. OF L.

ever, some cash could perhaps be raised, if needed, by sale or pledge of Jade's unproductive properties. Although this possibility does not altogether dispel our doubts, we believe that the plan can be found feasible.

In conclusion it should be noted that we have addressed ourselves to the proposed plan of reorganization in terms of the statutory requirements of fairness and feasibility. If the plan, amended as we recommend, is approved by the Court, it will be submitted for a vote by securityholders affected thereby. In this case, while the present stockholders' interest in Jade is marginal at best, those most vitally affected by the plan are the debenture-holders and other unsecured creditors. If they reject the plan, it is fair to assume that they favor liquidation. According to the Trustee, the Jade enterprise has (apart from its tax loss) a liquidating value of about $6.4 million. On that basis it is possible that, after deducting the amount due secured creditors and priority claimants and allowing for costs of reorganization, the unsecured creditors might realize about 30 percent on assumed claims of $4.2 million. It should be noted though that the Trustee makes no estimate of the potential realization in the event of a forced liquidation. If they vote for the plan in the hope of realizing more, they would obviously risk getting less. It is not for this Commission to arbitrate that choice.

OTHER MATTERS

Under the plan two of the seven members of the first board of directors will be named by the Union Bank, to which provision we have no objection. The provision under which the Trustee will designate two members of the first board is objectionable. We think it is for the stockholders to nominate those whom they wish to act for them. Under the plan as it now stands the unsecured creditors who would receive Series B preferred stock will designate one director. Under the amendments proposed by us, the unsecured creditors will own a majority of the stock. We suggest therefore that they designate three of the seven directors. We agree that the two remaining members of the board should be designated by the new investors, as the plan propposes.

All of the reorganized company's stock, preferred as well as common, is to be voting stock under the plan. Each share to have one vote, but we recommend that the plan be amended so as to include an express requirement for cumulative voting. Johnny Mitchell, the Debtor's former president and certain persons closely associated with him, own much of the present common stock. Those persons will also hold some of the new stock to be issued to the group of new investors, which Mitchell assembled. The plan provides that all of the Jade stock owned or to be owned by Mitchell and certain named affiliates of his is to be deposited in a voting trust. That trust, which will last 10 years, is to relate solely to the election of directors. We see no need to alter the proposed voting trust.[21]

Certain stockholders contend that the Trustee has not made a full investigation of the Debtor's affairs and of its prior management, referring to alleged indications that "the debtor's books reflect transactions, totaling approximately $8,600,000, which are questionable from an accounting point of view and which do not appear to be substantiated, as to their propriety, by the debtor's records, except as to the figures set forth in the debtor's books." They argue that it is therefore premature to consider a plan at this time.

How much, if anything, the Trustee will recover on any causes of action that he may pursue cannot now be foreseen. Such causes of action have been held much too remote to be deemed assets of the estate to which value can be assigned.[22] Accordingly, consideration of a plan need not be deferred, and lawsuits can be initiated and prosecuted even after the plan is confirmed and consummated. Indeed, this plan provides for the retention and the enforcement of causes of action by the Trustee as Section 216(13) of Chapter X requires. But the plan also provides that the Trustee's recoveries, if any, are to be "for the benefit of the reorganized company." Since, as we have pointed out, the standards of Chapter X limit the present stockholders to a nominal participation in the reorganized enterprise, this provision of the plan should be deleted. In its place there should be substituted a provision by which the Court would reserve jurisdiction to direct distribution of recoveries, if and when realized, to those equitably entitled thereto, which may include present stockholders or the reorganized company.

CONCLUSION

The plan is not fair and equitable and does not meet the standards of Chapter X in some other respects, unless

[21] In view of our recommendations regarding the stock to be issued to the new investors, we do not comment on the proposal in the plan under the new i.ivestors will be entitled to elect two directors in the event of a failure to pay divideneds on the Series A preferred.

[22] See *Central States Electric Corp.* v. *Austrian*, 183 F.2d 879, 882 (C.A. 4, 1950), *certiorari denied*, 340 U.S. 9151).

amended as we have proposed. Although we have some reservations about feasibility, the plan can be found feasible.

By the Commission (Chairman BUDGE and Commissioners OWENS, WHEAT, SMITH and NEEDHAM).

IN THE MATTER OF

PENNZOIL UNITED, INC.

File No. 3-617. Promulgated September 23, 1969

Public Utility Holding Company Act of 1935—Sections 11(b)(1) and 11(e).

INTEGRATION OF HOLDING COMPANY SYSTEM
Plan Under Section 11(e)

Transactions Necessary to Effectuate Compliance with Section 11(b)

Plan filed pursuant to Section 11(e) of Public Utility Holding Company Act of 1935 by successor by consolidation to registered holding company and gas utility subsidiary to effectuate compliance with order entered under Section 11(b)(1) of Act requiring divestment of ownership or control of all gas utility properties, providing for creation of separate gas utility company and transfer to it of substantially all such properties in exchange for its common stock, which will be offered through a rights offering to successor's stockholders, and for its mortgage bonds and debentures, which will subsequently be sold to the public, *held*, necessary to effectuate compliance with the provisions of Section 11(b)(1) of the Act.

Fair and Equitable Standard

Plan, filed pursuant to Section 11(e) of Public Utility Holding Company Act of 1935, providing for creation of independent gas utility company and transfer to it of gas utility properties in exchange for its common stock, bonds and debentures, the stock to be offered through underwritten rights offering to stockholders of transferring company, and the bonds and debentures to be subsequently sold to the public by that company, *held*, fair and equitable to the persons affected thereby.

APPEARANCES:

Baine P. Kerr, *Alvin Owsley, Jr.*, and *Moulton Goodrum, Jr.* of Baker, Botts, Shepherd & Coates, and *Emanuel J. Freiberg*, for Pennzoil United, Inc.

Lloyd C. Emery, III and *Roy E. Johnson*, for the City of Senatobia, Mississippi, and the Town of Como, Mississippi.

R. Moshe Simon, for the Division of Corporate Regulation of the Commission.

FINDINGS AND OPINION OF THE COMMISSION

I. INTRODUCTION

This proceeding relates to a plan, as amended ("Plan"), filed pursuant to Section 11(e) of the Public Utility Holding Company

Act of 1935 ("Act") by Pennzoil United, Inc. ("Pennzoil United") for the purpose of effectuating compliance with our order dated February 7, 1968, issued pursuant to Section 11(b)(1) of the Act (43 Sec. 709) wherein we directed Pennzoil Company ("Pennzoil") and United Gas Corporation ("United") its then subsidiary gas utility company, to dispose, or cause the disposition of, their direct and indirect interest in all the gas utility assets then owned by United and now by Pennzoil United.[1]

In brief, the Plan provides for the creation of a new company, United Gas, Inc., to which Pennzoil United will transfer substantially all of its remaining gas utility properties in exchange for the common stock, first mortgage bonds and debentures of United Gas, Inc. The common stock of United Gas, Inc. is to be offered to the stockholders of Pennzoil United through an underwritten rights offering, with any unsubscribed shares to be sold to the public. The United Gas, Inc. bonds and debentures issued to Pennzoil United will be subsequently resold to the public.

A notice of hearing of the Plan was issued June 12, 1969 (Holding Company Act Release No. 16403), according all interested persons an opportunity to be heard. A public hearing was held, at which no one appeared in opposition except the City of Senatobia and the Town of Como, both of Mississippi, which, after entering into a stipulation with Pennzoil United, no longer oppose the Plan. A hearing examiner's initial decision and other post-hearing procedures have been waived and it was agreed that our Division of Corporate Regulation could assist us in the preparation of these Findings and Opinions. We make the following findings on the basis of an independent consideration of the record.

II. PRIOR ADMINISTRATIVE PROCEEDINGS

By order dated February 21, 1968 (Holding Company Act Release No. 15980) we approved a modified plan filed, pursuant to Section 11(e) of the Act, by Pennzoil and United which, among other things, provided for the consolidation of Pennzoil and United to form Pennzoil United and, following the consolidation, for Pennzoil United to dispose of the gas utility properties then held by United. We applied, thereafter, to the United States District Court for the District of Delaware for an order

[1] Pennzoil United is the successor company, on consolidation, to Pennzoil Company, formerly a registered holding company, and its subsidiary company United Gas Corporation.

to enforce and carry out the terms of that plan. On March 22, 1968, such an order was entered, and the plan was consummated as of April 1, 1968.

On March 21, 1968 (Holding Company Act Release No. 16014), we declared, pursuant to Section 5(d) of the Act, that effective upon the date of the consolidation of Pennzoil and United, the registration of Pennzoil as a holding company would cease to be in effect, subject, among other things, to the reservation of jurisdiction over Pennzoil United to assure compliance with our February 7, 1968, divestment order. On February 7, 1969 (Holding Company Act Release No. 16286), we extended until February 7, 1970, the time for Pennzoil United to comply with our orders to dispose of its gas utility properties.[2]

III. GAS UTILITY PROPERTIES

The gas utility properties to be transferred to United Gas, Inc. (referred to as the Distribution Division of Pennzoil United) consist—except for the gas distribution system servicing the city of Monroe, Louisiana—of all its presently held retail gas utility properties. The Distribution Division serves natural gas at retail in 201 communities in eastern and central Texas, 114 communities in western Louisiana (exclusive of Monroe) and 88 in Mississippi having a total population of approximately 3,090,000, the four largest communities being Houston and Beaumont, Texas; Lake Charles, Louisiana; and Biloxi, Mississippi. As of December 31, 1968, it served approximately 687,000 customers, of which 618,800 were residential, 66,700 were commercial and 1,500 were industrial.

Upon the transfer of these gas properties to United Gas, Inc., it will own the underground mains and service lines in each of the cities and towns which it will serve, totaling about 18,000 linear miles, metering and regulating equipment on customer's premises, and various district offices, service centers, warehouses, work shops and garages. As at April 30, 1969, the *pro forma* net plant of United Gas, Inc. was $112,659,000 and, for the 12 months then ended, the *pro forma* gas operating revenues were $74,766,000 on sales of 111,133,000 mcf of gas.

The gas distribution properties located in Texas, now subject to the lien of Pennzoil United's Mortgage and Deed of Trust,

[2] In addition to the gas utility properties, described below, which are the subject of this proceeding, a smaller retail gas utility system was acquired by Pennzoil United in the consolidation. These utility properties, which are located in and around St. Petersburg, Florida, have been sold by Pennzoil United to a nonassociate company pursuant to our order issued February 23, 1969 (Holding Company Act Release No. 16279). In addition during the latter part of 1968 five Louisiana municipalities purchased the gas utility properties serving such municipalities.

will be released from such lien before being transferred to United Gas, Inc.; and following such transfer, most of the properties of United Gas, Inc., will be subject to its own Mortgage and Deed of Trust securing its First Mortgage Bonds, discussed below.

The principal supplier of natural gas for United Gas, Inc. will be United Gas Pipe Line Company ("Pipe Line"), a subsidiary company of Pennzoil United which, in 1968, furnished 91.5 percent of the Distribution Division's total gas requirements. The gas purchase rates for the Houston area, which expire this year, are under the jurisdiction of the Railroad Commission of Texas. The rates charged by Pipe Line in southern Louisiana are under the jurisdiction of the Louisiana Public Service Commission. Rates in the remaining areas are subject to the jurisdiction of the Federal Power Commission. Retail gas rates of the Distribution Division, particularly the sale of gas to residential and commercial customers, are generally subject to the approval of state regulatory or municipal authorities. United Gas, Inc., will commence operations under the rates presently charged by the Distribution Division.

IV. THE PROPOSED PLAN

Pennzoil United proposes to transfer the operating assets and current liabilities comprising its Distribution Division to United Gas, Inc.[3] In exchange therefor, Pennzoil United will receive the following securities of United Gas, Inc.: (i) $62,000,000 principal amount of 6½ percent First Mortgage Bonds due 1989, (ii) $8,000,000 principal amount of 6½ percent sinking fund debentures due 1979, and (iii) 4,056,714 shares of common stock, $5 par value. Each share of United Gas, Inc. will entitle the holder to one vote with the right of cumulative voting in the election of directors and to preemptive rights with respect to the issuances of additional shares of common stock.

Pennzoil United proposes to offer the shares of the common stock of United Gas, Inc. which it will acquire to the holders of its common and preference common stocks by means of a right offering. The shareholders of Pennzoil United will receive one

[3] Pennzoil United operates gas distribution properties serving the city of Monroe, Louisiana, under a franchise granted in 1947, which requires Pennzoil United to provide service at a fixed rate until April 1972. Operation of these properties has resulted in substantial operating losses for a number of years. For the year ended December 31, 1968, such losses amounted to $1,290,000. Pennzoil United twice unsuccessfully sought an increase in rates. Since the operation of the Monroe properties is unprofitable, Pennzoil United is not transferring them to United Gas, Inc., Pennzoil United proposes to enter into an operating agreement with United Gas, Inc., whereby the latter will operate such properties for the account and at the expense of Pennzoil United.

right per share and, for every eight rights, will be entitled to purchase one share of United Gas, Inc. The holders of Pennzoil United preference common stocks will receive one right for each share of common stock into which the preference common is convertible.[4] All the rights are fully transferable. No fractional shares will be issued, and any stockholder may sell or purchase up to seven rights through the exchange agent at no cost to him. The rights offering will provide for over-subscription privileges, subject to allotment, and will include a standby underwriting for unsubscribed shares, the compensation for which will be determined by competitive bidding.[5]

The $6^{1}/_{2}$ percent First Mortgage Bonds will mature in 1989 and will be issued pursuant to an Indenture of Mortgage and Deed of Trust. The Indenture will provide for cash sinking fund payments commencing in 1971 designed to retire $37,200,000 principal amount of the First Mortgage Bonds, or approximately 60 percent prior to maturity. Additional series of First Mortgage Bonds may be issued under the Indenture from time to time on the basis of, among other things, 60 percent of the cost or fair value (whichever is less) of net property additions, subject to certain conditions. The $6^{1}/_{2}$ percent Sinking Fund Debentures will mature in 1979 and will be issued pursuant to an Indenture which will provide for cash sinking fund payments commencing in 1971 designed to retire $2,550,000 principal amount of Sinking Fund Debentures, or approximately 32 percent, prior to maturity. Both the First Mortgage Bonds and Sinking Fund Debentures will be redeemable at the option of United Gas, Inc. at declining redemption prices commencing at 106.5 percent of the principal amount, except that no such redemption may be made within five years from the date thereof by the use of funds borrowed having a cost lower than $6^{1}/_{2}$ percent.

V. COMPLIANCE WITH STATUTORY STANDARDS

Section 11(e) provides that the Commission shall approve a plan filed thereunder if it finds such plan is "necessary to effectuate the provisions of" Section 11(b) and is "fair and equitable to the persons affected" thereby. The transactions

[4] The holders of Pennzoil united 1.33^{1}/_{3}$ and 1.58^{1}/_{3}$ preference common stock will be entitled to receive 1.44 and 1.4286 rights, respectively, for each share of stock held by them.

[5] Each bid will specify the amount to be paid by Pennzoil United, Inc., to the bidder, as compensation for their commitments, for each of the unsubscribed shares and for each share of common stock acquired by such bidder or bidders through the exercise of rights purchased by them; plus a standby commitment fee in an amount equal to a percentage of the compensation to be fixed by Pennzoil United, Inc. prior to the bidding of the compensation per shares so specified in the bid multiplied by each of the 4,056,714 shares of common stock of United Gas, Inc.

proposed by the plan must also satisfy the other applicable provisions of the Act.

NECESSITY

It is well established that a plan is "necessary" under Section 11(e) if it provides an appropriate means of achieving the results required by Section 11(b) even though it may not be the only plan that could secure such statutory result.[6]

As already noted, our order of February 7, 1968, required divestment by Pennzoil United of its interest in the gas distribution properties. Accordingly, the proposed disposition of the shares of common stock of United Gas, Inc. satisfies Section 11(b)(1) and our order thereunder.[7] Our order herein will continue the reservation of jurisdication with respect to the disposition of its bonds and debentures and of the Monroe, Louisiana, properties contained in our prior order of February 7, 1968.[8]

FAIRNESS

Set forth in Appendix A is a *pro forma* condensed balance sheet of United Gas, Inc. on the assumption it was organized as at April 30, 1969, and had borrowed $6,000,000 on a short-term bank loan at 8½ percent interest to provide cash for initial working capital. United Gas, Inc. will commence operation with a *pro forma* capitalization as of April 30, 1969, of $106,500,000, per books consisting of (a) the $62,000,000 First Mortgage Bonds (or 58.2 percent), Sinking Fund Debenture of $8,000,000 (or 7.5 percent), and common stock equity of $36,500,000 (or 34.3 percent).

Appendix B is a *pro forma* condensed statement of income of United Gas, Inc. for the twelve months ended April 30, 1969, assuming the company had been in operation as a separate entity for this period and relfecting interest payment on the proposed capital structure, including the $6,000,000 bank loan. The 6½ percent interest rate for both the bonds and the debentures is approximately equivalent to Pennzoil United's average cost on its presently outstanding long-term debt[9] and,

[6] *Lahti* v. *New England Power Ass'n.*, 160 F.2d 845 (C.A. 1, 1947).

[7] See *Louisiana Gas Service Co. et al.*, 40 S.E.C. 193 (1960; *American Gas and Electric Co. et al.*, 25 S.E.C. 481 (1947); *Electric Bond and Share Co. et. al.*, 23 S.E.C. 674 (1946); *American Gas and Electric et al.*, 22 S.E.C. 560 (1946); *Pennsylvania Power & Light Co. et al.*, 21 S.E.C. 143 (1945).

[8] The plan states that the bonds and debentures of United Gas, Inc. to be acquired by Pennzoil United will be divested within one year following their receipt by it. However, our order of February 7, 1969, extended the date for full compliance with our Section 11(b) (1) order until only February 7, 1970.

[9] This interest rate is less than the effective rate which could be expected to be obtained if the bonds and debentures were sold to the public at the present time. The current prime rate for commercial loans from banks is in excess of 8 percent.

as indicated in Appendix B, the interest thereon will amount to $4,550,000 for the first year. For the 12 months ended April 30, 1969, the total interest cost of $5,193,000, including estimated interest cost of $510,000 on the entire $6,000,000 bank loan, would be covered 3.1 times before Federal income taxes and 2.0 times after provision for Federal income taxes. On the basis of 4,057,000 outstanding shares of common stock the *pro forma* per share earnings would be $1.28 per share.

Projected construction expenditures for 1969 and the four years ending December 31, 1973, will average approximately $8,000,000 per year. It is contemplated that the initial dividend rate on the common stock for the new company will be fixed at a level representing a 40 percent payout. With a compound rate of projected growth for net income of slightly less than 4½ percent, and assuming an average of $8,000,000 for construction expenditures and 40 percent payout for common stock dividends, the cash requirements to service the proposed debt and meet the cash sinking fund payments required by the two new debt indentures would require additional borrowings of $1,000,000 in 1970 and $2,000,000 in 1971. New borrowings for 1972 and 1973 are estimated to average $1,250,000. On the basis of such projected cash flow, including the debt retirements as required by the indenture, the debt ratio as at December 31, 1973 would be 55.3 percent as compared to the initial 65.7 percent.

The subscription price to be fixed by Pennzoil United for the common stock of United Gas, Inc. will reflect a discount ranging from 8 percent to 12 percent below the estimated market price for the United Gas, Inc. common stock. Such estimated market price is to be based primarily upon a comparison of financial and operating characteristics of United Gas, Inc. with other gas utility companies in the area, whose outstanding shares of common stock are actively traded in the market. For such comparison, four Texas gas-utility companies and three other such companies serving parts of Louisiana and Mississippi were selected.[10] Data concerning these two groups of companies indicated that for the 12-month period ended June 30, 1969, the Texas group experienced an average price earnings ratio of 16.8 times, while the Louisiana and Mississippi group had a 10.7 times ratio. Because 75 percent of United Gas, Inc.'s operations are in the Houston, Texas area, a

[10] The four Texas companies are: Houston Natural Gas Corp.; Lone Star Gas Co.; Pioneer Natural Gas Co.; and Southern Union Gas Co. The three Louisiana-Mississippi companies are: Arkansas Louisiana Gas Co.; Louisiana Gas Service Co.; and Mississippi Valley Gas Co.

similar weight was applied to the Texas companies price earnings ratio in reaching a ratio of 15.3 times as the appropriate price earnings ratio for United Gas, Inc.

The *pro forma* income statement of United Gas, Inc. for the 12 months ended April 30, 1969, indicates a net income of $1.28 per share which, multiplied by 15.3, would yield an estimated market price of $19.58. An expected discount from 8 percent to 12 percent would result in a subscription price for the common stock ranging from a high of $18.01 to a low of about $17.23. The actual subscription price is to be filed as a post-effective amendment.

The only persons directly affected by the proposed sale of the common stock of United Gas, Inc. are the Pennzoil United stockholders. They will receive rights to purchase the United Gas, Inc. shares of common stock at a subscription price that bears a reasonable relationship to the earnings capacity of the new company. During the period the rights remain outstanding, the market will have had an opportunity to establish a market price for the rights, and the Pennzoil United stockholders will thus have the option either to exercise their rights or sell them in the open market. This is fair and equitable treatment of the affected stockholders.

ACCOUNTING

The assets and current liabilities of the gas distribution properties will be transferred to United Gas, Inc. at the book value thereof. The bonds and debentures will be recorded at the principal amount thereof and the common stock at par value. The balance equal to the value of the assets less the liabilities and the par value of common stock will be recorded as capital surplus. Pennzoil United will apply the cash proceeds derived from the proposed transaction to reduce its indebtedness. The entire net capital gains, as ultimately realized by Pennzoil United, will be credited to the excess acquisition cost, stated on Pennzoil United books at $88,859,000, which was created when the 42.013 percent of United's shares held by Pennzoil were cancelled upon the consolidation of the two companies. Our Findings and Opinion of February 7, 1968 provided that "upon the divestment of the gas distribution properties an appropriate allocation of the excess cost should be amortized or accounted for as appropriate."[11] The proposed accounting would so apply the entire capital gain. This appears to be appropriate.

VI. OTHER MATTERS CONSIDERED

OFFICERS AND DIRECTORS OF UNITED GAS, INC.

The Board of Directors of United Gas, Inc., has nine members. The entire initial board, which has been designated by Pennzoil United to serve until the first regular annual meeting of shareholders, consists of residents of the service area, three of whom are senior officers as well. Four of the five senior officers of United Gas, Inc., now employees of the Distribution Division, will, after the transfer, no longer have any connection with Pennzoil United. None of the non-officer directors has any present connection with Pennzoil United. No officer or director of United Gas, Inc., will at any time be an officer or director of Pennzoil United or any of its subsidiary companies.

FEES AND EXPENSES

We shall postpone consideration of, and reserve jurisdiction to pass upon, the fees and expenses, other than those relating to the compensation of the underwriters in connection with the common stock of United Gas, Inc.

TAX RECITALS

Pennzoil United has requested that our order entered herein recite that the transactions proposed in the Plan are necessary or appropriate in the integration or simplification of the holding company system of Pennzoil United and are necessary or appropriate to effectuate the provisions of Section 11(b) of the Act, all in accordance with the meaning and requirements of Section 1081(f) of the Internal Revenue Code of 1954. This request will be granted.

By the Commission (Chairman BUDGE and Commissioners OWEN WHEAT, SMITH and NEEDHAM).

[11] On the effective date of the consolidation, the assets and liabilities of Pennzoil and United were recorded in the accounts of Pennzoil United at their underlying book values as recorded in the respective accounts of Pennzoil and United. Entries were made to reflect the exchange of securities and the cancellation of the shares of common stock of United owned by Pennzoil. Such cancellation resulted in a debit to an account entitled "cost of investment in the United over uderlying book value at date of acquisition" in the amount of $88,859,000. See *Pennzoil Company et al.*, 43 S.E.C. 709, 748–49 (1968).

APPENDIX A

UNITED GAS, INC.

Pro Forma balance sheet
April 30, 1969
(Unaudited)

(000 omitted)

Assets	
Plant, property and equipment:	
Gas utility plant, at original cost	$157,221
Less—Reserve for depreciation	44,562
	112,659
Current assets:	
Cash	6,674
Other	12,740
	19,414
Deferred charges	479
	$132,552
Liabilities	
Shareholders' equity:	
Common stock ($5 par value)—authorized 5,000,000 shares, outstanding 4,056,714 shares	$ 20,284
Capital surplus	16,216
	36,500
Long-term debt:	
6½ First mortgage bonds due 1989	62,000
6½ Sinking fund debentures due 1979	8,000
	70,000
Current liabilities:	
8½ bank loans	6,000
Other	7,792
	13,792
Deferred credits	947
Contributions in aid of construction	11,313
	$132,552

APPENDIX B

UNITED GAS, INC.

Pro Forma statement of income
For the 12 months ended April 30, 1969
(Unaudited)

(000 omitted)

	Historical	Adjustments (See notes A, B, C, D)	Pro Forma
Operating revenues:			
Natural gas	$73,011	$1,755	$74,766
Other	1,679	—	1,679
Total operating revenues	74,690	1,755	76,445
Operating expenses:			
Natural gas purchased	30,162	—	30,162
Operations—			
Distribution	3,733	77	3,810
Customers' accounts, sale, and administrative and general	12,882	251	13,133
Maintenance	3,961	61	4,022
Depreciation and amortization	3,783	—	3,783
Taxes, other than Federal income	5,480	(67)	5,413
Total operating expenses	60,001	322	60,323
Net operating income before Federal Income taxes	$14,689	$1,433	$16,122
Pro Forma:			
Federal income taxes			5,741
Net operating income			10,381
Interest:			
Interest on long-term debt			4,550
Interest on bank loans			510
Interest on customers' desposits			133
Total interest			5,193
Net income—pro forma			$ 5,188

( ) Indicates red figure

Notes:

A. Adjustments to Operating Revenues

Notes (continued)

(1) Operating revenues have been increased $1,755,000 to reflect, on an annualized basis, rate increases which became effective in the fourth quarter of 1968 and the first quarter of 1969 in Houston and 41 other cities and communities in Texas.

B. Operating expenses have been adjusted to give effect to the following

(1) A general wage adjustment of January 1, 1969 which would have increased operating expenses $301,000.

(2) The cost of group life insurance, group hospitalization insurance, a stock purchase plan and a pension plan, all with benefits similar to those presently available to employees of Pennzoil, increased $107,000 when computed on a separate company basis.

(3) The cost of casualty insurance was reduced $19,000 based on current premium rates.

C. Taxes other than Federal income taxes have been reduced $67,000 giving effect to:

(1) Increase in gross receipts resulting from rate increases in Texas—$73,000.

(2) Reduction of $140,000 for state franchise taxes reflecting the computed liability based on the capitalization of the Company.

D. Pro Forma Federal Income Taxes

(1) Federal income taxes have been provided at the present statutory rate of 52.8 with no reduction for the amount of investment tax credit generated ($183,000) for the twelve months ended April 30, 1969.

E. Pro Forma Interest

(1) Interest on long-term debt is based on the proposed issuance by the Company of $62,000,000 of 6$^{1}/_{2}$ First Mortgage Bonds due 1989 and $8,000,000 of 6$^{1}/_{2}$ Sinking Fund Debentures due 1979 and assumed interest at the rate of 8$^{1}/_{2}$ on $6,000,000 of proposed short-term bank borrowings.

In the Matter of

GENERAL ELECTRIC COMPANY

File Nos. 3-1057. Promulgated September 29, 1969

Investment Company Act of 1940—Sections 16(a), 32(a) and 6(b)

EXEMPTION FOR EMPLOYEES' SECURITIES COMPANY

Application on behalf of employees' securities fund pursuant to Section 6(b) of the Investment Company Act of 1940 for exemption, inter alia, from Section 16(a) requiring that its directors be elected by its stockholders and from Section 32(a) requiring that the selection of its independent public accountant be ratified by its stockholders, *granted,* the Commission finding that such exemptions are consistent with the protection of investors in view of the safeguards provided under fund's terms and applicable statutory provisions, and the special character of an employees' securities company in the context of the statutory scheme.

APPEARANCES:

Fritz F. Heimann and *Thomas F. Hilbert,* for General Electric Company.

Irving Abramson, Ruth Weyand and *Melvin Warshaw,* for International Union of Electrical, Radio and Machine Workers, AFL-CIO.

Stephen I. Schlossberg, John A. Fillion, Jordan Rossen, Bernard F. Ashe and *Stanley Lubin,* for International Union, United Automobile, Aerospace & Agricultural Implement Workers of America—UAW.

Elihu Leifer, for International Brotherhood of Electrical Workers, AFL-CIO.

Gerald Osheroff and *Oliver L. App,* for the Division of Corporate Regulation of the Commission.

FINDINGS AND OPINION OF THE COMMISSION

General Electric Company ("GE") filed an application pursuant to Section 6(b) of the Investment Company Act of 1940 ("Act") for an order exempting the General Electric S & S Program Mutual Fund ("Fund") as an employees' securities company[1] from certain provisions of the Act.[2] Following public notice and hearings,[3] the hearing examiner in his initial decision granted and denied various exemptions. GE filed a petition for review, which we granted, with respect to the examiner's denial of exemptions from (1) the requirement of Section 16(a) that the directors of an investment company be elected by its stockholders; and (2) the requirement of Section 32(a) that the selection of an independent public accountant be ratified by vote of the stockholders.

Briefs in support of the requested exemptions from Sections 16(a) and 32(a) were filed by GE and our Division of Corporate Regulation ("Division");[4] briefs in opposition were filed by the International Union of Electrical, Radio and Machine Workers, AFL–CIO ("IUE") and the International Union, United Automobile, Aerospace & Agricultural Implement Workers of America ("UAW"); and we heard oral argument.[5] Our findings are based upon an independent review of the record.

The Fund is one part of the General Electric Savings and Security Program ("Program") which permits GE employees other than officers and directors to participate in a payroll deduction plan to which the employee may allocate up to 6 percent of his pay (7 percent after three years participation), with GE contributing for the account of the employee an amount equal to 50 percent of the employee's payments. A participating employee may select one or more of the following media for the investment of his own payments and GE's contributions: United States Government Savings Bonds, GE common stock, life insurance, and the Fund. The General Electric Savings and Security Trust ("Trust") receives all payments and makes required investments. It holds all securi-

[1] In pertinent part Section 2(a) (13) of the Act defines an "employees' securities company" as any investment company all of whose outstanding securities are beneficially owned by employees or former employees of a single employer or affiliated employers or by members of the immediate families of such employees or former employees, or by such employer or employers together with any of the foregoing classes of persons.

[2] Section 6(b) provides that upon application the Commission shall exempt any employees' securities company from provisions of the Act if and to the extent that such exemption is consistent with the protection of investors. Under Rule 6b–1, the Fund is exempt from the Act pending final determination of the application for exemption filed under Section 6(b).

[3] See *General Electric Company*, Investment Company Act Releases Nos. 4973 and 5217 (May 31 and December 28, 1967).

[4] The Division took the position before the hearing examiner that certain of the exemptions requested in the application would be inappropriate, and as noted above, the hearing examiner in his initial decision rejected exemptions from certain provisons. GE has not taken exceptions to such denials except in the two instances now before us.

[5] Two other unions had been granted leave to participate in the proceedings, and one of these, the International Brotherhood of Electrical Workers, AFL–CIO, appeared at the oral argument in oppositon to the exemption application.

ties credited to an employee in trust for a three-year period,[6] at the end of which time distribution is made to the employee unless he elects to have the securities purchased with the company's contribution held in trust until his retirement or other termination of employment. An employee may withdraw his own payments at any time, but if he does so during the three year holding period he forfeits the securities purchased with the company's contributions except in the event of specified contingencies including layoffs, illness, injury, plant closing, retirement and death. For certain employees who elect to participate in the Program, primarily certain salaried and hourly rated employees to whom general pay raises apply, there are deductions from pay of up to 1.75 percent.

In 1967 about 149,000 of GE's approximately 300,000 employees[7] in this country participated in the Program through payroll deductions with the payments made by them amounting to about $81,909,000. Company contributions were $37,300,000. Participations in the Program, including the Fund, are registered under the Securities Act of 1933, and are offered to GE employees by means of a statutory prospectus. The Program itself is stated to be exempt from the Investment Company Act under Section 3(c)(13), which excludes from the definition of an investment company any employees' stock bonus, pension or profit sharing trust which qualifies under Section 401 of the Internal Revenue Code for favorable tax treatment. As pointed out later, the Program is so qualified.

The Fund is an employees' securities company within the meaning of Section 2(a)(13) of the Act. Interests in the Fund ("units") are offered only to employees participating in the Program and are transferable only to members of their immediate families.[8] The Fund has registered under the Act as an open-end management investment company and it is administered by five trustees who are senior executives of and appointed by GE, and who serve without cost to the Fund. The principal functions of the Fund trustees are to engage an investment manager and supervise his activities in conformance with the Investment Policies promulgated in the Rules of the Fund ("Investment Policies"). The trustees have con-

[6] The holding period ends on January 1 three years after the year in which the securities are credited.

[7] About 144,500 employees were represented by unions, around 98,000 of them by the four unions granted leave to participate in these proceedings. It appears that union-represented employees account for about 5 percent of the interests in the Fund.

[8] Units distributed to participants at the end of the holding period are redeemable; units held subject to a termination of employment option are not redeemable until the occurrence of such event except in certain limited circumstances.

tracted with a major bank and trust company for investment management services and custody of Fund assets, and GE states that the annual management fee, on the basis of the $60,000,000 portfolio which the Fund had in January 1969, is $35,000.

Under the Fund's Investment Policies, which cannot be changed by GE or by the trustees, monies received by the Fund are invested principally in common stock and in securities convertible into common stock. The Fund may not invest in securities of GE or its affiliates or the investment manager. The Investment Policies also prohibit, among other things, portfolio transactions with those companies or their officers or directors, the acquisition of over 10 percent of the outstanding voting stock of any issuer, and the investment of more than 5 percent of the Fund's assets in securities of any one issuer or more than 25 percent in any particular industry.

The Act clearly discloses a Congressional intention to provide an employees' securities company with more favorable exemptive treatment than an ordinary investment company. Section 6(b) not only provides a separate exemptive provision specially for employees' securities companies but it directs that we "shall . . . exempt" any such company "if and to the extent that such exemption is consistent with the protection of investors." In contrast, Section 6(c) provides that we "may . . . exempt" investment companies generally "if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of the Act. From an early date it has been recognized that an employees' securities company is "a peculiar type of company which the Congress evidently desired to have treated as a special case," and that exemptions granted such companies are not necessarily precedents with respect to investment companies generally.[9] Moreover, the complete and automatic exemption provided under Section 3(c)(13) for any plan established by an employer for the benefit of his employees which qualifies under Section 401 of the Internal Revenue Code, further reflects a Congressional determination that participants in employees' funds created in the context of the labor-management relationship may not require the protections provided by the Act to the same degree as shareholders in investment companies generally.

[9] *G.E. Employees Securities Corporation*, 10 S.E.C. 652, 674 (1941); see also *Executives Investment Trusts-Elfun Trusts*, 14 S.E.C. 826, 829 (1943).

Having in mind the peculiar relationships involved in an employees' securities company, we turn to the question whether the requested exemptions are consistent with the protection of investors, taking into consideration relevant factors under Section 6(b).[10]

We have noted that the Fund is an integral part of the Program, which is a complex employee benefit package. There are no management fees paid to GE in connection with the operation of the Fund. On the other hand, GE contributes a significant portion of the money invested in the Fund, and while such contributions may be regarded as a form of employee compensation, it is reasonable to assume that GE's interests and incentive are to assure that its contributions provide a maximum amount of benefit to its participating employees.[11]

The investment management fee has been negotiated with an independent trust company by the Fund's trustees, who are experienced officials of GE, and appears not to be, and no claim is made that it is, in any way inappropriate. The salaries of the trustees are not charged to the Fund, and no sales or redemption charges are imposed on participating employees.

Other investor safeguards are provided in the Investment Policies described above which cannot be changed by GE [12] or by the trustees and which look toward a policy of reasonable diversification and prohibit any investments in securities of GE or its affiliates or portfolio transactions with those companies.[13] Moreover, the Fund will in any event remain subject also to the conflict of interests restrictions of Section 17 of the Act and to reporting requirements of the Act.

Upon consideration of all these factors, we agree with the Division that GE has acted responsibly to safeguard the inter-

[10] Section 6(b) provides that in granting exemptions thereunder we shall give due weight, among other things, to the form of organization and the capital structure of the fund, the persons owning the fund's securities, the sales load on the sales of the fund's securities, the use of the proceeds of such sales, the character of the securities in which such proceeds are invested, and any relationships between the fund and the issuer of any such security.

[11] Payments into the Fund for January 1968 indicated an annual rate of investment of $38,264,000, of which $22,803,000 would represent employee savings and $15,461,000 GE contributions. Employee participants in the Program may direct that their savings be invested in a manner different from that in which the company's contribution is to be invested, which would appear to explain the fact that the company's contributions in the fund are more than half of those of the employees.

[12] Under the Fund's Rules GE may suspend or terminate the Fund but any such action cannot adversely affect the right of any participant to Fund units credited to his account as of the date of such action.

[13] The Investment Policies also provide that portfolio purchases will be made primarily on the basis of opportunities for long term growth of capital and income and that no purchases will be made for trading purposes; that monies in the Fund will not be used in underwriting securities, for the purchase of real estate or commodities, or for the purpose of exercising control or management; and that there will be no margin transactions, joint trading accounts, or transactions in puts or calls.

ests of employee participants in the Fund and that no apparent conflicts of interest between management and such participants exist which would warrant denial of the exemptions. Under the circumstances, and in view of the Congressional intent evidenced in the Act to favor employees' securities companies, we conclude that it is consistent with the protection of investors to grant the exemptions from Sections 16(a) and 32(a) as requested.[14] In reaching this conclusion we have also taken into account that the Program, including the Fund, is registered under the Securities Act, and that GE will furnish each participant with an annual prospectus under that Act covering the Program and the Fund as well as a statement of the Fund's fixed Investment Policies.[15] The independent public accountant selected for the Fund is a well-known national accounting firm which has served as the independent auditor for the entire Program as well as the Fund, and the Fund's financial statements certified by that independent public accountant will be included in filings made with us as well as in prospectuses and reports distributed to Fund participants.

We also give consideration to the features which the examiner seemed to stress in reaching his conclusion, the provisions concerning the loss of GE's contributions under certain circumstances upon an employee's withdrawal during the holding period and the deductions from pay for certain participating employees. We do not find those features of significance in relation to the question of the selection of trustees and the auditor. These are general provisions of the Program which apply regardless of the investment medium chosen by the respective Program participant. Thus such provisions are applicable even if a Program participant makes no investment in the Fund, and the Fund's trustees have no powers or functions with respect to such matters.

The Program itself is a qualified employee trust under Section 401 of the Internal Revenue Code and is automatically exempt from the Act by virtue of the provisions of Section 3(c)(13) thereof. It appears that the Fund too would be such a qualified employee trust and thus completely exempt from the Act but for the fact that participants in the Fund may, at their option, retain the Fund units distributed to them at the end of the holding period or upon termination of employment, instead

[14] With respect to Section 16(a), the hearing examiner had concluded that three of the five trustees should be elected and that GE could appoint the other two.

[15] The statutory prospectus under the Securities Act states that the Fund units have the right to vote on amendments to the Investment Policies of the Fund.

of being required to redeem such units and receive immediate payment in cash whenever a distribution occurs. This option gives the employee–participant greater flexibility with respect to his investment in the Fund, and the safeguards embodied in the Fund's Investment Policies go beyond the protective features required for qualified employee plans under the Internal Revenue Code.

We have considered the various arguments presented by the unions in opposition to the requested exemptions, including the assertions that it is the policy of the Act that ultimate control of the policy and management of an investment company be in the hands of those whose funds are at risk, and that employees who are investors are no less entitled to the protections of the Act than other mutual fund investors. The two specific provisions in question are important protective features of the Act, but in view of the employee safeguards already provided by the terms of the Fund and GE's interest in its success, and by the reporting and other applicable requirements of the Act and of the Securities Act, they would not appear to provide such additional protections as to be necessary for the protection of the participants in this employees' securities company. Our conclusions in this regard are limited to the situation of an employees' securities company in the circumstances presented here, and would not afford a precedent for similar exemptions in other situations.

In view of the foregoing, we shall issue an order declaring the hearing examiner's decision effective as to the matters on which no exceptions were filed, and granting the requested exemptions from Sections 16(a) and 32(a). However, we shall reserve jurisdiction to reconsider the exemptions thereby granted and to alter or withdraw any such exemption after notice and opportunity for hearing, should it appear in the light of subsequent facts that such exemption is not consistent with the protection of investors.[16]

[16] After the close of the public hearing, the UAW filed a motion that notice of the proceedings be served at least by mail on all GE employees eligibile to participate in the Fund and on all of the approximately 100 GE unions, which the examiner denied. Although the UAW and IUE reiterated in their briefs to us the position taken by UAW before the examiner, they did not seek interlocutory review of the examiners ruling nor have they filed any petition for review taking exception to the examiner's initial decision. In any event, we find no merit in their contentions. As pointed out by the examiner, the notice given in this case complied with Section 40(a) of the Act, which expressly provides that notice to interested persons other than parties to the proceedings may be given by publication in the Federal Register. Moreover, the Securities Act prospectuses distributed to participants and prospective participants in the Program referred to these proceedings, and as previously noted, these proceedings were announced and described in public releases, and four unions, which represented almost 70 percent of all union-represented employees, appeared and requested and were given leave to participate.

By the Commission (Chairman BUDGE, Commissioners OWENS, WHEAT and SMITH), Commissioner NEEDHAM not participating.

In the Matter of

GEORGE J. WUNSCH

File No. 3-2039. Promulgated October 7, 1969

Securities Exchange Act of 1934—Section 15(b)

FINDINGS AND ORDER

In these proceedings pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act"), an offer of settlement was submitted by respondent George J. Wunsch. Under the terms of the offer, respondent waived a hearing and post-hearing procedures and, solely for the purposes of these proceedings and without admitting or denying the allegations in the order for proceedings, he consented to findings of violations of Section 17(a) of the Securities Act of 1933 ("Securities Act"), and Sections 10(b) and 17(a) of the Exchange Act and Rules 10b-5 and 17a-3 thereunder as alleged in the order for proceedings. Respondent further consented to the entry of an order imposing certain sanctions as specified in the offer of settlement. He also agreed that for purposes of his offer of settlement and the findings based on it the record herein shall include the complaint filed in an injunctive action in which an order of permanent injunction by consent was entered against him[1] and certain supportive affidavits in that action.

After due consideration of the offer of settlement, and upon the recommendation of its staff, the Commission determined to accept such offer. Accordingly, on the basis of the order for proceedings, the offer of settlement and the aforesaid injunctive complaint and supporting affidavits, it is found that from approximately March 1964 through May 1967, respondent violated and aided and abetted violations of Section 17(a) of the Securities Act and Sections 10(b) and 17(a) of the Exchange Act and Rules 10b-5 and 17a-3 thereunder, in connection with

[1] *S.E.C.* v. *Dott (Wunsch), et al.*, U.S.D.C., S.D.N.Y., 69 Civ. 551; see S.E.C. Litigation Release No. 4411 (September 5, 1969). The complaint included 18 other defendants, all of whom previously consented to permanent injunctions. See S.E.C. Litigation Releases Nos. 4231 (February 13, 1969) and 4304 (April 25, 1969).

the purchase and sale of millions of dollars of United States Treasury and federal agency securities ("government securities").[2]

During this period respondent was employed as a government securities trader by Blyth & Co., Inc. ("Blyth"), a registered broker-dealer located in New York City, and was in charge of the firm's government securities trading desk.[3] While employed in this capacity respondent, in concert with others, used Blyth's inventory of government securities for his own benefit, by causing purchases and sales of government securities to be made from and to Blyth and other dealers, through secret accounts established with a bank and other brokers and dealers, whereby he obtained secret trading profits for himself while concealing from Blyth the nature of such transactions and his beneficial interests in them. As a result, Blyth incurred unnecessary costs and was deprived of trading profits.

Typically, respondent and the other persons acting in association with him would cause government securities held in the inventories of their employer firms to be sold to the secret accounts at or near the lowest prices at which sales of the same securities were executed by their firms on that day, and then caused their firms to buy back the same securities from the secret accounts at or near the highest prices at which purchases of those securities were executed that day. By so controlling the prices at which these securities were channeled through the secret accounts, respondent and his associates realized and guaranteed substantial trading profits for their personal accounts. They did so without incurring any personal risk or being required to advance personal funds through a practice known as "free-riding" under which they arranged to have a repurchase transaction consummated prior to the settlement date of a sale transaction. Respondent concealed these activities from Blyth by, among other things, violating the firm's rule requiring disclosure of all outside personal accounts, having confirmations sent to his home address, and causing certain records of Blyth to be falsified so as not to show the true nature of the transactions. Some of the above activities are summarized below.

[2] The findings herein are solely for the purpose of disposing of these proceedings as against respondent Wunsch and are not binding against any of the other respondents named in these proceedings. Consequently the propriety of the activities or transactions of any of the other respondents as to whom these proceedings are continuing is not involved here.

[3] From about January 1967 through about April 1968, respondent was also a vice-president and a stockholder of Blyth.

Trading primarily through an account established in his wife's name with a government securities broker, respondent caused government securities from Blyth's inventory to be sold to accounts at that broker and repurchased at higher prices by his associates' employers. In the same manner, his associates caused their employers to sell government securities from their inventories to the accounts with that broker, and respondent then caused Blyth to purchase such securities at higher prices. In this way respondent himself realized "trading" profits of over $22,000 in these accounts between March 1964 and November 1966.

Respondent and another Blyth employee entered into an arrangement with a government securities dealer, whereby transactions in government securities were executed back and forth between Blyth and that dealer in such a manner as to create substantial trading profits for the dealer. During 1966, respondent and his associate received about $9,350 each from that dealer, ostensibly as remuneration for trading advice regarding government securities allegedly rendered by respondent and his associate to the dealer, but actually representing the trading profits generated in those transactions.

Respondent during the period from August 1966 through May 1967 realized personal profits of over $39,000 in transactions effected through another government securities dealer firm which discontinued business in June 1967. Typically, respondent would cause Blyth to sell government securities from its inventory to that firm, and, prior to the settlement date, the latter would resell the securities to respondent's personal account with it. Respondent would then sell them back to the firm at a profit, and the firm would then resell them either back to Blyth or to another dealer.

Respondent also joined with others in maintaining secret clearance accounts in the securities clearance department of a bank, through which, with the assistance of an employee of that bank, they channeled transactions in which they realized secret trading profits on the purchase and sale of government securities. Between July 1965 and February 1967 respondent personally realized over $10,000 as his share of the secret profits in the transactions channeled through the bank. In the same manner as was used in the transactions through a secret account with the government securities broker, respondent in a typical transaction would cause Blyth to sell a government security to the clearance account at the bank. At the same time, another member of the group would arrange to have that security purchased at a higher price by his employer dealer or bank. In other instances, the other members of the group would cause their employers to sell to the secret account at the bank and respondent would cause Blyth to purchase the same security from the secret account at a higher price. After deduction of clearance charges, the profits on the transactions would be credited to checking accounts maintained at the bank and thereafter divided among the participants.

To facilitate and conceal these transactions, respondent caused the preparation of false Blyth order tickets, confirmations and blotters which reflected the trades as normal trades with the bank in the ordinary course of business, and which did not disclose the beneficial interests of respondent and his associates. The Blyth confirmations which falsely reflected the bank as the purchaser or seller of the securities,[4] were directed by respondent to the attention of the assisting employee in the bank's clearance department, rather than to the other departments at the bank that normally executed its trades and received confirmations, which would have revealed the fraud.

Although government securities are exempt from certain provisions of the Securities Acts, transactions in such securities are nevertheless subject to the antifraud provisions of such laws,[5] and members of national securities exchanges and registered broker-dealers are also subject to the record-keeping requirements of the Exchange Act with respect thereto. Respondent's activities described above constituted violations of the antifraud provisions even though his employer and other securities dealers were directly affected rather than public customers.[6] Respondent breached his fiduciary responsibilities in utilizing his employer's inventories of government securities to generate trading profits for himself at the expense of his employer and in failing to disclose his personal beneficial interests in the transactions.[7]

The offer of settlement provides that respondent may be

[4] The bank's securities clearance department handled the physical transfer of securities for brokers, dealers and other established customers. It was not a function of the clearing department to execute purchase and sale transactions in securities on behalf of the bank's own investment portfolio or on behalf of customers; such functions were performed in other separate department at the bank.

[5] *Blyth & Company, Inc.*, 43 S.E.C. 1037 (1969).

[6] *Carroll* v. *First National Bank of Lincolnwood*, 413 F.2d 353 (C.A. 7, June 27, 1969), see also *A. T. Broad & Co.* v. *Perlow*, 375 F.2d 393 (C.A. 2, 1967).

[7] In effect, the personal accounts in which respondent had an interest were "interpositioned" between Blyth and the best available market. Except for the fact that public customers were not directly involved on either side of the transactions, the trading schemes in this case resemble the "interpositioning" schemes recently found to constitute violations of antifraud provisions. See, *e.g.*, *Thomson & McKinnon*, 43 S.E.C. 785 (1968); *Delaware Management Company, Inc.*, 43 S.E.C. 392 (1967); *Folger, Nolan, Fleming & Co., Inc.*, Securities Exchange Act Release No. 8489 (January 8, 1969).

barred from association with a broker-dealer or investment adviser, and that such bar will not preclude him from applying for reentry into the securities business at a future time, which is legally permissible after a bar order, upon an adequate showing that he will be subject to proper supervision. Under the circumstances, it is appropriate in the public interest to dispose of these proceedings as to respondent in accordance with the offer of settlement and to impose the sanction permitted by such offer.

Accordingly, IT IS ORDERED that George J. Wunsch be, and he hereby is, barred from association with a broker-dealer or investment adviser.[8]

For the Commission (pursuant to delegated authority).

[8] Wunsch has been similary barred pursuant to an offer of settlement disposing of a separate, unrelated proceeding which had been instituted against him, among others. See, Securities Exchange Act Release No. 8704 (October 7, 1969).

In the Matter of

COMMONWEALTH SECURITIES CORPORATION

HERBERT BECK

File No. 8-6739. Promulgated October 16, 1969

Securities Exchange Act of 1934—Section 15(b) and 15(a)

OPINION PURSUANT TO REMAND

These proceedings have been remanded to us, by the Court of Appeals for the Sixth Circuit, for articulation of our reason for imposing upon respondent Herbert Beck the sanction specified in our Order of July 23, 1968 in this case.

In our Findings and Opinion accompanying that Order, we had found that Beck, who was a salesman of Commonwealth Securities Corporation, a registered broker-dealer, had committed willful violations of antifraud provisions of the securities laws in that in the offer and sale of securities he made false and misleading representations to customers concerning the safety of investment in the securities, the future market price and listing of such securities, dividends to be paid, and opportunities for resale without loss. We concluded, as had the hearing examiner, that by virtue of such violations, Beck was a cause of our order revoking the broker-dealer registration of Commonwealth. Under the Securities Exchange Act, such cause finding and the findings of willful violations have the effect of barring Beck from employment in the securities business, except with our permission. However, we adopted the examiner's recommendation that our order should not operate to prevent Beck's supervised employment after four months. In fixing this sanction as appropriate in the public interest we and the examiner took into account various factors urged by Beck including the fact that Commonwealth was Beck's first employer in the securities industry and did not train him properly, that thereafter Beck received appropriate training from a securities firm which has employed him since August 1962 and there have been no complaints concerning his conduct in that employment, and that Beck cooperated in the criminal prosecution of certain persons. We also noted that Beck stated that a sanction would be particularly onerous because he is over 62 years of age and has already suffered materially as a result of these proceedings, and that our staff had recommended that we adopt the hearing examiner's conclusion. We accepted that recommendation although we stated that in most cases we would view misconduct such as we found Beck engaged in as requiring in the public interest a longer exclusion from the securities business than four months.[1]

The Court of Appeals, while dismissing challenges made by Beck to the sufficiency of the evidence supporting our finding of willful violations and to the fairness of the hearing accorded him, was of the view that our opinion failed to disclose why the public interest necessitates barring him for four months. The Court referred to Beck's employment as a trained and supervised securities salesman for six years since the violations, and stated that Beck had received the opportunity to obtain adequate training and to restore his reputation because of a three-year delay in these proceedings occasioned by the pendency of criminal action against other respondents. The Court further stated that we had made no finding concerning the need for deterrence against further violations and that it could only speculate as to whether we considered that the four-month bar is required as an effective deterrent.

The sanctions authorized by Section 15 of the Exchange Act are part of a comprehensive regulatory scheme to protect the public interest in maintaining the integrity of the securities markets.[2] Their imposition serves to deter both the particular respondents as well as others in the securities industry from committing violations of the securities laws. We have been cognizant of the importance of exercising the discretionary power reposed in us in this area[3] in a manner that will afford investor protection without visiting upon the wrongdoers ad-

[1] Various other persons who had been associated with Commonwealth and had sold the same securities had been barred by us with their consent for a period of six months and certain of the firm's officers and principals had consented to an indefinite bar.

[2] The federal securities laws resulted from Congressional awareness that securities are "intricate merchadise." (H.R. Rep. No. 85, 73rd Cong., 1st Sess. (1933) p. 8). In their enforcement, recognition has been given to the fact that the securities business presents constantly recurrent opportunities for dishonesty and by its nature requires specialized legal treatment in order to provide adequate investor protection. *Archer* v. *S.E.C.*, 133 F.2d 795, 803 (C.A. 8, 1943), *cert. denied*, 319 U.S. 767; *Arleen Hughes* v. *S.E.C.*, 174 F.2d 969, 975 (C.A. D.C., 1949).

[3] See *Hanly* v. *S.E.C.*, 415 F.2d 589 (C.A. 2, 1969); *Tager* v. *S.E.C.*, 344 F.2d 5, 8–9 (C.A. 2, 1965); *Associated Securities Corp.* v. *S.E.C.*, 283 F.2d 773, 775 (C.A. 10, 1960); 293 F.2d 738, 741 (C.A. 10, 1961); *Blaise E'Antoni & Associates, Inc.* v. *S.E.C.*, 289 F.2d 276, 277 (C.A. 5, 1961), *rehearing denied*, 209 F.2d 688, *cert. denied*, 378 U.S. 899; *Pierce* v. *S.E.C.*, 239 F.2d 160, 163 (C.A. 9, 1956).

verse consequences not required in achieving the statutory objectives. In our Findings, Opinion and Order with respect to Beck concluding that the four-month bar was an appropriate sanction for his fraudulent conduct, we attempted to reflect these underlying considerations and objectives. We assessed the seriousness of his misconduct together with the mitigative factors asserted by him in light of the requirements of the public interest and the interest of investors.

Beck's position is that his continued employment in the securities business poses no hazard because he has been retrained and is supervised by his present employer which is an active and substantial firm. In our opinion, the public interest in enforcing industry standards of honest dealing and regulatory compliance is not adequately protected by accepting as a complete answer an assertion by one found to have defrauded investors that during the interval in which proof of his fraud was being established he has become rehabilitated in a new employment and that the likelihood of further misconduct on his part has been reduced. Indeed, any interim deterrent to misconduct occasioned by the pendency of the proceedings itself would no longer be present following their termination.[4] Though the training and supervision pointed to are favorable factors, as we recognized in imposing a sanction less than we considered would otherwise be appropriate,[5] they do not assure that Beck will observe the required standard of conduct in the future and are not determinative of the public interest.

A finding that a particular person will or will not pose a hazard to the investing public cannot be made with certainty; and we believe that we may reasonably determine, in situations such as the present one where serious fraud violations have been found to have occurred, that the probability of similar future occurrences is such that a temporary exclusion from the securities business is required in the public interest.[6] We imposed the sanction on Beck with a view to adequately impressing upon him, through the impact of the sanction, the

[4] It should be noted that although we referred in our earlier opinion to the factor, urged by Beck, that there had been no complaints concerning his conduct in his present employment, that factor provided no basis for an affirmative finding that his conduct was in all respects in conformity with required standards throughout the period of such employment or that he had been fully retrained and reformed, and we did not make such finding.

[5] We took into consideration the fact the the proceedings establishing Beck's violations were deferred for several years because of factors not attributable to him.

[6] Although counsel for Beck asserted in his brief in the Court of Appeals that a four-month exclusion would operate to remove Beck from the securities industry permanently, we find no basis for such assertion. *Cf. Melvin Hiller*, 43 S.E.C. 969, 971 (1968); *Armstrong, Jones and Company*, 43 S.E.C. 993, 996 (1968).

necessity of avoiding a repetition of his specific misconduct and the need for scrupulous propriety in all aspects of his securities activities in the future, as well as with a view to discouraging such misconduct by others in the securities industry. In our opinion under all the circumstances the sanction imposed was necessary and appropriate for the remedial purposes contemplated under the federal securities laws.

Accordingly, IT IS ORDERED that the Order heretofore entered finding that Herbert Beck is a cause of the revocation of the registration as a broker and dealer of Commonwealth Securities Corporation except that such finding shall not operate to prevent his employment in the securities business in a non-supervisory capacity after four months if he makes an appropriate showing that he will be adequately supervised, be, and it hereby is, reaffirmed.

By the Commission (Chairman BUDGE, Commissioners OWENS and SMITH), Commissioner NEEDHAM not participating.

In the Matter of

ABBETT, SOMMER & CO., INC.

CHARLES W. SOMMER III

ABBETT, SOMMER & COMPANY MORTGAGE CORPORATION

File Nos. 8–1510. Promulgated November 10, 1969

Securities Exchange Act of 1934—Sections 15(b) and 15A

BROKER-DEALER PROCEEDINGS

Fraudulent Representations in Offer and Sale of Securities

Offer and Sale of Unregistered Securities

Noncompliance with Records Requirements

Where registered broker-dealer, its controlling person, and another company controlled by him made false and misleading representations in offer and sale of mortgage notes, which also involved unregistered investment contracts, concerning safety of investment and value of property in relation to amount of mortgage, in willful violation of antifraud and registration provisions of Securities Act of 1933 and Securities Exchange Act of 1934 and rules thereunder, and where broker-dealer and controlling person failed to maintain certain books and records, in willful violation of latter Act and applicable rule, *held*, in public interest to revoke broker-dealer's registration, expel it from membership in registered securities association, bar controlling person from association with broker-dealer, and find affiliated company to be a cause of such revocation.

Offering of Mortgage Notes Involving Investment Contracts

Where, in purported reliance on Rule 234 under Securities Act which exempts from registration notes secured by first lien on real estate if offered in accordance with specified terms and conditions but provides that exemption is unavailable for any investment contracts involved in offering of notes, broker-dealer offered and sold mortgage notes obtained from note-discounter pursuant to arrangements under which discounter and broker-dealer provided various services, including investigation of property and mortgagor, collection of monthly payments for investors, and undertaking to repurchase notes, *held*, investment contracts were involved in offering of notes and no exemption was available.

APPEARANCES:

Joan H. Saxer and *Thomas W. McIlheran*, of the Fort Worth Regional Office of the Commission, for the Division of Trading and Markets.

Carl L. Shipley, of Shipley, Akerman & Pickett, for respondents.

FINDINGS AND OPINION OF THE COMMISSION

Following hearings in these proceedings pursuant to Sections 15(b) and 15A of the Securities Exchange Act of 1934 ("Exchange Act"), the hearing examiner filed an initial decision in which he concluded, among other things, that the registration as a broker and dealer of Abbett, Sommer & Co., Inc. ("registrant") should be revoked and registrant expelled from membership in the National Association of Securities Dealers, Inc.; that Charles W. Sommer III, registrant's president and sole stockholder, should be barred from association with a broker or dealer; and that Abbett, Sommer & Company Mortgage Corporation ("Mortgage Corp."), which is controlled by Sommer, should be found a cause of the revocation of registrant's registration. We granted a petition for review filed by the respondents, and briefs were filed by them and by our Division of Trading and Markets. On the basis of an independent review of the record and for the reasons set forth herein and in the initial decision, we make the following findings.

VIOLATIONS IN OFFER AND SALE OF MORTGAGE NOTES

We find, as did the examiner, that between December 1960 and April 1965 respondents, in connection with the offer and sale of certain mortgage notes, willfully violated, or willfully aided and abetted violations of, the antifraud provisions of Section 17(a) of the Securities Act of 1933 and Sections 10(b) and 15(c)(1) of the Exchange Act and Rules 10b-5 and 15c1-2 thereunder and the registration provisions of Sections 5(a) and 5(c) of the Securities Act. The notes in question, generally executed by home owners for home improvements and secured by first mortgages on the properties, were purchased by respondents from Century Trust Company ("Century") or sold as agent for Century. That company was engaged in the business of buying such notes at a discount from building contractors and others and reselling them "with recourse" against it in the event of default by the note maker.[1] Respondents sold over 600 of these notes to about 150 customers for more than $1.3 million.[2] The sales were effected by registrant prior to July 1963, and thereafter by Mortgage Corp., which was organized for that purpose by Sommer and, as found by the examiner, "lacked a palpable identity distinct from" registrant since it had the same officers and employees and used registrant's stationery.

We agree with the examiner that materially false and misleading representations were made to customers by respondents, in letters or orally, in the offer and sale of the mortgage notes. These representations were to the effect that the notes were guaranteed in such a manner that "you can only gain" by investing in them, that the only risk was from inflation, that the notes were as safe as deposits in savings accounts, or that the notes were "as good as gold". The safety of such investment, however, was largely dependent on the financial ability of Century to repurchase notes in the event of default,[3] which in turn was dependent on various factors including the profitability of its operations and the volume of notes presented for repurchase. While a note purchaser also had the security of the mortgaged property, foreclosure in the event of default in payments would likely be costly and time-consuming. Moreover, it was improper to compare the safety of the notes with savings account deposits, which are normally insured by a government agency. In addition, as found by the examiner, sales literature used by respondents falsely represented that the mortgage never exceeded 75 percent of the value of the property or that the value of the property normally was from 2 to 6 times the amount of the mortgage, when in fact the amount of the mortgage at times exceeded the entire value of the property.

Respondents argue that our Regional Office, although in frequent communication with them concerning sales literature and despite respondents' request for advice, never advised them that the literature violated the antifraud provisions. Apart from the question whether our staff was required to

[1] If a payment on a note was overdue by more than 90 days, Century agreed to repurchase the note from the investor at a price representing the total remaining principal balance of the investor's purchase cost.

[2] In addition to the notes sold to respondents, a large number of notes were sold by Century to another fianance company, to savings and loan associations, and to its stockholders.

[3] In April 1965, Century stopped honoring its recourse obligations because of financial difficulties which eventually culminated in bankruptcy proceedings.

furnish such advice,[4] however, there is no indication in the record that prior to commencement of its investigation following the period under consideration, our staff saw respondents' correspondence, or was aware of the oral representations referred to above or that the underlying property values were not as represented. It is no defense that some of the more sophisticated investors may have, as asserted, realized that an investment in mortgage notes was attended by inherent risks.[5] And there is no basis for the intimation by respondents that investor witnesses were improperly coached by our staff, or for respondents' argument that the examiner should not have credited the testimony of "disappointed investors." [6]

The record also supports the finding of the examiner that the offer and sale of the notes, as to which no registration statement under the Securities Act had been filed or was in effect, were not exempt from the registration requirements of that Act pursuant to Rule 234 thereunder. That Rule exempts from registration promissory notes directly secured by a first lien on real estate if offered in accordance with specified terms and conditions, but provides that no exemption is available for any "investment contract . . . the offering of which is involved" in the offering of the notes.[7] Contrary to respondents' contention, an investment contract was involved in the offering of the mortgage notes.

The term "investment contract" is not defined in the Securities Act. However, the Courts and this Commission have concluded that various contracts which in form involved noth-

[4] *Cf. Capitol Leasing Corporation*, 42 S.E.C. 232 (1964).

[5] The record does not bear respondents' assertion that the investor witnessess were all experienced business persons or sophisticated investors. We note that a number of them had been solicited to purchase the mortgage notes after responding to registrant's newspaper advertisements offering higher interest rates for savings and loan deposits. In any event, the sophistication of customers is irrelevant, and it is not necessary to show reliance on a broker-dealer's representations or that customers were in fact misled in order to establish violations of the antifraud provisions. See *Hamilton Waters & Co., Inc.* 42 S.E.C. 784, 790 (1965), and cases there cited; *Richard N. Cea*, 44 S.E.C. 8 (1969); *Richard J. Buck & Co.*, 43 S.E.C. 998, 1009 (1968), *aff'd sub nom. Hanly* v. *S.E.C.*, 415 F.2d 589 (C.A. 2, 1969).

[6] See *Batkin & Co.*, 38 S.E.C. 436, 422, n. 11 (1958); *Richard N. Cea, supra*, at p.—; *Richard J. Buck & Co., supra*, at p. 1007.

[7] Investment contracts as well as notes are included within the definition of "security" in Section 2(1) of the Securities Act. While Rule 234 did not become effective until January 1961, shortly after registrant and Sommer began the sale of the mortgage notes, in pertinent respects the exemptive provisions which it superseded (Regulation A—R) contained essentially the same terms and conditions. And while that Regulation did not in terms specify that the exemption was not available for investment contracts involved in the offering of first lien notes, this had been our long-standing position. See Securities Act Release No. 3892 (January 31, 1958).

Among the conditions specified in Rule 234 is that the amount of the indebtedness secured shall not exceed 75 percent of the appraised value of the mortage property. As we have seen, the indebteness at times exceeded the entire value of the property. In addition, a number of the notes sold by respondents were secured by a second, rather than a first, lien on the property. However, the instant review of the initial decision does not include issues as to compliance with the terms and conditions of the Rule and we make no adverse findings in these respects.

ing more than the sale of interests in real estate or chattels were in fact investment contracts and therefore securities because accompanied by an offer of or representation concerning services upon which the investor relied to obtain a profit on his purchase.[8]

In a public release issued in 1958,[9] we stated that arrangements providing for various services to investors in connection with offerings of mortgages frequently constitute investment contracts. We enumerated some of the more common services and other arrangements which had come to our attention, each of which in our opinion would have a bearing on whether an investment contract was involved. Such arrangements include a complete investigation and placing service, the servicing of collection, payments and foreclosure, a guarantee against loss or provision of a market for the underlying security, advances of funds to protect the security of the investment, circumstances necessitating complete reliance on the seller such as the existence of great distances between the mortgaged property and the investor, and the selection by the seller of mortgages for investors. The release pointed out that "the wider the range of services offered and the more the investor must rely on the promoter or third party, the clearer it becomes that there is an investment contract." On the other hand, as noted in the release, where such services are offered, the fact that "the purchaser looks solely to his own mortgage or deed of trust for income or profits will [not] obviate the requirements for registration."

The record shows that Century investigated each note and mortgage to determine, among other things, the value of the underlying property, the existence of prior liens, and the credit standing of the mortgagor. While prospective investors, a large proportion of whom was solicited by respondents in the Fort Worth area of Texas, were free to inspect properties prior to purchase, this was seldom done, partly because many of the properties were located at a considerable distance from that

[8] See, *e.g.*, *S.E.C.* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943) (assignments of oil leases on small tracts, coupled with seller's undertaking to drill test well); *S.E.C.* v. *W. J. Howey Company*, 328 U.S. 293 (1946) (sale of small tracts of land in citrus grove, coupled with contract for cultivating, marketing and remitting proceeds to investors); *Blackwell* v. *Bentsen*, 203 F.2d 690 (C.A. 5, 1953) (sale of tracts which were part of larger tract to be developed as citrus grove, coupled with management contract); *Continental Marketing Corporation* v. *S.E.C.*, 387 F.2d 466 (C.A. 10, 1967) (sale of beavers which purchasers were encouraged to leave with a rancher for breeding); *National Resource Corp.*, 8 S.E.C. 635 (1941) (assignments of oil and gas leases on small tracts, coupled with representation regarding drilling operations).

[9] "Public Offerings of Investment Contracts Providing for the Acquisition, Sale or Servicing of Mortgages or Deeds of Trust," Securities Act Release No. 3892 (January 31, 1958).

area within Texas, and others were in Louisiana and at least one in Arkansas.[10] In some instances, respondents, after ascertaining the amount which a customer wanted to invest, selected for him a note or notes approximating that amount. Century collected the monthly payments from the mortgagors and remitted them to the note purchasers. Although, as previously noted, it undertook to repurchase notes when any payment was more than 90 days delinquent, in a number of instances, where note makers were delinquent in their payments, Century made such payments with its own funds. In addition, respondents represented to some purchasers that they would be willing to repurchase the notes at any time. In their sales literature respondents stressed the "guarantee" of the notes by Century, the strong financial position of that company, the services provided by Century for the noteholders, and Century's record of prompt repurchase of defaulted mortgages.

We do not consider it significant that in the "investment contract" cases previously cited the services were designed to create a profit, whereas in the present case the services were directed essentially toward minimizing the risk involved in the investment. In both types of situations, the investor relies upon the services and undertakings of others to secure the return of a profit to him. We are satisfied that, under the principles enunciated in the cases and stated in our release, the arrangements and representations pursuant to which the mortgage notes were offered gave rise to the creation of investment contracts wihin the meaning of Section 2(1) of the Securities Act.[11]

Respondents claim that we are estopped from finding that an exemption was unavailable because in October 1964, about 6 months before the close of the relevant period, our staff advised Century and Sommer that although the question whether Century's agreement to service the mortgage notes constituted an investment contract was not free from doubt, it appeared that the Rule 234 exemption would be available provided the notes were offered subject to the terms and conditions specified in the Rule.

Aside from the fact that the doctrine of estoppel cannot be

[10] For example, a widow residing in Fort Worth and later Houston invested about $90,000 in 36 mortgage notes which were secured by properties in Louisiana and in widely scattered parts of Texas.

[11] *Cf. Los Angeles Trust Deed and Mortgage Exchange* v. *S.E.C.*, 285 F.2d 162 (C.A. 9, 1960), *cert. denied* 366 U.S. 919.

invoked against the Commission,[12] the record shows that the representations of Century's counsel, made in a July 1964 letter which Sommer saw and on which our staff's interpretation was essentially based, were as Sommer knew or should have known not in conformance with the facts or misleading in material respects. Inconsistent with the representation that the notes were secured by properties in Texas, some of the properties, as noted above, were located in Louisiana and Arkansas. While the record does not indicate that these out-of-state properties were farther removed from investors who purchased the notes relating to them than properties which might have been in remote parts of Texas, the difference in applicable laws would tend to increase the reliance of investors on Century.[13] In addition, a representation that selection of the notes was made by the purchasers was misleading because, as noted above, at least in some instances respondents selected a note or notes for customers after ascertaining the amount they wanted to invest. Moreover, while Century's counsel represented to our staff that the only guarantee offered by Century was the "with recourse" endorsement, which became applicable in the event of a 90-day delinquency in payment by the note maker, as previously mentioned. Century occasionally made the payments itself and respondents represented to some purchasers that they would repurchase the notes at any time. Under the circumstances, respondents cannot shield themselves behind the staff interpretation, particularly in view of the indication by our staff that the question whether investment contracts were involved was not free from doubt. Respondents should have been aware that any deviation from the facts described to our staff that would cause investors to place more reliance on respondents or Century would be likely to bring the offering into the investment contract area.

Respondents further contend that any violations of the registration provisions were not willful. They assert that they relied in good faith on the advice of Century's counsel that an exemption was available for the offering of the notes, as well as on the interpretation by our staff in October 1964. They state that they had no power to bring about registration of the securities and claim that "at worst" they were engaged in good

[12] See *John W. Yeaman, Inc.*, 42 S.E.C. 500 (1965) and the court decisions cited at p. 508 n. 16.

[13] Century's president stated the Louisiana law relating to liens is quite different from Texas law and that foreclosure is more difficult and expensive in Louisiana.

faith in broker-dealer transactions which are exempt from registration under Section 4 of the Securities Act.

With respect to the claimed reliance on Century's counsel, respondents apparently have reference to counsel's July 1964 letter to our staff as well as to a September 1960 letter by him to Century's president. It is well established that reliance on the advice of counsel does not negate willfulness.[14] Moreover, as we have previously indicated, Sommer was or should have been aware that the representations in the 1964 letter were inaccurate or inadequate. And the 1960 letter merely stated that since the terms and conditions of our regulation were "apparently" being met, there was no need to register the notes. The letter did not discuss the services provided by Century with respect to the notes, much less those subsequently provided by respondents. Respondents therefore cannot claim to have relied in "good faith" on counsel's advice.[15] Nor, in light of our discussion of the staff interpretation, is there any substance to respondents' claim of good faith reliance on it.

Respondents' remaining contentions are similarly without merit. Their asserted inability to bring about registration of the investment contracts by Century cannot excuse the sale of securities in violation of the registration provisions. Registrant and Mortgage Corp. were underwriters within the meaning of Section 2(11) of the Securities Act,[16] or co-issuers with Century, and as such their sales were not exempt from registration. It is clear that respondents' violations of Section 5 were willful since they knew that no registration had been effected and they knew or should have known that no exemption was available.[17]

VIOLATIONS IN OFFER AND SALE OF MORTGAGE NOTES

We also sustain the examiner's findings that registrant, willfully aided and abetted by Sommer, willfully violated Section 17(a) of the Exchange Act and Rule 17a–3 thereunder. Inspections by our staff at various times between April 1960 and November 1966 disclosed, among other things, that certain records were not posted on a current basis, customers' accounts did not reflect the date of delivery or receipt of securi-

[14] Gearhart & Otis, Inc., 42 S.E.C. 1, 28 (1964), *aff'd* 348 F.2d 798 (C.A.D.C., 1965).

[15] *Id.*, at p. 7, n. 13.

[16] That Section defines "underwriter" to include person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security.

[17] *Cf. Strathmore Securities, Inc.*, 43 S.E.C. 575, 578, 582, 584 (1967), *aff'd* 407 F.2d 722 (C.A.D.C., 1969); *Armstrong, Jones and Company*, 43 S.E.C. 888, 894 (1968), appeal pending.

ties, receipts and deliveries of securities in and out of accounts with other brokers and dealers had not been recorded, securities position records were inaccurate, and memoranda of brokerage orders, instead of showing both time of entry and, to the extent feasible, time of execution, showed only one time of day without characterizing it.

Respondents concede that they made errors in record-keeping and do not challenge any of the examiner's specific findings of deficiencies. They assert that they sought the advice of certified public accountants and legal counsel and that, despite their repeated requests for guidance, our staff merely made vague and indefinite criticisms. However, as previously indicated, reliance on advice of counsel or other experts does not preclude a finding of willfulness. And, contrary to respondents' assertion, registrant was repeatedly advised of specific record-keeping deficiencies uncovered during inspections by our staff as well as admonished to comply with applicable requirements. In any event, registrant and Sommer cannot shift their responsibility in this respect to our staff. Certainly, they were aware that records must be accurate and current.

OTHER MATTERS

Respondents contend that they were not given an opportunity to achieve compliance prior to the institution of proceedings, as required by Section 9(b) of the Administrative Procedure Act ("APA") (5 U.S.C. § 558(c)). They further argue that the failure to make Century a party to these proceedings deprived them of a meaningful opportunity to defend themselves; that Section 7(c) of the APA (5 U.S.C. § 556(d), requiring that administrative agency action be supported by "reliable, probative and substantial evidence," calls for considerably more than a preponderance of the evidence; and that respondents were denied their constitutional rights against self-incrimination by not being advised, during our staff's investigation, that they could claim a right not to testify or produce records and that the evidence obtained therefore cannot be used against them.

None of these arguments has any merit. These proceedings are within the exceptions expressly provided in Section 9(b) of the APA for cases of willfulness or those in which the public interest requires otherwise.[18] Respondents have not indicated in what respects the failure to make Century a party ham-

[18] See *Lile & Co., Inc.*, 42 S.E.C. 664, 666 (1965), and cases there cited; *Dlugash* v. *S.E.C.*, 373 F.2d 107, 110 (C.A. 2, 1967).

pered their defense. Moreover, in proceedings under the Exchange Act such as these, which are remedial rather than penal in nature,[19] allegations of willful violations need be proven only by a preponderance of the evidence.[20] Finally, the record shows, contrary to respondents' assertion, that when Sommer was called to testify during our staff's investigation, he was advised of his privilege against self-incrimination. And such privilege does not permit the withholding of corporate records[21] or of "records required by law to be kept in order that there may be suitable information of transactions which are the appropriate subjects of governmental regulation and the enforcement of restrictions validly established.' "[22]

PUBLIC INTEREST

In concluding that the public interest required the imposition of the designated sanctions upon the respective respondents, the examiner referred to the gravity and extended duration of their violations. He also stated that there were no mitigating factors and found that, on the contrary, Sommer was an evasive and argumentative witness, was slow and reluctant in producing records pursuant to subpoena and deliberately disposed of records of Mortgage Corp., after Century's financial difficulties became known, in order to prevent the use of such records against him. Respondents urge that the proposed sanctions are excessive, and that it would be unfair to "punish" them for the bankruptcy of Century and the resulting losses to investors. However, the sanctions are not based on the factors cited by respondents; indeed, in our opinion, the fraud violations alone would be sufficient to support them. The record reflects gross indifference by Sommer and his companies to basic requirements of the securities acts and the standards applicable to those engaged in the securities business, which, taken together with the other factors noted by the examiner, make it in our view inconsistent

[19] *Wright* v. *S.E.C.*, 112 F.2d 89, 94 (C.A. 2, 1940); *Pierce* v. *S.E.C.*, 239 F.2d 160, 163 (C.A. 9, 1956); *Associated Securities Corp.* v. *S.E.C.*, 283 F.2d 773, 775 (C.A. 10, 1960); *Blaise D'Antoni & Associates* v. *S.E.C.*, 289 F.2d 276, 277 (C.A. 5, 1961), *reh'g denied*, 290 F.2d 688.

[20] See *Norman Pollisky*, 43 S.E.C. 852, 860 (1968); *James De Mammos*, 43 S.E.C. 333, 337 (1967), *aff'd* without opinion (C.A. 2, October 13, 1967).

[21] *George Campbell Painting Corp.* v. *Reid*, 392 U.S. 286, 288—89 (1968).

[22] *United States* v. *Shapiro*, 43 S.E.C. 25, 34 (1966). 335 U.S. 1, 33 (1948). See also *Hayden Lynch & Co., Inc.*, 43 S.E.C. 25, 36 (1966).

with the public interest to permit their continuance in the securities business.[23]

Accordingly, IT IS ORDERED that the registration as a broker and dealer of Abbett, Sommer & Co., Inc., be, and it hereby is, revoked and that registrant be, and it hereby is, expelled from membership in the National Association of Securities Dealers, Inc.; that Charles W. Sommer III be, and he hereby is, barred from association with a broker of dealer; and that Abbett, Sommer & Company Mortgage Corporation be, and it hereby is, found a cause of the revocation of the registration of Abbett, Sommer & Co., Inc.

By the Commission (Chairman BUDGE and Commissioners OWENS, SMITH and NEEDHAM), Commissioner HERLONG not participating.

[23] Respecting respondent's argument that such sanctions would amount to cruel and unusual punishment in violation of the Eighth Amendment, particularly since Sommer would be "barred for life from a gainful occupation," it suffices to point out as noted above that broker-dealer proceedings under the Exchange Act, which specifically authorizes the impositon of such sanctions, are remedial rather than penal in nature, and that under the Exchange Act and applicable rules Sommer is not precluded from applying for permission at some future time to reenter the securities business upon an appropriate showing.

Respondents' exceptions to the initial decision of the hearing examiner are overruled or sustained to the extent that they are inconsistent or in accord with our decision.

IN THE MATTER OF

NATIONAL FUEL GAS COMPANY

File No. 3-1959. Promulgated November 20, 1969

Public Utility Holding Company Act of 1935—Sections 6(a), 7, 9(a), 10, and 12

ISSUANCE, SALE, AND ACQUISITION OF SECURITIES

Application-declaration by registered holding company having gas utility subsidiaries with respect to proposed issue of its own common stock in exchange for outstanding stock of nonassociate gas utility company *granted and permitted to become effective*, where proposal satisfied provisions of Sections 7 and 10 of Public Utility Holding Company Act.

APPEARANCES:

Arthur C. Dwyer, of Stryker, Tams & Dill, for National Fuel Gas Company

Robert F. McCulloch, for the Division of Corporate Regulation of the Commission.

FINDINGS AND OPINION OF THE COMMISSION

INTRODUCTION

National Fuel Gas Company ("National"), a registered holding company, has filed an application-declaration with this Commission pursuant to Sections 6(a), 7, 9(a), 10, and 12(e) of the Public Utility Holding Company Act of 1935 ("Act") and Rules 50(a)(5) and 62 promulgated thereunder regarding a proposal by National to exchange shares of its common stock for the outstanding common stock of Producers Gas Company ("Producers"), a nonassociate gas utility company.

After appropriate notice,[1] a public hearing was held at which evidence was adduced in support of the proposed transactions. No one appeared in opposition to National's proposal, and post-hearing procedures have been waived. On the basis of the record, we make the following findings:

[1] *National Fuel Gas Company*, Holding Company Act Release No. 16382 (May 21, 1969).

DESCRIPTION OF THE COMPANIES INVOLVED

National, a New Jersey corporation, owns all of the capital stock of three gas utility companies serving an area located principally in the western portion of the State of New York and in the adjacent northwestern portion of Pennsylvania. A small part of the service area is located in adjoining Ohio. In addition, National owns all of the outstanding securities of a natural gas production company which sells natural gas to one of National's gas utility subsidiary companies, and a small gasoline extraction company. At December 31, 1968, National and its subsidiary companies had consolidated gross property, plant, and equipment, stated at original cost, of $357,661,000, and related reserves for depreciation of $92,089,000, and for the year then ended consolidated operating revenues amounted to $156,004,000 and net income amounted to $8,979,000. National has 5,093,715 shares of common stock outstanding, par value $10 per share, which are traded on the New York Stock Exchange.

Producers is a New York corporation and distributes natural gas at retail in the western portion of the State of New York to approximately 4,900 residential, commercial, and industrial customers in Allegheny and Cattaraugus Counties. At December 31, 1968, Producers had gross property, plant, and equipment, stated at original cost, of $1,669,000, and related reserves for depreciation of $482,000, and for the year then ended operating revenues were $1,345,000 and net income was $69,000. Producers has 48,000 shares of $10 par value common stock outstanding held by approximately 82 stockholders. Its stock is inactively traded; only four transactions involving 7,448 shares were effected in the period February 23, 1965, to August 20, 1968.

THE PROPOSED TRANSACTIONS

National proposes to acquire all 48,000 of the shares of common stock of Producers for 28,800 shares of National's authorized but unissued common stock, at the rate of 0.6 of a share of National's common stock for each share of Producers pursuant to an Agreement dated January 28, 1969, between Naticnal and 25 stockholders of Producers who own 39,892 shares, or 83 percent, of its common stock. National will acquire the 39,892 Producers' shares and within a 15-day period after our authorization will offer, upon the same terms, to acquire the remaining 8,108 shares. The offer will remain open for a period of 30 days, unless extended.[2]

STATUTORY STANDARDS APPLICABLE TO THE PROPOSED TRANSACTION

The proposed acquisition by National of the shares of Producers common stock is subject to the provisions of Section 10 of the Act. The proposed issue by National of its shares to effect the exchange is subject to Section 7.

A. INTEGRATION ASPECTS OF THE PROPOSED ACQUISITION

Under Section 10(c)(2) of the Act, we may not approve National's proposed acquisition of Producers stock unless we affirmatively find that ". . . such acquisition will serve the public interest by tending towards the economical and efficient development of an integrated public-utility system," [3] and for reasons noted below we make such findings.

The utility assets of Producers are located in or adjacent to the same service area in which gas utility assets already owned and operated by Iroquois Gas Corporation ("Iroquois"), a gas utility subsidiary company of National, and another National gas utility subsidiary company are located. Two of Iroquois' transmission pipelines run through the center of Producers' service area, and Producers' Sanford Station is located about one-half mile from Iroquois' 24" transmission pipeline. The transmission lines cross at two primary points, and at these points the two systems could be tied together. National's engineers estimate it will cost a total of approximately $35,000 for both connections. Producers' natural gas requirements are purchased from Consolidated Gas Supply Corporation, a nonaffiliate natural gas company, under a contract which expires July 1, 1981. Iroquois and other National subsidiary companies also purchase gas from this supplier. Producers has no underground storage facilities available to it, but as contractual arrangements permit National

[2] No fractional shares will be issued by National, but the holders of stock of Producers otherwise entitled to fractional shares of National stock will be afforded an opportunity to sell their fractional interest for cash or to purchase additional fractional interests to make a full share.

[3] An "integrated public-utility system" as applied to gas utility companies is defined in Section 2(a)(29)(B) as "a system consisting of one or more gas utility companies which are so located and related that substantial economies may be effectuated by being operated as a single coordinated system confined in its operations to a single area or region, in one or more States, not so large as to impair (considering the state of the art and the area or region affected) the advantages of localized management, efficient operation, and the effectiveness of regulation . . . "

hopes to make its gas supplies and storage pools available to Producers. This will enable Producers to take advantage of National's underground gas storage and thereby reduce its need to buy gas at high winter take rates. National plans eventually to merge Producers into Iroquois and to tie the two systems together. Iroquois' rates are generally somewhat lower than those of Producers, and it is planned that Iroquois' uniform rate structure will ultimately be applied to the area served by Producers.

The acquisition of Producers by the National system and its eventual merger into Iroquois will result in the effectuation of substantial economies of operation. Although no specific dollar amounts are indicated, savings, generally, will result with respect to purchasing, accounting, financing, data processing, customer billing, sales promotion, meter inspection and repair, engineering planning, and reduction in management personnel. National asserts that eventually, as part of a large natural gas system, Producers will be able to provide better long-term service to its customers.

In light of the foregoing, we make the affirmative finding required by Section 10(c)(2).

B. Fairness of the Exchange Offer

Under Section 10(b)(2), we may not approve the proposed acquisition if the terms of the exchange offer, including the fees and expenses incident thereto, are not fair and reasonable.

Appendix A presents a condensed balance sheet as of December 31, 1968, and Appendix B an income statement for the 12 months then ended for National and subsidiaries on a consolidated basis and for Producers per books, and also on a *pro forma* consolidated basis, after intercompany eliminations, assuming acquisition by National of all of the outstanding shares of Producers' capital stock.

The following table presents, for the years indicated, the per share earnings, actual and as estimated, applicable to the present common shares of National and Producers, the *pro forma* earnings per common share of National, per 0.6 of a share of National to be offered in exchange, and book values as of December 31, 1968, actual and *pro forma.*

EARNINGS PER SHARE

	National		Producers	
	Present Shares	Pro Forma	Present Shares	.6 Shares of National
1964	$ 2.17	$ 2.17	$ 1.45	$ 1.30
1965	2.35	2.35	1.37	1.41
1966	2.45	2.45	1.15	1.47
1967	2.24	2.24	1.49	1.34
1968	1.76	1.77	1.43*	1.06
1969 (Est.)	2.26	2.27	1.46	1.36
1970 (Est.)	2.61	2.61	1.54	1.57
	Book Value			
12/31/68	$27.66	$27.71	$21.85	$16.60

*Adjusted to eliminate nonrecurring income of $35,328 realized on the sale of 1,028 shares of Dresser Industries, Inc. common stock.

As shown below, the proposed terms of exchange would, on the basis of dividends paid during the period 1964–1968 and the current annual National dividend of $1.68 per share, result in an effective substantial increase in dividend income for the Producers stockholders.

DIVIDENDS PER SHARE

	National	Producers	
	Present Shares	Present Shares	.6 Shares of National
1964	$1.37	$.40	$ .82
1965	1.46	.425	.88
1966	1.57	.425	.94
1967	1.66	.45	1.00
12 mos. ended 9/30/68	1.68	.50	1.01
1968	1.68	.50*	1.01

*Adjusted to eliminate nonrecurring special dividend of 50 cents per share representing income realized on sale of 1,028 shares of Dresser Industries, Inc. common stock.

Upon the basis of the above, the Producers shareholder will receive stock with a lower book value per share and, initially, less earnings per share, although the per share earnings estimated for 1970 are comparable. On the other hand, Producers shareholders may expect substantially increased dividend income and will receive stock which has an active trading market. At the same time, the per share net income available for dividends to National shareholders will not be diminished as a result of the acquisition of Producers stock, and the book value of the National stock will be increased slightly.

In the light of all the comparative data noted above, and the fact that the terms of the exchange offer were arrived at by arm's-length negotiations, we conclude that the proposed exchange offer is fair and reasonable to the stockholders of Producers and National. Accordingly, we make no adverse findings under Section 10(b)(2). Of course, our approval of the exchange offer is not a recommendation that the stockholders of Producers either accept or reject the exchange offer. Each such stockholder must decide for himself, after careful and independent consideration of all the facts, whether to exchange his shares.

C. OTHER SECTION 10 ASPECTS OF THE PROPOSED ACQUISITION

Under Section 10(b)(3), we must consider whether the proposed acquisition will unduly complicate National's capital structure or will be detrimental to the functioning of the National system or to the interests of the public or investors or consumers. A comparison of the consolidated capitalization and surplus of National and Producers, and *pro forma* consolidated, assuming acquisition by National of all the outstanding shares of capital stock of Producers, shows that practically no change in the capitalization of National will result from the proposed acquisition.[4] Accordingly, we do not make any adverse findings under Section 10(b)(3).

Under Section 10(c)(1) we may not approve the proposed acquisition if, among other things, it ". . . is detrimental to the carrying out of the provisions of Section 11. . . ." A detrimental effect may result if National should acquire under the proposed exchange less than all of the outstanding capital stock of Producers, thus creating a publicly-held minority interest. The existence of such an interest has been held to be contrary to the standards of Section 11(b)(2) of the Act.[5] National, however, has agreed to eliminate any such minority interest pursuant to a plan under Section 11(e) of the Act or pursuant to such other procedure as the Commission may direct. Holders of shares of Producers capital stock who do not deposit their shares for exchange should recognize, therefore, that their continued status as such stockholders will be temporary. Of course, any plan to eliminate such minority interest must be found to be fair and equitable in a separate proceeding under Section 11(e) of the Act after notice and opportunity for

[4] The ratio of long-term debt to total capitalization for National would decrease from 48.6 percent per books to 48.4 percent pro forma after the acquisition

[5] *New Orleans Public Service, Inc.*, 40 SEC 887, 889 (1961); *Lynn Electric Company*, 40 SEC 828, 833 (1961) and cases there cited.

hearing. In view of the undertaking of National as indicated above, we do not make any adverse findings under this provision of Section 10(c)(1). The acquisition by National of the stock of Producers has been authorized by the Public Service Commission of the State of New York, and counsel for National has furnished an opinion that all State laws will have been complied with.

Under Section 10(b)(1), we are required to approve the proposed acquisition unless we find that "such acquisition will tend towards . . . the concentration of control of public-utility companies, of a kind or to an extent detrimental to the public interest or the interest of investors or consumers. . . ." Thus, Section 10(b)(1), irrespective of compliance with the other standards of the Act, requires us to disapprove the proposed acquisition if we find that such acquisition tends toward an undue concentration of economic power; and the general antitrust policies of the United States are required to be considered.[6]

As noted, National had consolidated net utility plant at December 31, 1968, of $265,572,000, and for the 12 months then ended its consolidated operating revenues were some $156,000,000. Its consolidated net income was $9,000,000. At the same date, Producers had net utility plant of $1,187,000, and its operating revenues for the same period were $1,345,000. Its net income was $69,000, adjusted to exclude profit on the sale of securities. Producers serves only about 4,900 customers in two counties located in the western portion of New York State. There are a number of independent companies which sell either gas at retail or electric energy or both within and adjacent to the general areas served by National and Producers, including New York State Electric & Gas Corporation, North Penn Gas Company, Niagara Mohawk Power Corporation, and subsidiary companies of The Columbia Gas System, Inc. and of General Public Utilities Corporation.[7]

It is evident that the proposed acquisition will result in only a minute increase in the economic size of National and will not give rise to an undue concentration of economic power. Similarly, considering the small area and number of customers now served by Producers, its limited assets, revenues, gas sales, and income, and the number and size of the other companies in the area affected, there is no basis for finding that the pro-

[6] *Municipal Electric Association of Massachusettes et al.* v. *S.E.C.*, 413 F.2d 1052 (D.C. Cir. 1969); *Northern Natural Gas Company* v. *FPC*, 399 F.2d. 953 (D.C. Cir. 1968).

[7] None of which indicated an interest in this proceeding.

posed acquisition will result in a substantial lessening of actual or potential competition. We accordingly make no adverse findings under Section 10(b)(1).

D. Proposed Issue of Common Stock by National

The common stock to be issued by National will have a par value, will together with the common stock now outstanding be the only voting security outstanding, and will not be preferred as to dividends or distribution over any other outstanding security. Accordingly, the provisions of Section 7(c)(1)(A) are satisfied. In view of our above analysis we make no adverse findings under Section 7(d), and we do not find it necessary, under Section 7(f), to impose any terms or conditions.

National has requested an exception from the competitive bidding requirements of Rule 50 with respect to the issue of its common shares in connection with the exchange. We agree that competitive bidding is not appropriate for the issue of National shares to effectuate the proposed exchange, and we shall grant the request.

OTHER MATTERS

A. Accounting Treatment

National proposes to record its investment in the common stock of Producers at an amount equal to the sum of the common stock and retained earnings of Producers as recorded on its books as of September 30, 1968, adjusted pursuant to the agreement with stockholders of Producers. National will credit its capital stock account in an amount equal to the aggregate par value of the shares of common stock it will issue and will credit its retained earnings account in an amount equal to the retained earnings account of Producers. The excess of the par value of Producers' common stock to be acquired over the par value of National's common stock to be issued will be credited to capital surplus. This proposed accounting treatment seems appropriate.

B. Information To Be Sent To Producers' Stockholders

National has filed with us the solicitation material which it intends to send to Producers' stockholders in connection with the proposed exchange offer. Such solicitation material appears to be in proper form. Our order herein will also require that National send a copy of these Findings and Opinion and related Order to each stockholder of Producers who is to be solicited.

C. FEES AND EXPENSES

Fees and expenses to be incurred in connection with the proposed transactions are estimated at $7,250, including legal fees and expenses of $5,000. It appears that the fees and expenses have been properly incurred and are reasonable in amount.

CONCLUSION

Having found that the proposed transactions meet the requirements of the applicable provisions of the Act, we will issue an order granting the application and permitting the declaration to become effective forthwith, subject to the conditions contained in Rule 24 of the General Rules and Regulations under the Act.

By the Commission (Commissioners OWENS, SMITH, NEEDHAM and HERLONG), Chairman BUDGE absent and not participating.

APPENDIX A

NATIONAL FUEL GAS COMPANY AND SUBSIDIARIES (CONSOLIDATED) AND PRODUCERS GAS COMPANY

Pro Forma condensed combined balance sheet
December 31, 1968

(000 omitted)

			National (Consolidated)	Producers	Pro Forma Combined
ASSETS AND OTHER DEBTS					
Property, Plant, and Equipment—at					
Original Cost			$357,661	$1,669	$359,330
Less: Accumulated Depreciation			92,089	482	92,571
Net Utility Plant			265,572	1,187	266,759
Other Property and Investments			505	5	510
Current and Accrued Assets			55,841	254	56,095
Deferred Debits			1,197	2	1,199
Total			$323,115	$1,448	$324,563
LIABILITIES AND OTHER CREDITS					
Common Stock Equity					
Common Stock Par Value $10 per Share					
	Present	Pro Forma			
Shares Authorized	6,000,000	6,000,000			
Shares Outstanding	5,093,715	5,122,515	$50,937	$ —	$ 51,225
Capital Stock			—	480	—
Capital Surplus			12,188	—	12,380
Retained Earnings			77,775	569	78,344
Total Common Stock Equity			140,900	1,049	141,949
Long-term Debt			133,264	88	133,352
Current and Accrued Liabilities			45,449	310	45,759
Deferred Credits			1,014	1	1,015
Reserve for Annuities Granted			1,100	—	1,100
Investment Tax Credit Deferred			1,388	—	1,388
Total			$323,115	$1,448	$324,563

APPENDIX B

NATIONAL FUEL GAS COMPANY AND SUBSIDIARIES AND PRODUCERS GAS COMPANY

Pro Forma combined statement of income for the 12 months ended December 31, 1968

(000 omitted)

	National	Producers	Pro Forma
Operating revenues:			
Gas Sales	$155,769	$1,345	$157,114
Other Operating Revenues	235	—	235
	156,004	1,345	157,349
Operating revenue deductions:			
Purchased Gas	80,304	843	81,147
Operating Expense	31,160	196	31,356
Maintenance	5,360	55	5,415
Depreciation	6,690	31	6,721
Federal Income Tax	5,077	39	5,116
Investment Tax Credit Deferred-Net	129	—	129
State Income Tax	689	—	689
Property, Franchise & Other Taxes	12,063	105	12,168
	141,472	1,269	142,741
Operating income	14,532	76	14,608
Other income:			
Interest	383	—	383
Miscellaneous	619	5	624
	1,002	5	1,007
Gross income	15,534	81	15,615
Other deductions:			
Interest on Debentures	5,605	—	5,605
Other Interest	1,052	12	1,064
Interest Charged to Construction (Credit)	(102)	—	(102)
	6,555	12	6,567
NET INCOME	$ 8,979	$ 69*	$ 9,048

*Excludes profit on sale of securities.

IN THE MATTER OF

BERKSHIRE INDUSTRIES, INC.

File No. 3-1302. Promulgated November 28, 1969

Investment Company Act of 1940—Section 17(b)

MEMORANDUM OPINION AND ORDER

In these proceedings pursuant to Section 17(b) of the Investment Company Act of 1940, Berkshire Industries, Inc. has filed a withdrawal of its application for an order exempting from the provisions of Section 17(a) of the Act certain transactions incident to a proposed merger with its 95.5 percent owned subsidiary, American-Hawaiian Steamship Company, a registered closed-end non-diversified investment company. A group of American-Hawaiian stockholders, whom the hearing examiner granted leave to participate in these proceedings ("participants"), oppose the withdrawal. Briefs have been filed by Berkshire and participants.[1]

The merger proposal as originally submitted by Berkshire provided that the public stockholders of American-Hawaiian be paid $275 for each share of stock held by them. During the course of the extensive hearings, at which evidence was presented by applicant and participants relating to the value of the assets of American-Hawaiian, Berkshire increased its offer to $375; and at the close of the hearings the amount was increased to $575. Subsequently, we granted Berkshire's request to reopen the hearings to introduce evidence with respect to, among other things, recent transactions engaged in by American-Hawaiian assertedly having a bearing on the valuation of its stock. Shortly before the reconvened hearings were to begin, Berkshire submitted to participants a revised offer of $635 per share (plus an additional amount if certain construction costs proved to less than estimated). When participants indicated that the amount offered was not acceptable, Berkshire filed the instant withdrawal, citing, among other

[1] Berkshire and participants submitted letters in response to the reply briefs which we have also considered.

things, the further delay which it envisaged would be entailed by participants' continued opposition before the proposed transactions could be consummated.

Berkshire contends that the filing of its withdrawal effectively terminated these proceedings. Participants argue that withdrawal requires our permission and should be allowed only subject to various conditions requested by them, and they urge that the hearings should continue. However, assuming that our consent to withdrawal is required, we find no basis for denying withdrawal here. We see no purpose in taking additional evidence with respect to a proposal that has now been abandoned nor, as noted below, any reason to impose the requested conditions.

One of the conditions which participants request is that Berkshire and/or American-Hawaiian be required to reimburse them for their expenses and directed to pay a reasonable attorney's fee to their counsel, who took a very active part in the proceedings, the amount to be fixed after hearing. We do not have jurisdiction with respect to participants' expenses and attorney's fee.[2] Nor do we see any basis for imposing a further condition requested by participants respecting the composition of American-Hawaiian's board of directors. Participants allege that, contrary to the Act's requirements, one individual controls all of American-Hawaiian's directors, and ask that we appoint or require the appointment of three of the company's seven directors, or, if we deem it necessary, order a hearing with respect to this matter. We do not view this issue as germane to the instant proceedings under Section 17(b).[3]

Participants have pointed to Berkshire's statement that one reason for withdrawing its application is that it appears probable that American-Hawaiian may be in a position to apply for an order terminating its registration under the Act. They argue that Berkshire is attempting through termination of American-Hawaiian's registration to accomplish indirectly an elimination of the interests of public stockholders that it has failed to effect in a fair manner directly. However, the inter-

[2] This conclusion does not, of course, preclude participants from taking legal action to pursue any remedy they may have in this respect.

[3] Participants also cite a 1967 purchase of American-Hawaiian stock by Berkshire's parent company at $275 per share under a contract which provided that if this Commission approved a higher price in these proceedings the selling stockholder would be paid the difference between that price and $275. They argue that, since Berkshire now admits to a valuation of at least $635 per share, withdrawal of its application works a fraud on the seller. Whatever the rights of the seller may be under the contract, we do not consider that such sale warrants continuation of these proceedings under Section 17 of the Act. Moreover, Berkshire states that it and its parent company will permit ex-stockholders who sold their American-Hawaiian stock for $275 under such contracts to rescind the sales.

ests of those stockholders would be considered in any proceeding on an application by American-Hawaiian for termination of its registration, participants would have an opportunity to introduce evidence, including relevant portions of the record in these proceedings, and any order terminating registration could reserve jurisdiction with respect to further proposals to eliminate the interests of American-Hawaiian's minority stockholders and impose such other conditions as might appear appropriate for their protection. Under the circumstances, since American-Hawaiian is still a registered investment company, no order is required, as participants request, directing it to comply with the provisions of the Act for as long as it has public stockholders.[4]

Accordingly, IT IS ORDERED that the application of Berkshire Industries, Inc. for an order exempting certain transactions incident to a proposed merger with American-Hawaiian Steamship Company from the provisions of Section 17(a) of the Investment Company Act be, and it hereby is, withdrawan, and that these proceedings be, and they hereby are, dismissed.

By the Commission (Commissioners OWENS, SMITH and NEEDHAM), Commissioner HERLONG not participating and Chairman BUDGE absent and not participating.

[4] We also see no useful purpose to be served by our exploring, as further requested by participants, into the assertedly inadequate reasons given by Berkshire for withdrawal of its application, or with respect to whether Berkshire should have disclosed earlier in the proceedings that certain negotiations which could affect the value of American-Hawaiian stock were then in progress, especially since the transaction that resulted from such negotiations was one of those which formed the basis for Berkshire's subsequent request to reopen the hearings.

Participants' request for oral argument will be denied.

IN THE MATTER OF

LOUIS GUIDUCCI

NATIONAL ASSOCIATION OF SECURITIES DEALERS INC.

File No. 3-1807. Promulgated December 5, 1969

Securities Exchange Act of 1934—Section 15A(g) and 15(h)

REGISTERED SECURITIES ASSOCIATION—REVIEW OF DISCIPLINARY PROCEEDINGS

In proceedings for review of action of registered securities association expelling member who shared commissions with person who had been expelled from membership, *held*, under all circumstances and having due regard to public interest penalty is affirmed without prejudice to application for reinstatement within three months.

APPEARANCES:

Louis Guiducci, pro se.

Lloyd J. Derrickson and *Philip C. Finegan*, for the National Association of Securities Dealers, Inc.

FINDINGS, OPINION AND ORDER

Louis Guiducci, a member of the National Association of Securities Dealers, Inc. ("NASD"), has applied pursuant to Section 15A(g) of the Securities Exchange Act of 1934 for review of disciplinary action taken against him by the NASD. The NASD found that Guiducci violated Sections 1, 21 and 27(a) of Article III of its Rules of Fair Practice,[1] expelled him from membership, and assessed costs of $315.54. The NASD filed a brief in opposition and Guiducci filed a statement in support of his application.[2]

Guiducci is a sole proprietor registered with us as a broker-dealer and became a member of the NASD in September 1962. He specialized in the retail sale of mutual funds, including voluntary accumulation plans.

[1] Section 1 requires the observance of "high standards of commercial honor and just and equitable principles of trade." Section 21 requires members to keep and preserve various books and records. Section 27(a) requires members to establish and maintain appropriate written supervisory procedures.

[2] At Guiducci's request, oral argument was scheduled but was not held due to his failure to appear.

The basic facts are not in dispute. About October 1964, Guiducci entered into an arrangement with Ernest F. Boruski, Jr., whereby about 225 mutual fund voluntary accumulation plans previously serviced by Boruski were transferred to Guiducci. Between October 1964 and April 1965, Guiducci paid Boruski, through the medium of International Dynamics, a Canadian corporation, about 78 percent of the commissions totalling $1,052 received on these pre-existing accounts and on seven new accounts forwarded to him by Boruski. Subsequently, beginning in October 1965 and ending in November 1966, Guiducci made periodic payments totalling $1,850. Prior to these arrangements, Boruski had been the subject of disciplinary proceedings before the NASD and us, in the course of which he had been expelled from membership in the NASD,[3] and so he was ineligible under the NASD rules to receive discounts from or share commissions with NASD members. In addition, during the period from July 1965 to January 1967, Guiducci failed to retain copies of voluntary plan applications, failed to establish and maintain written supervisory procedures, and at various intervals failed to maintain the minimum net capital of $2,500 required under our rules.[4]

On the basis of our review of the record we sustain the NASD's findings of violations. Accordingly, under Section 15A(h) of the Act, we must dismiss these review proceedings unless we find that the penalty of expulsion from membership is excessive or oppressive, as urged by Guiducci, having due regard to the public interest.

The NASD's action in expelling Guiducci was based principally on his conduct with respect to the payments to Boruski which it found were made in a manner that enabled Boruski to share in concessions payable on mutual fund sales effected by him.[5]

[3] Boruski was suspended in 1960 from membership by the NASD for 60 days for violations respecting improper sales literature, confirmations and books and records, and the suspension was upheld by us, 10 S.E.C. 258 (1960), and judicially affirmed, 289 F.2d 738 (C.A. 2, 1961). After we instituted broker-dealer proceedings against Boruski in July 1962, he formed Financial Counsellors, Inc. In proceedings against Financial Counsellors, we first suspended and then revoked its broker-dealer registration, based on its failure to disclose Boruski as a controlling person, and found Boruski a cause of such revocation. *Financial Counsellors, Inc.* 41 S.E.C. 926 (1964) and 42 S.E.C. 153 (1964). Subsequently, we revoked Boruski's own broker-dealer registration, expelled him from the NASD, and denied him registration as an investment adviser. *Ernest F. Boruski, Jr.*, 42 S.E.C. 348 (1964), *aff'd* 340 F.2d 991 (C.A. 2, 1965). Thereafter we denied his application for an order directing the NASD to continue him in membership. Securities Exchange Act Release No. 7440 (October 8, 1964).

[4] Rule 17 CFR 240.15c3-1.

[5] The NASD found that the other violations, which Guiducci asserted were inadvertent and had been corrected, were of a minor nature in view of the minimal nature of Guiducci's business, which was described by the NASD District Business Conduct Committee as amounting to "a one-man shop" limited to the sale of mutual funds, although the NASD Board of Governors believed such violations tended to emphasize Guiducci's carelessness and lack of concern for NASD rules and procedures.

Guiducci admits he agreed to pay Boruski 80 percent of the commissions received on the transferred accounts during the initial period October 1964–April 1965, but he denies any intent to violate the prohibitions against sharing of commissions with non-members. He states that he had an oral agreement with Boruski to purchase the accounts in question, and that the payments at first were about 80 percent of the commissions received pending actual experience with the accounts on the basis of which a total purchase price could be agreed upon. He asserts that he sought guidance from the NASD and our staff as to permissible arrangements for the acquisition of accounts of a person no longer an NASD member.

Following inquiries made to our New York Regional Office in April 1965, in the course of which he described his payments to Boruski, that Office advised him that although the outright purchase from a revoked broker-dealer of the rights to future commissions on existing accounts might be lawful,[6] his existing arrangement whereby he paid Boruski 80 percent of such commissions raised serious legal problems. Guiducci thereupon advised that he would not pay any more continuing commissions to Boruski but inten7ed to arrive at a value for the accounts and pay Boruski a lump sum for them. In October 1965, Guiducci reported that he determined to pay $2,500, in addition to the $824.50 previously paid in April 1965, to purchase the accounts, payable $150 per month. He then made periodic payments which became irregular after February 1966 and totalled $1,850 by November 1966, after which he made no further payments because of his financial inability to do so and he states that his securities business since then has been dormant.

The NASD points to various statements by Guiducci to the effect that his original understanding with Boruski was that the 80 percent payments would continue indefinitely. While we would agree that a deliberate scheme arrived at in concert with Boruski to circumvent the NASD's disciplinary mechanism would warrant an unqualified exclusion from membership, we think that the record as a whole shows that Guiducci was generally of the impression it was permissible to acquire the accounts of an expelled member, was not certain of and made efforts to ascertain what mode of payment could prop-

[6] *Cf. Richard J. Buck & Co.*, 43 S.E.C. 998, 1012 (1968), where we stated that a broker-dealer is not precluded from selling the tangible assets of his business to an independent purchaser by the revocation of his broker-dealer registration, when such sale is not merely a device to ensure the revoked registrant's continuance in business.

erly be made, and thereafter took steps to avoid any further violations. We are satisfied that, as the NASD District Committee found, Guiducci's conduct stemmed from misplaced loyalty toward and naive confidence in Boruski, the instigator of the arrangement who was a fellow West Point graduate whom Guiducci trusted, rather than deliberate planned action on Guiducci's part. Nevertheless Guiducci showed a degree of a lack of sensitivity toward his obligations as an NASD member dealing with an expelled NASD member which cannot be justified by the trust and confidence he placed in Boruski.[7]

The District Committee concluded that Guiducci should not be barred completely from the securities business and should be expelled with the understanding that he may immediately apply for reentry as a controlled person under such supervision as might appear appropriate. The Board of Governors while affirming the findings made and penalty imposed by the District Committee, disapproved the statement that Guiducci may immediately apply for reentry as a controlled person under such supervision as appears appropriate, on the ground that on any future application by Guiducci to return to the securities business, the decision, subject to our approval, would rest with the Board, which is not bound by the language in the District Committee's decision.

We are of the opinion that, notwithstanding the absence of any conscious intent to violate, Guiducci's misconduct was serious in that its effect was in part to nullify the consequences of a major sanction available to the NASD in carrying out its regulatory functions. Under all the circumstances, however, we conclude that an indefinite exclusion would be excessive, having due regard to the public interest, and that it is appropriate that expulsion from membership be coupled with the provision that it shall be without prejudice to an application by Guiducci after three months for reinstatement of his membership upon a showing that his activities would be conducted with appropriate safeguards against future violations.

Accordingly, IT IS ORDERED that the action of the National Association of Securities Dealers, Inc. expelling Louis

[7] Guiducci admittedly was aware that Boruski had been expelled from the NASD. He asserted that he had not read our previous decisions detailing Boruski's previous activities in the form of "devious and complicated arrangements with respect to the handling of the concessions payable on mutual fund shares effected by him which were designed to conceal the true disposition of those amounts" (e.g., *Financial Counsellors, Inc., supra*, pg. 156) and states that he probably would not have made any arrangements with Boruski had he read such decisions.

In particular, Guiducci clearly should not have accepted the seven new accounts from Boruski. Initially he treated those accounts as part of the arrangement relating to the old accounts, but then he became concerned about the propriety of accepting them and refused to accept any more.

Guiducci from membership be, and it hereby is, affirmed, provided, however, that such action is without prejudice to an application by Guiducci after three months for reinstatement of his membership upon a showing that his activities a would be conducted with appropriate safeguards against future violations.

By the Commission (Chairman BUDGE and Commissioners OWENS, SMITH and NEEDHAM), Commissioner HERLONG not participating.

In the Matter of

A.V.C. CORPORATION

File No. 3-2093. Promulgated December 22, 1969

Investment Company Act of 1940—Section 8(f)

DEREGISTRATION OF AN INVESTMENT COMPANY

Change in the Nature of the Business of Investment Company

Where an investment company has reduced its holdings of investment securities to a point where they are significantly less than 40 percent of the company's assets less cash and government securities; and the major portion of the time of its management is devoted to the operations of majority-owned or wholly-owned companies in the industrial, commercial, and communications fields; and the holders of a majority of its outstanding voting securities have approved a change in the nature of the company's business so as to cease to be an investment company; *held*, the company is primarily engaged in business other than that of investing, reinvesting, owning, holding, or trading in securities and therefore is entitled to an order pursuant to Section 8(f) of the Investment Company Act of 1940, declaring that it has ceased to be an investment company.

APPEARANCES:

Orvel Sebring, *Thomas V. Lefevre*, and *George G. Loveless*, of Morgan, Lewis & Bockius, for A.V.C. Corporation ("A.V.C.").

Stephen Mishkin, for Carrie W. Garrison, Participant.

Stanley B. Judd and *Peter Kiernan*, for the Division of Corporate Regulation ("Division").

FINDINGS, OPINION AND ORDER

This is a proceeding with respect to an application filed by A.V.C. pursuant to Section 8(f) of the Investment Company Act of 1940 ("Act") or, in the alternative, Section 3(b)(2) of the Act, for an order declaring that A.V.C. has ceased to be an investment company. After appropriate notice (Investment Company Act Release No. 5778), a public hearing was held before a hearing officer in which Carrie W. Garrison, a shareholder of A.V.C., was allowed to file a statement under Rule 9(f) of the Commission's Rules of Practice and was granted leave to participate pursuant to Rules 9(c) and 9(d). A.V.C. and the Division waived an initial decision by the hearing officer, A.V.C. consented to the Division rendering assistance to the Commission in the preparation of its opinion, and A.V.C. and Mrs. Garrison submitted briefs and proposed findings of facts and conclusions of law. Upon a review of the record we make the following findings:

A.V.C., a Delaware Corporation, has been registered under the Act since 1963 as a closed-end, non-diversified management investment company. A.V.C. alleges that it has ceased to be an investment company and is now primarily engaged in the business of acquiring, developing, and operating, through majority-owned or wholly-owned subsidiaries, operating companies in industrial, commercial, and communications fields. A.V.C. further alleges that it intends to continue in the business of operating such companies and that its interests in its majority-owned or wholly-owned subsidiaries are not held as investment securities for the purpose of resale.

Section 8(f) of the Act provides, in pertinent part, that when the Commission, upon application, finds that a registered investment company has ceased to be an investment company, it shall so declare by order, which, if necessary for the protection of investors, may be made upon appropriate conditions, and upon taking effect of such order, the registration of such company shall cease to be in effect.

Section 3(a)(1) of the Act defines as an investment company an issuer which is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities.

Section 3(a)(3) of the Act further defines as an investment company an issuer which is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis. The term "investment securities" includes all securities except Government securities, securities issued by employees' securities companies, and securities issued by majority-owned subsidiaries of the owner which are not investment companies.

We have previously stated that the issue raised as to the businesses in which a company is primarily engaged is one of fact which must be resolved with reference to the particular facts of each case, and that the principal relevant considerations to a determination of this factual issue are as follows: (1) the company's historical development; (2) its public representations of policy; (3) the activities of its officers and directors; (4) the nature of its present assets; and (5) the source of its present income.[1]

A.V.C. was incorporated in Delaware in 1922 as American Viscose Corporation and was an operating company until 1963 when its operating assets were sold, its name was changed to A.V.C. Corporation, and it was registered under the Act as an investment company. Between 1963 and 1966 A.V.C. made three tender offers to its shareholders with the result that approximately 95 percent of the company's stock was tendered.

At A.V.C.'s annual meeting on May 2, 1966, shareholders approved Drexel Harriman Ripley, Incorporated, as A.V.C.'s investment adviser and approved a program for diversification of the company's assets. It was also provided that A.V.C. would invest no more than 25 percent of its assets in any one industry.

In the proxy statement for the next annual meeting, May 1, 1967, stockholders were informed that the company intended to remain an investment company. They were further informed of A.V.C.'s agreement to purchase from D.H. Overmyer 80 percent of the stock five UHF television stations ("Overmyer stations") with an option to purchase the remaining 20 percent and to loan $3,000,000 to the Overmyer warehouse companies. This proxy also stated that:

> "The Corporation may enter into other transactions which involve the purchase of more than 50 percent of the voting securities of another corporation, and, as a non-diversified investment company, investments of this nature could amount to 100 percent of the Corporations' net assets . . ."

In 1966 A.V.C. had purchased a 50 percent interest in A.C. Forr Company; and, in 1967, A.V.C. acquired 82.4 percent of Carolina Pump and Supply Company. In 1968 A.V.C. acquired 100 percent of Oceanchem International, the Kedea Company, and Genu Products Canada Ltd.; consummated the merger of Station W.P.H.L. in Philadelphia and the Overmyer television stations into U.S. Communication Corporation, a 70 percent owned A.V.C. subsidiary; brought its ownership in the A.C. Forr Company up to 76 percent of that company's stock; and purchased all of the outstanding common stock of the Davison Sand and Gravel Company.

[1] *In the Matter of Atlas Corporation*, 41 S.E.C. 144, 145, (1962), and cases cited therein.

A.V.C.'s investment advisory contract with Drexel Harriman Ripley, Incorporated was terminated on May 1, 1968. Shareholders were told in the proxy statement for the annual meeting held in May of 1968 that the contract with Drexel Harriman Ripley, Incorporated was terminated because A.V.C. had an experienced portfolio manager on its staff. That employee left A.V.C. in March of 1969 and has not been replaced.

Dr. Frank Reichel, President and Chairman of the Board of A.V.C. testified that he devotes approximately 60 percent of his time to A.V.C.'s majority or wholly-owned subsidiaries, and that Mr. E. D. Tatum Smith, Jr., Vice Preisdent of A.V.C, spends the major portion of his time on U.S. Communications Corporation and Davison Sand and Gravel Company and also spends time on general administrative activities of A.V.C. The balance of Mr. Smith's time is spent on A.V.C.'s investment portfolio. Mr. Herman B. McManaway, Senior Vice President of A.V.C., stated that he spends between 35 and 40 percent of his time on Oceanchem International, 15 to 20 percent on A.C. Forr Company, 5 percent on Carolina Pump and Supply Company, and the remainder of his time on special investments and general corporate activities.

At A.V.C.'s 1969 annual meeting held on May 5, 1969, shareholders acted on management's proposal and approved a resolution that A.V.C. change the nature of its business so as to cease to be an investment company. The vote was 65.25 percent of the shares outstanding in favor of the resolution and 13.34 percent opposed.

As of July 31, 1969, A.V.C. held investment securities having a value of 27.72 percent of the value of its total assets exclusive of cash items on an unconsolidated basis.[2] No government securities were listed as assets as of the above date. Assets referred to as "commercial paper" *are* included in this computation as investment securities since A.V.C. has not identified them sufficiently to support a finding that they are not investment securities.

[2]

Total Assets as of July 31, 1969	$39,587,069
Less: Cash	1,638,819
Total assets exclusive of cash	37,948,250
A.V.C.'s marketable securities	$6,159,327
Non Controlled special investments	3,155,360
Short Term Commercial paper	1,205,322
	10,520,009
A.V.C.'s total investment securities as a percentage of total assets exclusive of cash	27.72 percent

All "special investments" and interests in majority and wholly-owned companies have been valued by the Board of Directors of A.V.C. at their original cost. The record supports a finding that such valuation was made by the directors of A.V.C. in good faith in an attempt to determine the fair value of such securities. There is nothing in the record to indicate that such valuations are significantly incorrect.

In recent years, the nature of A.V.C.'s business has changed so that it now operates through majority or wholly-owned companies rather than acting primarily as an investor, reinvestor, or trader in securities. Management has been changed to reflect this change and now devotes the major portion of its time to the operating companies. Application of the 40 percent test contained in Section 3(a)(3) of the Act no longer results in A.V.C. being an investment company.

We find, therefore, that A.V.C. is primarily engaged in the industrial, commercial, and communications fields and not in the business of investing, reinvesting, owning, holding, or trading in securities, and that it has ceased to be an investment company within the meaning of Section 3(a) of the Act.

There is presently pending an application by affiliated persons of A.V.C. for an order permitting certain transactions which might otherwise be prohibited by Section 17 of the Act (Administrative Proceeding No. 3–2019). Counsel for A.V.C. has consented that any order in this proceeding allowing A.V.C. to deregister may be conditioned on the Commission's retaining jurisdiction over the other matter. Counsel for Mrs. Garrison has asked that if we issue an order of deregistration pursuant to Section 8(f) we should, for the protection of A.V.C. investors, make such order subject to the conditions, that A.V.C. (1) be required to continue the disclosure of its investment policies to its stockholders, (2) be prohibited from changing its investment policies or the nature of its business without authorization of its stockholders, and (3) continue to be bound by the restrictions of Sections 17, 18, 23, 25, and 36 of the Investment Company Act of 1940.

Section 8(f) provides that, if necessary for the protection of investors, an order thereunder may be made upon appropriate conditions.

We understand this to mean that we have the right to attach conditions to an order of deregistration to protect investors against injury. We do not believe, however, that the placement of investors in the status of shareholders in non-investment companies, or the loss of the specific protections of the Investment Company Act, which would be the necessary result of an order of deregistration, was the kind of injury that was contemplated. Since this is the only injury which it is alleged shareholders of A.V.C. would suffer if A.V.C. is allowed to deregister, we do not believe that the imposition of the requested conditions would be appropriate.

Accordingly, it is:

ORDERED that A.V.C. be, and hereby is, declared to have ceased to be an investment company, subject to the condition: that Section 17 of the Act shall remain applicable to the transactions referred to in Administrative Proceeding No. 3–2019.

By the Commission (Chairman BUDGE and Commissioners OWENS, SMITH and NEEDHAM), Commissioner HERLONG being absent and not participating.

In the Matter of

ILLINOIS POWER COMPANY

File No. 3-1568. Promulgated January 2, 1970

Public Utility Holding Company Act of 1935—Sections 3(a)1, 9(a)(2) and 10

ACQUISITION OF SECURITIES OF ELECTRIC-GAS COMPANY

Divestment of Gas Properties

Application by exempt holding company, which is also electric and gas utility company, for approval of proposed acquisition of outstanding common stock of electric-gas utility company doing business in contiguous area in same state and for order continuing applicant's exemption, *granted subject to condition* that gas properties of both companies be divested.

APPEARANCES:

Milton H. Cohen, George B. Pletsch, William T. Hart and *Roger P. Pascal,* of Schiff Hardin Waite Dorschel & Britton, for Illinois Power Company.

Ove B. Dentler, of Isham, Lincoln & Beale, for Central Illinois Public Service Company.

Myron J. Isaacs and *Clement F. Springer;* and *Samuel W. Block, John C. Tucker* and *Jonathan T. Howe,* of Raymond, Mayer, Jenner & Block, for certain preferred stockholders of Central Illinois Public Service Company.

Solomon Freedman, Paul Gonson, Frank Field, Robert F. McCulloch and *H. Kennedy Linge,* for the Division of Corporate Regulation of the Commission.

FINDINGS AND OPINION OF THE COMMISSION

Illinois Power Company ("IP"), an electric and gas utility company and an exempt holding company, has filed an application, pursuant to Sections 9(a)(2) and 10 of the Public Utility Holding Company Act of 1935 ("Act"), for approval of its proposed acquisition of the outstanding common stock of Central Illinois Public Service Company ("CIPS"), a non-associate company. After appropriate notice, hearings were held at which certain holders of CIPS preferred stock ("participants") were granted leave to be heard. An initial decision by the hearing examiner was waived, briefs were filed by IP and participants, proposed findings and conclusions were filed by our Division of Corporate Regulation ("Division"), and we heard oral argument.

I. DESCRIPTION OF COMPANIES INVOLVED

IP and CIPS were organized in Illinois. They generate, transmit, distribute and sell electricity, mostly at retail, and distribute and sell natural gas at retail, in contiguous and interlocking areas in Illinois.[1] As of April 30, 1968, their total assets, less depreciation reserves, were about $591 million and $349 million, respectively. For the year ended on that date, their gross operating revenues were about $184 million and $103 million, of which 64.7 percent and 78.5 percent, respectively, were derived from electric service. Each company was formerly part of a registered holding-company system from which it emerged as a publicly-held electric and gas utility company and each is a holding company by virtue of its ownership of 20 percent of the capital stock of Electric Energy, Inc., an electric utility company which was organized in Illinois to supply power for an Atomic Energy Commission project. IP and CIPS, however, by virtue of their intrastate status, have been exempt, pursuant to Section 3(a)(1) of the Act and Rule 2 thereunder, from all provisions of the Act except Section 9(a)(2) by filing annual exemption statements pursuant to the Rule.[2]

II. THE PROPOSED TRANSACTION

IP proposes to offer .65 of a share of its common stock for each outstanding share of CIPS common stock. The exchange is conditioned on acceptance of the offer by the holders of at least 82.8872 percent of the outstanding shares of CIPS com-

[1] At December 31, 1967, IP furnished electric service to about 406,000 customers in 434 communities, and gas service to about 300,000 customers in 304 communities. The corresponding figures for CIPS were 258,000 electric customers in 533 communities and 113,636 gas customers in 192 communities.

[2] Section 3(a) (1) provides that we shall exempt a holding company and its subsidiaries from any provision or provisions of the Act if the holding company and its public-utility subsidiaries from which it derives any material part of its income are predominantly intrastate in character and carry on their business substantially in a single state in which they were organized, "unless and except insofar as [we find] the exemption detrimental to the public interest or the interest of investors or consumers."

Rule 2 permits holding companies and their subsidiaries meeting the basic standard for exemption specified in Section 3(a) (1) to obtain exemption from all provisions of the Act except Section 9(a) (2) upon the filing annually of a prescribed exemption statement.

mon stock.[3] Under the proposal, the outstanding 375,000 shares of CIPS voting cumulative preferred stock, $100 par value, would remain outstanding.

IP also requests that upon consummation of the proposed acquisition an order be issued pursuant to Section 3(a)(1) of the Act continuing its present exemption or granting it a new exemption. However, unless IP acquires all of the outstanding CIPS common stock, it proposes to register as a holding company solely to file a plan pursuant to Section 11(e) of the Act for the elimination of the publicly-held minority interest in such stock.

III. ISSUES UNDER SECTIONS 10 AND 3(a)(1) OF THE ACT

The principal issues presented by the application and the contentions of the parties and participants are whether approval of the application should be conditioned on (1) divestment of the gas properties of IP and CIPS and (2) elimination of or other provision with respect to the CIPS preferred stock.[4]

COMBINATION OF GAS AND ELECTRIC OPERATIONS

There is no dispute and the record establishes that IP's proposed acquisition of CIPS common stock "will serve the public interest by tending towards the economical and efficient development of an integrated public-utility system," within the meaning of Section 10(c)(2) of the Act, with respect to the electric utility assets of the two companies.[5] It also appears that the gas utility assets of IP and CIPS could be economically and efficiently integrated into one system.[6]

IP contends that approval of its application without any conditions would be consistent with previous interpretations of Sections 10 and 3(a) permitting combined electric and gas operations in various situations. It cites decisions by us in

[3] The exchange offer is further conditioned on its prior approval by the Illinois Commerce Commission (which approved it on October 30, 1968) and the holders of a majority of the shares of IP's outstanding capital stock and on the issuance of a satisfactory ruling by the Internal Revenue Service with respect to the tax-free nature of the exchange.

[4] Section 10(e) of the Act provides in pertinent part that in an order approving the acquisition of securities we may prescribe such terms and conditions as we may find necessary or appropriate in the public interest or for the protection of investors or consumers.

Under Section 10(b) of the Act we many condition our approval of the acquisition of securities of another company upon such a fair offer to purchase such of the other securities of that company as we may find necessary or appropriate in the public interest or for the protection of investors or consumers.

[5] The electric systems of IP and CIPS would meet the standards prescribed by the definition of an integrated electric system in Section 2(a) 29 (A) of the Act. They are to a large extent contiguous and are physically interconnected, and their operations are presently coordinated in most respects as a result of their membership in the Illinois-Missouri Power Pool. Operation as a single electric system would achieve substantial economies and other benefits including savings in capital investment, fixed charges and fuel costs.

[6] See Section 2(a) 29(B) of the Act.

which we permitted the divestment of combination operating companies from registered holding company systems without requiring the separation of gas operations from those of electric,[7] and decisions exempting combination holding companies under Section 3(a)(1) or 3(a)(2)[8] on the theory that compliance with the integration standards of Section 11(b)(1) of the Act[9] was not a prerequisite to the availability of such an exemption.[10] IP argues that since both the electric and gas properties of CIPS can be economically integrated with those of IP, the proposed acquisition would satisfy Section 10(c)(2). It claims that the phrase "an integrated public-utility system" in Section 10(c)(2) is not synonymous with the phrase "a single integrated public-utility system" in Section 11(b)(1), and therefore cannot be read as automatically barring an acquisition resulting in a combination of an integrated electric system and an integrated gas system. And it contends that the correctness of its reading of Section 10(c)(2) is indicated by Section 8, which deals with the requirement of state commission approval of acquisitions of electric-gas combinations, which it argues would otherwise be redundant.[11]

The Division contends, on the other hand, that the standards of Section 10 and the "unless and except" clause of Section 3(a) require that approval of the acquisition and the requested exemption should be conditioned upon the divestment of the gas properties of the two companies. It argues that the phrase "an integrated public-utility system" in Section 10(c)(2), which it construes to mean "only one" integrated system, does not permit an acquisition of utility properties which do not tend toward the development of one such system, even though such properties, if owned prior to passage of the Act, were retainable as an additional integrated system if the standards of Section 11(b)(1) were satisfied. The Division also cites Section 10(b)(1) which requires approval of an acquisition unless we find, among other things, that it will tend toward "the

[7] See, *e.g.*, *Public Service Corporation of New Jersey*, 27 S.E.C. 682 (1948); *The Kansas Power & Light Company*, 29 S.E.C. 640, 648 (1949).

[8] Section 3 (a) (2), which is subject to the same "unless and except" clause as Section 3 (a) (1), *supra*, relates to holding companies which are predominantly public-utility companies.

[9] Section 11 (b) (1) of the Act provides that operations of a registered holding-company system must be limited to a "single integrated public-utility system," except that one or more additional integrated systems may be retained if certain specified standards are met.

[10] See, *e.g.*, *Northern States Power Company*, 36 S.E.C. 1 (1954); *Union Electric Company*, 40 S.E.C. 1072, 1078 (1962).

[11] Section 8 makes it unlawful for a registered holding company or a subsidiary thereof to acquire an interest in an electric utility company and a gas utility company serving substantially the same territory without the express approval of the state commission when that state's law prohibits or requires approval of such acquisition.

concentration of control of public-utility companies, of a kind or to an extent detrimental to the public interest or the interest of investors or consumers." Finally, the Division argues that the proposed acquisition is prohibited by Section 10(c)(1) which provides that we may not approve an acquisition of securities which is "detrimental to the carrying out of the provisions of Section 11."

The Division urges that Sections 10 and 3(a) should be interpreted and applied in light of the emphasis placed by the Supreme Court, in its recent decision in *S.E.C.* v. *New England Electric System* ("NEES"),[12] on the adverse factors inherent in the retention in one holding company system of both gas and electric properties. NEES was a registered holding company which controlled both an integrated electric utility system serving four states and an integrated gas utility system serving one of those states. In a proceeding under Section 11(b)(1) of the Act, the Court sustained our determination that NEES had failed to establish, as required under one of the retainability standards, that divestment of the gas system would result in a loss of substantial economies and that NEES therefore had to divest itself of its interests in the system's gas properties. In its opinion, the Court referred, by way of background, to the Congressional objective to protect consumer interests through the elimination of "restraint of free and independent competition" [13] and the fact that one of the abuses that had resulted from the control of utilities by holding companies was the retention in one system of both gas and electric properties and the favoring of one of these competing forms of energy over the other. The Court stated that "Congress therefore ordained separate ownership—and divestiture where necessary to reduce holdings to one system—as the 'very heart' of the Act." [14] It also referred to a footnote in an earlier decision by it in the NEES matter stating that "by fostering competition between gas and electric utility companies, the Act promotes what has been described as 'variegated competition'." [15]

IP contends that the NEES case is distinguishable because it involved a registered interstate system, a contention that it seeks to support by pointing to statements in our opinion in

[12] 390 U.S. 207 (1968).

[13] Section 1(b) (2) of the Act specifies the "restraint of free and independent competition" in transactions by subsidiary public-utlity companies as one of the abuses or "evils" to which the Act was directed. Section 1(c) requires that the provisions of the Act be interpreted so as to meet the problems and eliminate the evils enumerated in Section 1(b).

[14] 390 U.S. at 210.

[15] *S.E.C.* v. *New England Electric System*, 384 U.S. 176, 184, n. 15 (1966).

the NEES case to the effect that the Act did not express a Federal policy against combined electric and gas operations as such and was concerned with interstate holding company activities and prescribed tests of retainability within that area.[16]

After careful consideration of the decisions cited and the applicable statutory provisions, we have concluded that approval of the application should be conditioned on divestment of the gas properties. Whatever we said in our opinion in the NEES case, the Supreme Court's pronouncements in that case are now controlling. Aside from the facts that Section 11 draws no distinction between interstate and intrastate holding company systems and that IP's application includes a request for an exemption from registration which would otherwise be required, the Supreme Court's statements in our view reflect an approach to interpretation of the Act in the area of competition between gas and electric companies which transcends the precise issues before the Court in the NEES case.

With respect to our previous decisions permitting combination companies to continue as such after their separation from holding company systems being reorganized under the Act, we recently pointed out that, although compliance with the integration standards of Section 11(b)(1) and the simplification standards of Section 11(b)(2) are of equal importance,[17] there was in those cases a lesser need for insistence on complete integration than on financial reorganization and we did not deem it appropriate to delay the accomplishment of both but exercised our discretion to allow the consummation of plans most closely in conformity with the Act as soon as practicable.[18] Here we are not confronted with a similar choice as between statutory objectives.

Moreover, we consider it a pertinent factor that IP and CIPS are engaged as independent companies in combined intrastate gas and electric operations as a result of prior action by us involving the breakup of registered interstate holding com-

[16] 41 S.E.C. 888, 902-3 (1964).

[17] Section 11(b) (2) of the Act requires a registered holding company and its subsidiaries to take steps "to ensure that the corporate structure or continued existence of any company in the holding-company system does not unduly or unnecessarily complicate the structure, or unfairly or inequitably distribute voting power among security holders," of such system.

[18] *Pennzoil Company*, 43 S.E.C. 709, 719-21 (1968). See also *Public Service Corporation of New Jersey*, 27 S.E.C. 682 (1948).

pany systems to which they formerly belonged.[19] We focused at that time on the simplification or integration of the systems as a whole and permitted component companies to emerge as combined gas and electric companies.[20] Our prior action did not, however, terminate our continuing concern with the nature of such companies as they affect investors and consumers. And, notwithstanding their intrastate status, they are of course subject to the acquisition provisions of the Act. In our opinion, the present proposal to consolidate the operations of two such companies goes beyond what was contemplated when they left interstate systems and represents a step in the direction of re-creating conditions which the Act was designed to eliminate.

Turning to the issues raised under Section 10, we find on the record before us that, in light of the substantial nature of the gas businesses involved and the Supreme Court's decision reading the statute in favor of competition between electric and gas utilities, the proposed acquisition would be detrimental to the carrying out of the integration provisions of Section 11(b)(1), the test contained in Section 10(c)(1). Accordingly, unless an intrastate exemption under Section 3(a)(1) is available, approval of such acquisition can be granted only on condition that the gas properties be divested. In view of our conclusion, we need not consider whether, as urged by the Division, divestment of the gas properties as a condition to approval is also required by Sections 10(c)(2) and 10(b)(1).[21]

We further conclude that no Section 3(a)(1) exemption is appropriate without provision for divestment of the gas properties. The Supreme Court's emphasis on competition between gas and electric operations is in our opinion highly pertinent in determining under the "unless and except" clause of Section 3(a) whether a Section 3(a)(1) exemption would not be detrimental to the public interest or the interest of consumers. Where, as here, the issue is whether we should permit the

[19] As to IP, see *The North American Company*, 26 S.E.C. 169 (1947), *approved and enforced*, 74 F. Supp. 317 (D.C. Del., 1947), *aff'd*, 170 F.2d 924 (C.A. 3, 1948); *The North American Company*, Holding Company Act Release No. 9151 (June 9, 1949). As to CIPS, see *The Middle West Corporation*, Holding Company Act Release No. 7986 (February 24, 1948), referring to order entered on January 23, 1948.

[20] We permitted CIP'S stock to be distributed by its then parent company, The Middle West Corporation, to Middle West's stockholders as a partial liquidating dividend, as part of a program of dissolution by Middle West. Proceedings under Section 11(b) (1) were pending as to Middle West at that time, in which issues had been raised regarding the retainability of its interest in CIPS. See *Central Illinois Public Service Company*, 27 S.E.C. 414, 421 (1947).

[21] We make no adverse findings under Section 10(b) (1) with respect to the elimination of competition by the proposed acquisition as between the electric businesses of IP and CIPS, since there does not appear to be any substantial competition between them. In addition, the competitive position of the combined enterprise vis-a-vis certain large neighboring utilities in regard to the negotiation of interchange agreements would be stronger than than of IP and CIPS separately.

consolidation and therefore enlargement of combined operations and the creation of what would in substance represent a new holding company system consisting of two combination companies, we think the Court's statements require denial of an exemption. We have in the past pointed out that it is "highly unrealistic" to expect "vital competition between the two types of service when controlled by the same interest."[22] While the record before us shows that the gas business of both IP and CIPS has grown significantly in recent years, it seems clear that true competition with its attendant advantages could be achieved only by a separation of the electric and gas businesses.[23]

In reaching our conclusion under Section 3(a), we have considered the various problems and adverse consequences which IP asserts would inhere in or result from divestment of the gas properties.[24] We cannot find, however, that these problems outweigh the anti-competitive considerations discussed above.

Nor do we consider that our findings under Sections 10(c)(1) and 3(a) are inconsistent with the terms or intent of Section 8 of the Act. IP refers to our decision in *Northern States Power Company*[25] where, in granting an exemption application under Section 3(a)(2) by a combination holding company, we noted the statement of the Senate Committee on Interstate Commerce, in its comments on Section 8, that competition in the field of distribution of gas and electric energy was "essentially a question of State policy," [26] and we stated that the conclusion of the local authorities should be given great weight in determining whether the public interest would be adversely affected by the retention of combined operations. Subsequently,

[22] *The North American Company*, 18 S.E.C. 611, 621 (1945). See also *The North American Company*, 32 S.E.C. 169, 179-180 (1950), where we referred to "the inevitable tendency of joint control over gas and electric businesses to stifle the natural competitive features of these enterprises by the favoring of that business in which the controlling company is most interested and which is most profitable" and "the substantial benefits which . . . accrue from healthy and agressive competition between gas and electric systems."

[23] This conclusion finds support in the testimony of IP's board chairman that in an area where IP sells both fuels, he considered that it had an obligation to its stockholders to promote the use of that fuel resulting in the largest net return.

[24] Among the problems cited by IP are the requirement under the companies' mortgage indentures for deposit, in cash or eligible property, of the greater of the fair value of gas properties or the consideration received for them in order to obtain their release from the mortgage lien, the income tax consequences, the capital needs of a new gas company, and increased gas operating costs. IP recognized, however, that the value of any offsetting benefits might have to be taken into account in the event a specific proposal were made providing for divestment of the gas properties. IP also asserted that while "theoretically" and apart from feasibility a Section 11(e) plan might avoid or minimize a number of the problems, increased operating costs would still result from segregation of the electric and gas properties.

[25] 36 S.E.C. 1, 8 (1954).

[26] S. Rep. 621, 74th Cong., 1st Sess. (1935), p. 29.

however, the Supreme Court, in its first NEES decision, declared that there was no warrant for concluding that Section 8 was the exclusive legislative effort relating to the problem of electric-gas competition.[27] And in our opinion in the NEES case, we held that while the views of interested regulatory authorities should be considered, the statutory pattern did not contemplate that the standards of Section 11 should yield to the views of local authorities whenever gas and electric properties were involved. We pointed out that Section 8 merely served "to prevent circumvention of express State restrictions against . . . acquisitions [of gas and electric properties] by imposing a condition of State approval even though acquisitions are otherwise permissible under the standards of the Act . . . and must be read together with the provisions of Sections 9 and 10 which impose other conditions to acquisitions that apply even if all State laws are met and which are directed toward and embrace the standards of Section 11." [28]

ISSUES WITH RESPECT TO CIPS PREFERRED STOCK

Participants, who as noted are holders of CIPS preferred stock, contend that it would be inconsistent with the standards of the Act to permit IP to acquire CIPS common stock while leaving the preferred stock outstanding. They urge that the application should either be denied or conditioned on elimination of the preferred stock through redemption, exchange for IP common or preferred stock, merger of the two companies, or otherwise.

CIPS presently has outstanding 10,390,800 shares of common stock and 375,000 shares of cumulative preferred stock which consists of five series with dividend rates ranging from 4 percent to 5.16 percent.[29] As required by Illinois constitutional and statutory provisions,[30] CIPS' preferred stock has equal voting rights with the common in the election of directors,[31] giving it 3.5 percent of the total voting power. It represents 12.5 percent of CIPS' capitalization including long-term debt,

[27] 384 U.S. at 183–184, n. 13.

[28] 41 S.E.C. at 902.

We do not consider it necessary at this time to determine whether the consideration to be given in connection with the proposed acquisition is unreasonble or unfair within the meaning of Section 10(b) (2) of the Act. If and when IP amends its application to include a plan for divestment of the gas properties, a different exchange offer may be presented and, in any event, further consideration of the questions of reasonableness and fairness may be required. We note that an indepenent expert retained by both IP and CIPS to consider those questions testified that his conclusion that the proposed exchange offer was fair and reasonable would not stand if divestment were ordered.

[29] Participants own about 75,000 shares and three institutional holders of preferred which have indicated opposition to the application own 97,000 shares.

[30] Ill. Const., Art. 11, § 3; Ill. Rev. Stat. 1967. ch. 32 § 157.28.

[31] The preferred stock is also entitled to vote as a class on certain matters such as merger.

and about 26 percent of the book equity which comprises common and preferred stock and retained earnings.

Participants contend that the continued existence of the voting preferred stock following the proposed acquisition would violate the standards of Sections 10(b)(3), 10(c)(1) and 11(b)(2) of the Act, in that it would constitute an undue complexity in the capital structure of IP's holding-company system and result in an inequitable distribution of voting power. IP, supported by the Division, opposes the imposition of any condition with respect to the preferred stock, urging that participants' arguments provide no basis under the Act for requiring that such stock be eliminated.

It is well established that the existence of a publicly-held minority interest in the common stock of one or more subsidiaries of an integrated holding-company system constitutes an inequitable distribution of voting power, and that the elimination of such an interest is required by Section 11(b)(2).[32] IP argues that the voting rights possessed by CIPS preferred stock because of state law should not entitle such stock to be treated the same as common stock or differently from the non-voting preferred stocks for which no provision was made in Section 11 plans eliminating the common.[33] Participants, on the other hand, assert that the determinative element is the existence of voting power in the CIPS preferred stock. They cite *Utah Power and Light Company*,[34] which involved the proposed acquisition by a holding company of all the outstanding common and voting second preferred stock of a public-utility company. We held in that case that if less than all the voting shares were acquired, an inequitable distribution of voting power by reason of the existence of the publicly held minority interests would exist contrary to the standards of Section 11(b)(2).

We agree with IP and the Division that the *Utah Power* case does not require elimination of the CIPS preferred stock. The second preferred stock in that case was a hybrid security with more characteristics of a common than a preferred stock. The CIPS preferred stock is more analogous to the non-voting first preferred in the *Utah Power* case which was permitted to remain outstanding. The junior preferred stock there had a $1 par value as compared to the $100 par value of the senior preferred, and had about 56 percent of the voting power

[32] See, *e.g.*, *Eastern Utilities Associates*, 43 S.E.C. 243 (1967) and cases cited therein at Note 2.

[33] See, *e.g.*, *Eastern Utilities Associates*, *supra*; *New Orleans Public Service, Inc.*, 40 S.E.C. 886 (1961).

[34] 38 S.E.C. 358, 366 (1958).

although it represented only 18.5 percent of capitalization as compared to the 24.7 percent of capitalization represented by the common stock.[35]

Participants further contend that if the proposed acquisition is consummated, there will be many conflicts of interest between IP and CIPS which will be resolved in the interests of the consolidated enterprise and adversely to the separate interests of CIPS and its preferred stockholders. They argue, among other things, that the management of IP will be tempted to concentrate available capital in, and effect capital financing through, IP, and that the result will be stagnation of growth of CIPS and gradual reduction of its fixed assets and a weakening of the preferred stock. Participants further assert that because of the danger of abuse of the control relationship, including the possibility that IP might find it advantageous to withhold dividend payments on the CIPS preferred stock, and the extinguishment of CIPS' common stock as a medium of public investment, the value of the preferred stock would be impaired.

In our opinion the ability of IP to resolve conflicts in a manner harmful to the interests of CIPS preferred stockholders following the proposed acquisition of CIPS stock subject to the gas divestment condition we will impose would be a limited one. It would be restricted both by regulatory limitations[36] and economic considerations. In view of the magnitude of IP's investment in CIPS, the likelihood that CIPS' assets or business will be permitted to deteriorate to an extent which would jeopardize the interests of the CIPS preferred stock seems to us remote.[37] The types of conflicts envisaged by participants are comparable to the differences in interest which exist as between companies in any integrated system, and, as noted, we have not in the past considered the elimination of preferred

[35] Participants also urge, as another ground for distinguishing prior cases where no provision was made for the outstanding preferred stock, that they involved parents which were soley holding companies whereas here the parent and its subsidiary would both be operating companies. However, as previously mentioned, in the *Utah Power* case, which involved a holding company which was also an operating company, we permitted the first preferred stock of the subsidiary to remain outstanding following acquisition by the holding company of the common and second preferred stock. Moreover, in at least some of the cases in question, the subsidiaries with preferred stock dealt with other subsidiaries in the system so that the operating relationships were comparable to those between a holding-operating company and its operating subsidiary.

[36] IP points out, among other things, that the Illinois Commerce Commission would not permit either IP or CIPS to provide service in areas served by the other company and that acquisitions of utility properties and transfers of customer would be subject to the jurisdiction of that commission or the Federal Power Commission or both.

[37] For the 12 months ended April 30, 1968, on a pro forma basis assuming consummation of the exchange offer, combined fixed charges and preferred dividend requirements were covered 3.70 times after provision for Federal income taxes, as compared to an actual coverage for CIPS of 3.24 times.

stock of subsidiaries in such systems to be required, deeming that adequate safeguards were afforded by the dividend and liquidation preferences and other protective provisions that are applicable to such stock.[38]

The record does not support participants' assertion that the proposed acquisition would result in impairment of the value of the CIPS preferred stock. The evidence presented by participants in this regard is in our opinion speculative in nature and is outweighed by the testimony of IP's expert witness that, on the basis of his own experience in the underwriting of utility preferred stock and a study of specific offerings, he considered that CIPS preferred stock, which is not convertible, would not be discounted by virtue of IP's acquisition of the junior equity security.[39]

Finally, it seems to us extremely unlikely that notwithstanding the availaility of funds IP would resort to a deliberate interruption or withholding of dividends on the CIPS preferred stock in order to use the funds for property additions. Aside from the fact that the non-payment of preferred dividends would also preclude dividends on the CIPS common stock, thereby depleting IP's cash resources, a deferral policy would according to IP's witnesses have a disastrous effect on the credit standing and reputation of both IP and CIPS and would seriously impair their financing capability. Even participants' expert witnesses acknowledged that such a course of action would be improper and would not be pursued by a responsible management.

In view of the remoteness of the possibility that IP would act in such a manner or that dividends will be extensively interrupted because of financial necessity, we do not consider material the fact, pointed to by participants, that CIPS preferred stock does not have the right, which is specified in our Statement of Policy with respect to preferred stock, to elect a majority of the board of directors in the event of arrears equal to one year's dividends until such time as all arrears have been

[38] Under CIPS' charter, preferred stockholders are entitled to cumulative dividends payable before any dividends are paid on common stock and, in the event of liquidation, dissolution or winding up, must be paid par value plus accrued dividends before any payment is made to common stockholders. Other provisions of the charter, by requiring the affirmative vote of holders of two-third of the outstanding preferred stock for certain corporate acts, afford additional protection against dilution of the security and rights of the preferred stock.

[39] There appears to be no basis for the contention made by participants that there would be a reduction in the amount of available information about CIPS. Moody's Public Utility Manual, which publishes comprehensive information about public-utility companies, contains equally detailed information about independent operating companies and subsidiaries of holding companies. And the record shows that CIPS intends to continue its present distribution of information through annual and other reports.

paid.[40] Should it appear in the future that the payment of dividends to CIPS preferred stockholders is seriously jeopardized as a result of actions taken by IP or CIPS, we could then consider, pursuant to Section 3(c) of the Act, whether there existed a change of circumstances adverse to the interests of those investors warranting revocation of our order exempting IP or imposition of appropriate conditions for continuance of the exemption.[41]

CONCLUSION

In view of the foregoing, we shall enter an order approving the proposed acquisition of CIPS common stock by IP and continuing IP's present exemption under Section 3(a)(1) on condition that appropriate provision is made for the divestment of the gas properties of IP and CIPS. We shall reserve jurisdiction to pass upon the fairness of the terms of the acquisition and upon the terms of such divestment.[42]

By the Commission (Chairman BUDGE and Commissioners OWENS and SMITH), Commissioners NEEDHAM and HERLONG not participating.

[40] Because, as noted, Illinois law provides that all shares of stock are entitled to vote equally for directors, we did not deem it "practicable" to require the adoption of such a provision when we authorized the issuance of CIPS preferred stock. *Central Illinois Public Service Company*, 24 S.E.C. 163, 170-71 (1946).

[41] In accordance with the pooling-of-interests concept of accounting, IP proposes to record its investment in the common stock of CIPS at an amount equal to the underlying book value of such stock as shown on CIPS' balance sheet as of the date of acquisition. IP would credit its capital share account in an amount equal to the stated value of the CIPS common stock and its retained earnings account in an amount equal to the sum shown in the CIPS retained earaings account. We have considered participants' contention that IP's investment should properly be record on IP's books at the market value of IP's stock issued in exchange for CIPS common stock. However, we are of the opinion that the accounting treatment proposed by IP is consistent with generally accepted accounting principles.

[42] The companies may appropriately determine the nature and timing of any steps to be taken with respect to the acquisition of CIPS stock and the divestment of the gas properties in light of pertinent financial and money-market conditions. The reasonable flexibility available to the companies would thus not foreclose the selection of a program entailing more than one stage in the interests of feasibility and fairness to all concerned.

In the Matter of

M. G. DAVIS & COMPANY, INC., ET AL.*

File No. 3–250. Promulgated January 9, 1970

Securities Exchange Act of 1934—Section 15(b)

BROKER-DEALER PROCEEDINGS

Where, in connection with offer and sale of securities, registered broker-dealer and salesmen made misleading representations and predictions and distributed market letter containing misrepresentations concerning, among other things, increases in price of stock, issuer's financial condition, earnings and sales, merger with and acquisition of other companies, and listing on a securities exchange, *held*, in public interest to revoke broker-dealer registration and to bar individuals from association with any broker-dealer without prejudice to application for supervised association after stated periods.

APPEARANCES:

Charles Snow, *Mortimer Gerber*, *Morris Rosenzweig*, *Dennis J. Block* and *Lawrence Jaffe*, of the New York Regional Office, for the Division of Trading and Markets of the Commission.

Seymour Kleinman, of Golenbock & Barell, for M. G. Davis & Co., Inc., Lawrence Levine, Walter Wax and Morris Kopel.

Stanley Kligfeld, for Harold R. Rosenberg.

*Lawrence Levine, Walter Wax, Morris Kopel, and Harold R. Rosenberg.

FINDINGS AND OPINION OF THE COMMISSION

The hearing examiner filed an initial decision in these proceedings in which he concluded pursuant to Section 15(b) of the Securities Exchange Act of 1934 that the registration as a broker-dealer of M. G. Davis & Co., Inc. ("registrant") should be revoked and that Lawrence Levine, Walter Wax, Morris Kopel and Harold R. Rosenberg should be barred from association with any broker-dealer.[1] We granted a petition for review filed by respondents, briefs were filed, and we heard oral

[1] Previously we had accepted offers of settlement, pursuant to which the broker-dealer registration of Crerie & Co., Inc. and the investment adviser registration of Mario Trombone Associates, Inc. were withdrawn, and Frank H. Crerie and Mario Trombone were prohibited from engaging in the securities business or becoming associated with a broker-dealer or an investment adviser without our prior permission or until the expiration of the specific period. Securities Exchange Act Releases Nos. 8288 and 8327 (April 2 and June 6 1968).

argument. After an independent review of the record, we agree with the findings and conclusions of the hearing examiner and we adopt the detailed findings set forth in his initial decision except to the extent we indicate otherwise in this opinion.

As the hearing examiner found, registrant in the period from about July to about November 1963 offered and sold about 37,000 shares of common stock of The Cosnat Corporation to approximately 150 public investors. Levine and Wax had become officers, directors and the sole stockholders of registrant in June 1963, and Kopel and Rosenberg were registered representatives who participated in the offer and sale of Cosnat shares.

Cosnat had been organized in 1960 to acquire a phonograph record distributing business which had been started in 1946. Early in 1961, Cosnat acquired three companies, the Monarch Record Group ("Monarch"), which had manufactured records for label owners since 1945, and late in that year acquired an affiliate which had been producing its own records since 1945. Levine had been acquainted with Jerry Blaine, president of Cosnat, prior to these acquisitions, and he assisted Blaine in the Monarch acquisition and was compensated therefor by Blaine.

To finance the Monarch acquisition Cosnat found it necessary to borrow large sums from factors at interest rates of 10 to 15 percent and secured by a pledge of its accounts receivable. Blaine with the assistance of Levine sought to obtain funds at a lower cost to refund that indebtedness, which by June 1962 totalled almost $1,500,000. To this end, Cosnat in May 1961 filed a registration statement under the Securities Act of 1933, which as amended proposed a public offering through underwriters of $1,250,000 face amount of 6 percent convertible subordinated debentures. The proposed offering was abandoned, however, and the registration statement was withdrawn in March 1963. Subsequently, other efforts during 1963 by Cosnat to obtain financing to replace the high interest loans were also unsuccessful.

Around July 1963, persons other than the instant respondents prepared a market letter concerning Cosnat, referred to as the Crerie Report. Levine furnished a copy of an earlier analysis of Cosnat called the Meade Report to Crerie for use in preparation of the Crerie Report, read the Crerie Report in draft, and commented thereon. Registrant obtained copies of this report for use by its salesmen in recommending Cosnat stock, and copies were distributed to customers and prospective customers. As the hearing examinei found, the Crerie Report contained material misrepresentations regarding, among other things, Cosnat's negotiations to merge with or acquire other companies and to refund its existing debt, and its sales and earnings.

The Crerie Report stated that negotiations were in progress for the acquisition of three other companies in the record or related fields which if successful would enable Cosnat to increase its sales to $16 million plus, that negotiations were also underway to refund some of the existing debt with an institutional loan which could substantially reduce expenses, and that should the negotiations in progress prove successful Cosnat believed it could earn at the rate of $1 a share during the ensuing year.

In fact, the negotiations with the three other companies consisted principally of expressions of Cosnat's desire for a merger or acquisition, which representatives of the other companies testified Blaine had expressed on various occasions in prior years without any success. A meeting initiated by Blaine was held in May 1963 with principal officers of those companies, at which there was no discussion of or agreement as to terms of any merger and nothing was committed to writing. The only thing accomplished was that each company agreed to submit financial statements to Cosnat's accountants so that the latter could formulate a pro forma financial statement. It was understood that any merger or acquisition would first require that Cosnat secure a firm commitment for a long term loan of $1,500,000 to refinance its existing high interest indebtedness to factors. Cosnat had discussions with a member firm of the New York Stock Exchange, seeking the assistance of that firm to secure the needed funds from an institutional lender. In these discussions Cosnat was advised that any such financing was contingent on certain conditions including that there be a merger with the three other companies. No substantiation of the prospects of any merger were ever submitted by Cosnat, and no proposal on behalf of Cosnat was submitted by the exchange member to any institutional lender.

We agree with the hearing examiner's conclusion that the statements in the Crerie Report that negotiations were "in progress" or "underway" for the acquisition of three companies and for a refunding of Cosnat's existing debt which if successful would enable Cosnat to increase sales to $16 million plus and to earn at the rate of $1 per share were a gross exaggeration of the facts and misleading to prospective purchasers of Cosnat stock. The reference to possible earnings of $1 per share was doubly misleading, since it was founded on the assumption that a merger would take place, yet was computed on the number of Cosnat shares then outstanding although all the indications were that if a merger were to take place, the number of shares in the merged company would far exceed the existing Cosnat shares with a consequent substantial dilution of the earnings per share.

The Crerie Report also included statements that Cosnat's net income after taxes for the fiscal year ended September 30, 1962 and the six months ended March 31, 1963 was $162,000 and $143,000, respectively, and that earnings per share for such periods were 39 cents and 31 cents, respectively. These statements were materially misleading, as the examiner found, because they did not reflect deductions from net income for non-recurring special items, representing principally expenses of the abortive registration statement filed in 1961 and withdrawn in 1963. Such special items amounted to $41,528 for the 1962 fiscal year period and $104,500 for the six months period ended March 31, 1963. Net income after deduction of such special items would have been 29 cents per share instead of 39 cents for the year period, and only 8 cents per share instead of 31 cents for the six months period. The misleading nature of the earnings figures resulting from the failure to reflect the special items expenses was compounded by the statement in the Crerie Report that the "earnings" of 39 cents per share in 1962 were achieved "despite the heavy cost (estimated as $150,000)" of the abortive effort to make a public offering of convertible debentures. This statement falsely implied that the net income figure of $162,000 was after a deduction of $150,000, absent which net income would have been $312,000 or 74 cents a share.

The Crerie Report was incorrect and misleading in various other respects. For example, it stated that Monarch owned two plants in California with a combined capacity for pressing 6 million records per month. Blaine testified that in July 1963 Monarch's capacity was from 3 to 4 million units per month, and an amendment of September 1962 to Cosnat's abortive registration statement recited that the company had a capacity of slightly more than 2 million records per month. The Report further stated that an exclusive one-year contract to supply records to the General Service Administration was expected to add at least $2 million in sales. The General Services Administration had estimated purchases expected under the contract at only about $200,000. The Report also stated Cosnat had entered into the field of film production and that a movie starring a leading actor was going into production November 10 at the studios of a well-known company which would also distribute Cosnat's first two movies. In fact, the actor was never under a commitment to Cosnat, nor was there any commitment for the movie company to produce or distribute Cosnat's pictures. At another point the Crerie Report stated that Cosnat had record distribution centers in various cities and that "additional distribution centers are in the planning stage." In fact, some of the distribution centers had been losing money and three of them were being closed out.

As the hearing examiner further found, respondents Kopel and Rosenberg repeated to customers and embellished the misrepresentations of the Crerie Report and made further misrepresentations in connection with their sales of Cosnat stock. Three customers testified to having purchased Cosnat stock through Kopel, and three others through Rosenberg. All six customers stated that they had been told that the Cosnat stock was going to be or would probably be listed on a national securities exchange. All six customers witnesses, who had made purchases at prices ranging from $4\frac{1}{2}$ to $8\frac{3}{8}$ per share, also testified that Kopel or Rosenberg had represented that the price of the Cosnat stock would rise rapidly, such representations ranging from statements that the price could possibly rise 4 or 5 points in a year to statements that it could or would double or triple or quadruple within six months.

These representations and predictions, as well as those in the Crerie Report previously discussed, were without reasonable basis. There was no indication that Cosnat stock could satisfy listing requirements and in fact no application for listing on an exchange had been filed. And as we have frequently held, predictions of substantial price increases within relatively short periods of time with respect to a speculative security are inherently fraudulent whether expressed in terms or opinion or fact.[2]

Respondents have contended that they reasonably believed the representations in the Crerie Report and other material emanating from Cosnat. As the hearing examiner found, however, a reasonable investigation of the representations in the Crerie Report would have disclosed that they were materially

[2] See, *e.g.*, *Cortlandt Investing Corporation*, 44 S.E.C. 45 (1969); *Martin A. Fleishman*, 43 S.E.C. 314, 320 (1966) and cases there cited.

misleading. Levine was in a position to look behind the self-serving statements of management. The respondents themselves requested, and the hearing examiner made, the following finding:

> "During the course of the long standing and still-continuing relationship between Levine and Cosnat, 'virtually every aspect of the company's operations was discussed' and Levine attended and participated in many conferences of Cosnat officials, including its general counsel, auditors and other executive officers."

Through his personal participation in some of the events Levine was familiar with the facts relating to the acquisition of the Monarch Group in 1961 and its financing and the abortive and costly efforts to alleviate the attendant expense by a public offering of securities and the difficulties encountered in seeking a private refinancing or a merger with other companies. He should have realized that further inquiries were needed before recommending the Cosnat stock on the basis of optimistic references in the Crerie Report and Cosnat's releases to the benefits to be gained if merger negotiations were successful.

Levine admittedly saw the Special Items deductions in certified financial statements for 1962 prepared by Cosnat's independent public accountants, which were included in Cosnat's 1962 report. Those statements showed the deductions and net income figures reflecting them without any per share earnings computations. Levine testified that since this treatment of the Special Items was at variance with that in the president's letter which immediately preceded the certified financial statements in the report, which gave earnings figures for 1962 equivalent to 39c a share that did not reflect the special items and were the same as those in the Crerie Report, Levine consulted with an accountant friend. He stated that the latter told him there were two schools of thought, one of which considered it proper to treat non-recurring items differently than other items and that he accordingly did not question the Crerie Report's failure to reflect non-recurring expenses in the 1962 earnings figures. He did not, however, consult Cosnat's auditors, who testified in these proceedings that they considered it improper and misleading to show net income and per share earnings without showing the special items deductions and that they did not prepare any statements that failed to reflect such deductions. It is clear that Levine accepted both the year figure of 39c per share and the 31c per share six months figure because these figures were the ones used by

Cosnat, notwithstanding his awareness that the 1962 figures did not rerflect the special items deductions. He was not justified in doing so and should at the least have checked with the independent accountants whose financial statements were at variance with them.

We conclude that registrant could not reasonably accept all of the statements in the Crerie Report without further investigation. In recommending the purchase of Cosnat stock on the basis of such Report without further inquiry, registrant and its controlling officers, directors and stockholders, Levine and Wax, willfully violated and aided and abetted violations of Section 17(a) of the Securities Act and Sections 10(b) and 15(c)(1) of the Exchange Act and Rules 17 CFR 240.10b–5 and 15c1–2 thereunder.

We further conclude that Kopel and Rosenberg also willfully violated and aided and abetted violations of the antifraud provisions cited above. Even assuming that there may have been some basis for reliance by Kopel and Rosenberg on the Crerie Report and other Cosnat reports and releases, it is clear that at the least the representations by Kopel and Rosenberg concerning price increases went beyond and cannot be justified by the information emanating from Cosnat. In any event, as we have already noted, such predictions are inherently deceptive and violative of the antifraud provisions. There was no rebuttal or denial of the testimony of the customer-witnesses regarding such price predictions except the testimony of Wax that he monitored salesmen's telephone conversations and heard no such price predictions made, and the testimony of two other salesmen, not respondents herein, that they heard no improper sales representations except in the case of another salesman who was dismissed by registrant after it was reported to Wax that such salesman had made unwarranted representations. The hearing examiner credited the testimony of the customer-witnesses and we see no reason to reach a different conclusion.

OTHERS MATTERS

Respondents contend that they were denied due process in that they were deprived of access to records with which they claim they could have shown that they exercised "due diligence" in connection with their recommendation of Cosnat stock. In 1963 records of registrant and Levine and various other persons relating to Cosnat were subpoened by the Office of the Attorney General of the State of New York, and respondents assert that among registrant's records so taken was a "due diligence" file on Cosnat which was not returned despite repeated requests.[3] Counsel for respondents have stated that they were informed by that Office that the records were put into a master file and not segregated according to source, and that respondents could have access only to material obtained from them, of which no list had been made and some of which had been returned, and could not examine the materials in that Office's possession to identify which was theirs.[4]

Levine testified that the "due diligence" file contained annual reports, financial statements, financial releases by Cosnat's public relations firm, memoranda of notes concerning conversations between himself and the president and other officials of Cosnat, and "everything that was available [relating to Cosnat] that I was able to get my hands on." Most of these records, however, were introduced in evidence in these proceedings and so were available for use in respondents' defense. Thus, exhibits in the record herein, some of which were offered in evidence by respondents, include copies of Cosnat's annual reports for fiscal years 1961 through 1964; copies of two 1963 special Cosnat reports to shareholders; copies of four 1963 press releases issued on behalf of Cosnat by its public relations firm; and copies of various financial reports prepared for Cosnat by its independent public accountants, including certified statements for the fiscal year 1962, interim statements for the six months ended March 31, 1963, and pro forma uncertified statements giving effect to a proposed merger of Cosnat with three other companies and receipt of a loan to pay off existing notes. Included also among the exhibits are copies of the earlier analysis of Cosnat called the Meade Report which served as a basis for the preparation of the Crerie Report and which Levine testified he had in his Cosnat "due diligence" file and furnished to Crerie for use in preparing the Crerie Report; copies of drafts of the Crerie Report and of the final such report; and copies of a reprint of such report in a financial magazine.

[3] There is no contention that any member of our staff in any way supressed or deprived respondents of their records.

[4] It appears that, aside from the "due diligence" file, substantially all of the registrant's records were returned to it. Registrant's former bookkeeper testified that he obtained the return of some of registrant's books shortly after they were turned over to the State Attorney General's Office and was almost sure he received back all books except the blotters which he was told could not be located. Presumably the blotters were later found, because they were physically present at the hearings in the instant proceedings in the custody of a representative of the State Attorney General and available for examination by respondents.

Levine did not point to or identify any particular memorandum of discussions with associates or accountants of Cosnat as having been included in the "due diligence" file[5] and he himself testified extensively in these proceedings as to discussions and conferences concerning Cosnat in which he participated, as did Blaine and the Cosnat employee in charge of marketing, and three representatives of Cosnat's accounting firm.

Our findings of violations are not affected even accepting the assertion that registrant's "due diligence" file contained material with the same statements as appeared in reports to stockholders and press releases issued by Cosnat and the assertion that Levine received similar reports and representations orally from Blaine and associates in Cosnat. Those reports and releases stated that Cosnat's net income for 1962 was 39 cents a share and for the six months ended March 31, 1963 was 31 cents a share, that the General Services Administration contract would lead to at least $2 million in additional annual sales, that if negotiations in process were successful sales could increase over the $15 million mark, and that Blaine stated Cosnat would shortly be initiating steps to apply for listing on one of the major stock exchanges. As indicated above, however, we have found that Levine could not reasonably rely on such reports in view of his knowledge of adverse facts.

Accordingly, we conclude that any inability to regain possession of the contents of the "due diligence" file cannot properly be viewed as prejudicial, and we agree with the hearing examiner that respondents were not denied due process in respect to it.

Respondents have further contended that they were prejudiced by the examiner's refusal to allow them to call as witnesses a large number of persons who purchased Cosnat stock from or through registrant. Respondents made an offer of proof that they could call 47 former customers of registrant

[5] Respondents at no time took any formal legal steps to obtain the return of or subpoena records delivered by them to the State Attorney General in 1963. Respondents were advised by representatives of the State Attorney General several times during the course of the hearings herein, which began on December 20, 1966, that respondents and their counsel could examine any material which had been received from them provided such material remaind in the custody of the State Attorney General. None of the respondents made any effort to do so during the pendency of these proceedings, however, until June 19, 1968, the day before the close of the hearings herein, when according to respondents' counsel, he and Levine went to the Office of the State Attorney General and asked to examine records taken from registrant, specifically referring to a due diligence file but not specifically asking for any memoranda prepared by Levine. Counsel stated that a respresentative of the State Attorney General went through some files seeking to identify material belonging to registrant, and produced a few documents of no importance, not including a "due diligence" file nor any memoranda by Levine.

who would testify that they purchased Cosnat stock on the recommendation of registrant's salesmen, that they received the Crerie Report, and that the representatives of registrant made no misleading representations, excessive claims, or predictions of price rise.

In our opinion, the examiner's refusal to allow the presentation of this large number of additional witnesses was not error.[6] As the examiner pointed out, the testimony of additional witnesses that in connection with purchases of Cosnat stock they had received copies of the Crerie Report, which has been found to be materially misleading, would have only been cumulative evidence of violations of the antifraud provisions. And the testimony of some customers that other misrepresentations had not been made to them would not negate the testimony of the customers who testified that price predictions had been made to them.[7]

PUBLIC INTEREST

Respondents contend that it is not necessary in the public interest to impose any strict sanctions, and stress their reliance on the information made available through Levine's close and continuing relationship with Cosnat and through the Cosnat reports and releases which publicized the earnings, prospects and plans of Cosnat which was a seasoned company.

In view of Levine's knowledge of Cosnat's financial difficulties arising out of its acquisition of the Monarch group, he acted improperly in distributing to registrant's salesmen and customers and to other broker-dealers copies of the Crerie Report which failed to point out those difficulties.[8] Moreover, although he was aware that the earnings figure of 39 cents per share for the fiscal year 1962 used in that report did not reflect the special item deduction appearing in Cosnat's certified financial statements and was of questionable propriety, he did not, as has been noted, make any inquiry of the independent public accountants, and he either ignored or overlooked the further misleading statement in the Crerie Report implying that the 1962 earnings figure did reflect an even larger special item deduction.

[6] The examiner had allowed respondents to present testimony, similar to that proffered, of four former customers.

[7] *Alexander Reid & Co., Inc.*, 40 S.E.C. 986, 993 (1962).

[8] While registrant and its salesmen were recommending the purchase of Cosnat stock, four Cosnat employees, including its secretary and its sales manager, were selling an aggregate of approximately 21,800 shares of Cosnat stock. The record does not show the reasons for these sales; there is no evidence in the record that Levine, who was aware of these sales, brought them to the attention of registrant's salesmen or instructed the salesmen to inform customers of such insiders' sales.

Wax, who was registrant's sales manager, testified that he accepted Levine's assurance that he had verified the statements in the Crerie Report, that he made the report available to salesmen with the instruction that they confine their representations in selling Cosnat shares to the information in the report, and that he took measures including monitoring salesmen's telephone conversations to prevent any misrepresentations. However, in his position of officer and director of registrant who with Levine owned all its stock, whatever may have been his understanding with Levine of the division of functions, Wax cannot escape responsibility for the use of a materially misleading market letter as a major selling tool.[9] Moreover, apart from such knowledge of Cosnat's affairs as he acquired from discussions with Levine, Wax could have himself sought to compare the earnings figures in the Crerie Report against the company's certified financial statements which were available to him.

With respect to Kopel and Rosenberg, whatever justification there may have been for relying on public statements coming from Cosnat and on Levine's close relationship with Cosnat, the price predictions they made to customers went beyond the information given to them and in any event cannot be condoned.

We have taken into account the factors presented, including the fact that the individual respondents do not appear to have been the subject of any other disciplinary proceedings. In view of the nature of the violations, however, we conclude, as did the hearing examiner, that registrant's registration should be revoked,[10] and that sanctions should be imposed on the individual respondents. We are of the opinion that it is appropriate in the public interest and as a means of protecting investors against a repetition of such conduct, to bar the individual respondents from engaging in the securities business. Nevertheless, the factors listed above have led us to conclude that an application for reentry into the securities business in non-supervisory and supervised capacities would not be inappropriate after the expiration of a period of time. Accordingly, our bar order will be without prejudice to the filing by Levine, after a period of six months, and by Wax, Kopel and Rosenberg, after a period of three months, of an application that they be permitted to become associated with a broker-dealer in

[9] Wax admitted that registrant sold more shares of Cosnat stock than any other security.

[10] Registrant's application to withdraw its registration, filed before the institution of these proceedings, will be denied.

a non-supervisory capacity upon an appropriate showing that they will be adequately supervised.

An appropriate order will issue.[11]

By the Commission (Chairman BUDGE and Commissioners OWENS, SMITH and NEEDHAM), Commissioner HERLONG not participating.

[11] We have considered the initial decision of the hearing examiner and the exceptions thereto, and to whatever extent such exceptions involve issues which are relevant and material to the decision of the case, we have by our Findings and Opinion herein ruled upon them. We hereby expressly sustain such exceptions to the extent that they are in accord with the views set forth herein, and we expressly overrule them to the extent that they are inconsistent with such views.

In the Matter of

TALLEY INDUSTRIES, INC.

File No. 3–1980. Promulgated January 9, 1970

Investment Company Act of 1940—Section 17(b)

TRANSACTIONS BETWEEN AFFILIATED PERSONS

Merger of Affiliates of Investment Company

Where one affiliate of registered investment company proposed to merge with another affiliate on basis of exchange of its shares for those of other affiliate, *held,* approval of merger plan conditioned on its amendment in order to satisfy fairness standard of Section 17(b) of Investment Company Act, so as to provide for issuance to shareholders of non-surviving company of convertible preferred stock with changed conversion rights.

Where one affiliate of registered investment company proposed to merge with another affiliate on basis of exchange of its shares for those of other affiliate, *held,* transaction with respect to investment company constituted "purchase" and "sale" within meaning of Section 17(a) of Investment Company Act even though affiliates neither controlled nor were controlled by such company.

APPEARANCES:

Mahlon F. Perkins, Jr., Walter L. Stratton, Stuart B. Peerce, Roger W. Kapp, and *Steven M. Roth,* of Donovan, Leisure, Newton & Irvine, for Talley Industries, Inc.

William E. Hegarty, R. Anthony Zeiger, and *Lorin S. Weisenfeld,* of Cahill, Gordon, Sonnet, Reindel & Ohl, for General Time Corporation.

Clendon H. Lee, of Rogers, Hoge & Hills, for American Investors Fund, Inc.

William Klein, II and *Joel I. Genzer,* of Austrian, Lance & Stewart, for Mutual Shares Corporation, et al.

Leonard J. Kassel, stockholder of General Time Corporation, *pro se.*

Harold Sweetwood, Donald C. Chumley, and *Anthony A. Vertuno,* for the Division of Corporate Regulation of the Commission.

FINDINGS AND OPINION OF THE COMMISSION

Talley Industries, Inc. ("Industries") has filed an application pursuant to Section 17(b) of the Investment Company Act of 1940 ("Act") for an order exempting from Section 17(a) of the Act certain transactions incident to its proposed merger with General Time Corporation ("GTC"). Industries owns 257,937 shares or about 11 percent of the common stock of GTC. American Investors Fund, Inc. ("AIF"), a registered open-end diversified investment company, owns 210,000 shares or about 9 percent of GTC's stock and 238,051 shares or about 6 percent of Industries' stock. Industries and GTC are therefore each an affiliated person of AIF under the Act, and Industries is also an affiliated person of GTC.[1]

After appropriate notice, a public hearing was held at which GTC and AIF participated in support of the application. Various GTC stockholders appeared or submitted written views in opposition. An initial decision by the hearing examiner was waived and briefs were filed. Upon consideration of the record, we make the following findings.

THE COMPANIES AND TERMS OF MERGER

Industries conducts a diversified manufacturing and distribution business. From its incorporation in 1960, it has been engaged in the manufacture and sale of aircraft, aerospace and solid propellant products, and through fiscal 1967 substantially all of its sales were to the United States Government. In the latter part of that year the company instituted a program of diversification through acquisitions and the internal development of new products. Pursuant to this plan, it acquired 11 companies variously engaged in the aerospace, aircraft, hardware, wearing apparel, electronics, plastics, and metal products fields, as a result of which Industries showed a sharp increase in reported sales and earnings and attained an approximately equal division between military and commercial sales. Industries has also recently developed a process for the fracturing of oil wells and memory devices for the storage of information in computers.

GTC was formed in 1930 to acquire two established clock and watch manufacturers. Its business consists primarily of the manufacture and sale of (1) clocks and watches for consumer

[1] Section 2(a)(3) of the Act defines "affiliated person" of another person as, *inter alia*, "any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person."

use which are sold through a network of wholesalers and about 150,000 retail outlets in the United States and a large number of foreign countries, (2) ordnance and other Government items, and (3) industrial products, including timers and control devices sold to other equipment manufacturers. An important part of GTC's recent business has been the manufacture and sale of artillery shell fuses, and its newly developed commercial products include a plastic clock. In 1967–1968, GTC acquired three small companies to add to its basic capabilities in the timing area.

Industries had outstanding on March 31, 1969 206,983 shares of Series A $1.10 convertible preferred stock and 3,723,114 shares of common stock. No cash dividends have been paid on the common stock since Industries was formed in 1960; and Industries has stated that it has no present intention of declaring any cash dividends on that stock in the foreseeable future. Stock dividends of 3 percent were paid on the common stock in 1967 and 1968. GTC had outstanding on December 31, 1968 2,061,483 shares of common stock, excluding 257,937 shares held by Industries, and 5,395 shares of $4.00 preferred stock each convertible into four shares of common stock. Annual cash dividends have been regularly paid on the common stock, with 80c per share having been paid in 1968, an increase from 50c paid in 1965 through 1967.

Under the terms of the proposed merger Industries will be the surviving company. For each share of GTC common stock the holder will receive one share of new Industries Series B preferred stock convertible at any time after the effective date of the merger into 9/10 of a share of Industries common,[2] or, if he so elects in writing, one share of Industries common stock. Each share of GTC Series A preferred stock will be exchanged for 4 shares of the new Series B preferred stock or, at the holder's option, 4 shares of Industries common.

APPLICABLE STATUTORY STANDARDS

As noted above, Industries is an affiliated person of AIF. Section 17(a) of the Act, in pertinent part, makes it unlawful for an affiliated person of a registered investment company to purchase securities from or sell securities to such company.

[2] Each share of Industries Series B preferred stock would be entitled to preferred cumulative annual dividends of $1 per year and 9/10 of a vote. After 5 years the stock will be redeemable at Industries' option for $52.50 per share, and it will have a voluntary liquidating preference in that amount and an involuntary liquidating preference of $20 per share. Industries' holdings of GTC stock will be converted into an equal number of shares of Industries common and held as treasury stock.

Section 17(b) provides for the granting of an exemption from such prohibitions if evidence establishes, among other things, that "the terms of the proposed transaction, including the consideration to be paid, are reasonable and fair and do not involve overreaching on the part of any person concerned." The proposed merger must accordingly meet the exemptive tests of Section 17(b).

We reject the contention made by Industries, GTC and AIF that the proposed merger, at least in a situation where the investment company does not control and is not controlled by its merging affiliates, does not involve a "purchase" or "sale" within the meaning of Section 17(a) of the Act, and that we therefore have no jurisdiction over it. In *E. I. du Pont de Nemours & Company*,[3] we noted Congress' concern with fair treatment for all security holders in transactions involving investment companies and their affiliated persons, and overruled a prior holding that Section 17 was not applicable to mergers,[4] referring to our experience under the Act which had demonstrated that the prior construction tended to defeat the legislative purpose of Section 17.[5] We also emphasized that the term "affiliated person" within the meaning of that Section refers not only to controlling persons but also to persons having relationships which make the pattern of influence or control more subtle. We deem the proposed acquisition of GTC stock by Industries, a statutory affiliate to AIF, to be a "purchase" [6] and the exchange of its own securities for GTC stock to be a "sale" [7] within the ambit of the Section.[8] Nor do

[3] 34. S.E.C. 531 (1953).

[4] *Phoenix Securities Corporation*, 9 S.E.C. 241 (1941).

[5] 34 S.E.C. at 533–535. We have followed the *Du Pont* decision in subsequent cases. *Capital Administration Company, Ltd.*, 34 S.E.C. 735 (1953); *Atlas Corporation*, 37 S.E.C. 72 (1956); *International Mining Corporation*, 37 S.E.C. 209 (1956); *Century Investors, Inc.*, 40 S.E.C. 319 (1960); *Townsend Corporation of America*, 42 S.E.C. 282 (1964); *Electric Bond and Share Company*, 43 S.E.C. 653 (1967).

[6] Compare the holding of the Supreme Court that an exchange of shares pursuant to a merger constituted a "purchase" within the meaning of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, stating that, "The broad antifraud purposes of the statute and the rule would clearly be furthered by their application to this type of situation." *S.E.C.* v. *National Securities, Inc.*, 393 U.S. 453, 467 (1969).

[7] Section 2(a) (33) of the Act defines a "sale" as including "every . . . disposition of . . . a security . . . for value."

[8] We do not view our power to pass on mergers under Section 17 to be placed in doubt or circumscribed, as suggested by GTC, by the fact that Section 25 of the Act authorizes the Commission in certain circumstances to render advisory reports respecting the fairness of merger plans of investment companies and to seek court injunctions against plans involving gross unfairness, misconduct or abuse of trust. As the Supreme Court recently pointed out in an analogous situation, "The fact that there may well be some overlap of statutory authority is neither unusual nor unfortunate." *S.E.C.* v. *National Securities, Inc., supra*, 393 U.S. at 468. And we have consistently reviewed investment company merges involving affiliated persons under Section 17. See, *e.g., Capital Administration, Ltd., supra; Atlas Corporation, supra; Century Investors, Inc., supra; Townsend Corporation of America, supra; Electric Bond and Share Company, supra.*

we consider that a contrary conclusion is indicated by the decision in *S.E.C.* v. *Sterling Precision Corporation*,[9] which held that the redemption of securities there involved did not constitute a purchase within Section 17. Unlike the instant case, that case concerned the redemption of securities in substantial accordance with their express terms and so understood at the time of their issuance.

1. ALLEGED OVERREACHING

Various GTC stockholders who participated in these proceedings argue that the merger as proposed involves overreaching within the meaning of Section 17(b) because of certain events connected with Industries' acquisition of control of GTC. The following are the pertinent events to which they refer.

Franz G. Talley, president of Industries, first became interested in the possibility of a merger between his company and GTC in December 1967, and, as a result of purchases on the open market and a special bid on February 19, 1968, Industries acquired a substantial position in GTC stock. In February 1968, Industries made known to GTC its desire for a merger, but GTC's then management rejected Industries' overtures and a proxy contest developed for control of GTC. Talley organized a GTC stockholders committee which proposed a slate of nominees for GTC's board of directors pledged to support a merger of GTC and Industries "if the terms proposed by Talley Industries, Inc. are fair and equitable to General Time Corporation and its stockholders."

On April 15, 1968, seven days before the scheduled election of GTC directors at its annual meeting, GTC announced the terms of a proposed merger with Seeburg Corporation. On April 21, Talley issued a press release announcing plans for a merger of Industries and GTC based on the election of the slate of directors sponsored by Industries. It stated that a merger proposal would be presented promptly after such election and, "as contemplated," Industries would offer to exchange for each share of GTC common stock one share of an Industries preferred stock carrying a $1.20 annual dividend and convertible into the equivalent of 1⅓ shares of Industries common (the "1⅓ proposal"). The release was reported in *The Wall Street Journal* of April 22, 1968. On that day the stockholders meeting was held and the votes cast, but, due to litigation arising from the proxy contest and an injunctive action brought by this Commission, the certification of the vote

[9] 393 F.2d 214 (C. A. 2, 1968).

count and the announcement of the winning slate of directors were postponed.

Subsequent to the stockholders meeting, Talley approached the then GTC management about the possibility of proceeding with the merger on the proposed terms, but GTC did not wish to consider the proposal in view of the pending litigation. On June 25, 1968, Talley issued a press release stating "his concern whether all of the delays would not affect the viability of any merger on the terms previously announced." On July 21, 1968, *The New York Times*, after interviewing Talley, reported that, "So much time has elapsed since Mr. Talley's original offer that he will probably have to change the terms of the deal because of changing stock market conditions."

In December 1968, pursuant to court decree, the vote count was announced revealing that Industries' slate had won, and the new directors took office on January 13, 1969 upon termination of a court stay. On that date, the new GTC board appointed a "Special Committee", composed of several of its members who had been on the Industries-sponsored slate, to consider a merger with Industries. The Committee determined to retain Lehman Brothers, which had been GTC's investment banker, as its financial adviser and Industries retained its investment banker, Smith Barney & Co. Lehman Brothers was represented in the matter by William Osborn, a senior partner who had been a GTC director and had favored consideration of a merger with Industries, and Smith Barney was represented by Thomas Murtagh, a vice-president.

The Special Committee obtained an opinion of counsel that the 1$^1/_3$ proposal did not constitute a legally binding offer by Industries, and neither Osborn nor Murtagh gave it any serious consideration prior to negotiating the merger terms in February 1969. Osborn testified that he considered the 1$^1/_3$ figure "unattainable and unrealistically high" and Murtagh, that it was "out of the realm of what I considered reasonable." After the merger terms had been agreed upon, each of the financial advisers gave its client a written opinion that the terms were "fair and reasonable" to the stockholders, and such terms were approved by the boards of directors and stockholders of both companies.[10] The proxy statement sent to the GTC stockholders, however, while referring to the fact that an

[10] In view of the statutory requirement that our approval of the merger plan be obtained before it can become effective, the appropriate procedure would have been to secure our approval before submitting the merger to a vote of stockholders.

earlier merger proposal had been made, did not state the terms of that proposal.

Industries and GTC contend that the 1$^1/_3$ proposal was made in good faith but in the expectation that it would be presented to the Industries-sponsored slate, if elected, within a very short time thereafter. They point to Talley's renewal of that proposal after the election to the then GTC management and assert that during the approximately nine-month interval before the Industries slate was able to take office circumstances had altered significantly in that, among other things, the market price of Industries stock rose to a much greater extent than that of GTC, Industries' earnings and sales increased and it developed important new products, and Talley discovered the degree to which GTC's level of sales and profits was dependent on its sales of artillery fuses related to the Vietnam war.

We find no basis in the record for concluding that the 1$^1/_3$ proposal was not made in good faith, and while a serious question with respect to overreaching would have been posed if Industries had taken control of GTC immediately after the election and then withdrew the 1$^1/_3$ proposal, we do not consider that the overreaching test calls for holding that Industries could not vary from that proposal after the interval in which it was precluded from proceeding with it and notwithstanding pertinent changes during such interval. Under the circumstances, we conclude that we need not consider the 1$^1/_3$ proposal in determining whether the present merger terms are fair and reasonable to GTC stockholders within the meaning of Section 17(b).

2. FAIRNESS

Appendix A attached hereto contains "per books" balance sheets of the constituent companies as of March 31, 1969 for Industries and December 31, 1968 for GTC, and *pro forma* to reflect the merger as proposed. It shows total assets of $91,315,000 for Industries and $82,291,000 for GTC, and $162,457,000 on a *pro forma* basis, and total stockholders equity of $35,311,000 for Industries, $45,372,000 for GTC and $72,411,000 *pro forma*. Appendix B is a statement of income for each of the companies for the year ended the date of its balance sheet and on a *pro forma* basis. The following table shows, for the fiscal years ended March 31, 1965–1969, net sales, net income, and earnings per share as restated for poolings of businesses acquired by Industries through June 1969, and the percentage change in annual earnings per share, together with the ratio of earnings per share of GTC to Industries on a diluted basis. Notes 1 and 2 to Appendices A and B should be considered in connection with this table.

000 Omitted [11]

	Years Ended March 31				
Industries	1965	1966	1967	1968	1969
Net Sales	$47,175	$63,030	$80,432	$83,197	$118,258
Net Income	1,148	3,323	4,970	4,724	6,798
Percent Increase	—	189.57	49.56	(4.95)	43.90
Earnings Per Share	$0.39	$1.14	$1.60	$1.39	$1.76
Diluted Earnings Per Share	0.37	1.02	1.48	1.34	1.71
Percent Increase	—	175.68	45.10	(9.46)	27.61
GTC					
Net Sales	$79,904	$91,624	$110,880	$129,514	$143,503
Net Income	2,045	2,481	3,254	3,832	5,467
Percent Increase	—	21.37	31.13	17.77	42.66
Earnings Per Share	$0.99	$1.20	$1.57	1.80	$2.28
Percent Increase	—	21.21	30.83	14.65	26.67
Ratio Earnings Per Share GTC to Industries	2.68:1	1.18:1	1.06:1	1.34:1	1.33:1

Osborn testified that he opened the merger negotiations on February 11, 1969 by proposing that the GTC stockholders be given a package equivalent to 1.2 shares of Industries common stock for each share of GTC common stock which he urged was warranted on what he called a quantitative approach, stressing GTC's contribution of earnings and assets to the merged company. Murtagh initially proposed approximately .8 to .9 shares of Industries stock for each GTC share, relying on what he believed to be Industries' superior growth record and prospects. In agreeing to the present terms they concluded that they were fair and equitable to the respective stockholders.

Osborn testified he had considered, among other factors, the relative contribution of the two companies to the earnings of the combined company, and calculated that although GTC would contribute 54.6 percent of the combined net earnings, based on earnings for the nine months ended December 31, 1968, its shareholders would obtain no more than a 37 percent interest in the combined company. He felt, however, that this disparity was counterbalanced by other factors including the differences in the quality of the earnings as indicated by Industries' earnings growth and prospects.

[11] GTC's fiscal years ended December 31, 1964 through 1968 have been compared to industries' fiscal years ended March 31, 1965 through 1969.

Osborn computed four-year compound annual growth rates of the net earnings of GTC in the 1964–1968 period and of Industries based on its fiscal years 1965–1969, both on an "as reported" basis and on a pooled basis which included earnings of companies acquired by Industries for periods prior to their acquisition. For GTC he computed a growth rate of 31 percent and for Industries alternative rates of 150 percent using "as reported" earnings figures, 75 percent using pooled figures which included the earnings of companies acquired through February 1969, and 53 percent using pooled figures which included the earnings of three additional companies acquired in June 1969. He selected a rate of 100 percent as representative of Industries' growth, deeming the "as reported" figures to be more meaningful than the pooled figures because the latter included operations of acquired companies before they were under Industries' management. He projected the earnings contributions of the two companies to the combined company on the assumption of growth rates of 100 percent, 75 percent and 50 percent for Industries and 31 percent for GTC, and estimated that on any of these bases the percentage earnings contribution of the Industries segment of the combined company would equal the percentage ownership interest attributable to its present stockholders no later than the fiscal year ending March 31, 1973.

Osborn further stated that the 31 percent GTC growth rate was vulnerable because of the fact that a major part of the recent growth in GTC's sales and earnings had been due to the sale of fuses to the Government for use in Vietnam. He considered that the loss of this business, which had been substantially more profitable than GTC's commercial business, could result in a serious decline in GTC's earnings. He felt that Industries, on the other hand, had a significant potential because of its development of new products, particularly the "Talley-Frac" process which uses an explosive slurry for fracturing oil wells to stimulate their flow, and a nickel-cobalt plated computer memory disk. He believed that the Talley-Frac process had a good opportunity of taking over a substantial portion of the $100 million a year oil well fracturing market and that the memory disk might take over a significant portion of the computer disk market within the next three to five years. He also felt that Industries' dependency on Vietnam sales was smaller than that of GTC.

Osborn noted that GTC common shareholders receiving Industries preferred shares under the merger plan would obtain an increased annual dividend rate of $1.00, as compared to the 80c on the GTC common stock, which would be covered 4.3 times by earnings, assuming all GTC shareholders received preferred stock, as compared with 2.8 times coverage on the present GTC common dividend. He also noted that asset protection in the case of liquidation, whether voluntary or involuntary, would be improved for GTC shareholders receiving Industries preferred shares. He compared the approximately $20 book value per share of GTC common stock, as of December 31, 1968, with a liquidating value of the combined company of approximately $28.32 per preferred share. Osborn stated that while the net book value of GTC common, as of December 31, 1968, was $45 million compared with $30 million for Industries it was his opinion that the value of assets of a going concern should be viewed in light of the use made of them, and he noted that the return on Industries' net worth had been consistently higher than GTC's over the past five years and in 1968 was 16.3 percent compared with 12.1 percent for GTC, which he considered was reflective of a more efficient use of assets by Industries.

In appraising relative market values, Osborn noted that the Industries stock was selling at about 30 times earnings, which he considered an appropriate multiplier for a growth company of Industries' size and potentialities. As to GTC, he felt a multiplier of from 6 to 10 times earnings would be applicable to its military earnings in view of their vulnerability and 15 to 20 times to the earnings from its clock business. On this basis he arrived at a fair market value of $45 per Industries share and a range of from $23 to $33 for the GTC stock, and pointed to the fact that the GTC stock had sold at $24 or less for many years prior to Industries' arrival on the scene. Osborn further felt that the price of GTC stock was substantially affected by the pendency of the merger, and would drop if the merger were abandoned.

Murtagh in his testimony recognized that the merger terms appeared generous to Industries if emphasis is to be rested on the *pro forma* contributions to the merged company. He noted that Industries' present shareholders would retain approximately 65 percent of the ownership interest in the combined company although Industries' estimated earnings of $6.6 million for fiscal 1969 would be approximately 55 percent of the *pro forma* earnings of the combined company. Based on the balance sheet data of December 31, 1968, Industries would contribute approximately $30 million, or about 40 percent of the approximately $75 million book value of the combined company *pro forma*, and Industries would be contributing only 29 percent of the net working capital and as much as 60 percent of the short and long term debt. Earnings per share of Industries for fiscal 1969 would be increased from an estimated $1.70 before the merger to between $1.99 and $2.07 for the combined company, an increase of at least 17 percent. Industries' common share book value, based on December 31, 1968 data, would increase from $7.57 to $10.60, an increase of 40 percent. Murtagh asserted, however, that the foregoing *pro forma* contributions favoring Industries' stockholders were required to render the merger terms fair to them because of various quantitative and qualitative factors. Like Osborn, he compared Industries' compound annual growth rate for fiscal 1965 through 1969 to GTC's rate for the years 1964–1968, and noted Industries' higher return on invested capital for the twelve months ended December 31, 1968. He also pointed out that Industries' average profit margin in the past five years of 13.3 percent was much higher than GTC's of 5.9 percent.

Murtagh also considered the effect of the merger on the market value of the stock of the combined company. He testified that Industries had been valued in the market for long periods of time at a higher earnings multiplier than GTC. He believed that, in a merger where a historically high growth rate company combines with one of moderate growth, some diminution in the price earnings multiple of the surviving company may be expected. Accordingly, in order for the exchange to be fair to the Industries' shareholders, he felt that a significant *pro forma* increase in earnings per share ($1.99–$2.07 post-merger vs. $1.70 pre-merger) was necessary to protect the market value of Industries' stock.

Murtagh further expressed the opinion that with the broadened earnings and equity base provided Industries by the merger, payment of the annual preferred dividend requirements of the combined company, even assuming the maximum amount of preferred stock, would not be burdensome and Industries' ability to support future growth would be enhanced.

Osborn and Murtagh were both of the opinion that the proposed conversion right of the new Industries preferred stock into .9 share of common stock, coupled with the election afforded GTC shareholders to obtain at the outset a full share of common stock, was appropriate. They considered that the dividend and asset preferences obtained by a GTC stockholder who received new Industries preferred stock warranted reducing by 10 percent the equity interest he could thereafter obtain as against one who elected to receive Industries common stock and forego such benefits.

In addition to the testimony of Osborn and Murtagh, and by Industries' president respecting its business and prospects, testimony concerning the proposed merger terms was presented by Don G. Mitchell, former chairman of GTC. Mitchell pointed to various new products in the timing field being developed by GTC and differed with the assessments of Osborn and Murtagh that the business and prospects of GTC were substantially less favorable than those of Industries. It was his view that a fair exchange ratio in a merger of the two companies would provide at least 1¼ shares of Industries common stock for each share of GTC common, or, if Industries preferred were to be offered, that each common share of GTC be exchanged for an Industries preferred share with a $1.20 dividend convertible into one full share of Industries common stock at any time.

We have carefully reviewed the testimony as well as the other facts and data in the record, and have taken official notice of the market prices of the Industries and GTC common stocks, both of which are actively traded on the New York Stock Exchange. In considering the testimony of Osborn and Murtagh, we note that their conclusions as to the fairness of the proposed merger terms are based essentially on their assessments of future growth and that both of them considered that the future development of Industries' business will be substantially more favorable than that of GTC. In resting heavily on that assessment they in effect subordinated the factor of GTC's substantially greater contribution of assets and earnings to the combined company, selected growth rate figures that are in our opinion, as set forth below, of questionable validity, and gave great weight to forecasts as to the success of Talley-Frac which are as yet not substantiated by any sales, profits or marketing arrangements as far as is disclosed in the record before us.[12] Although applicant asserts that Osborn and Murtagh negotiated the merger terms at arm's length, they accepted far-reaching optimistic statements concerning expectations for Industries' new products, mainly the Talley-Frac process, made by Industries' management, without any independent engineering or market study or

[12] Talley testified that in October 1968, Industries entered into an agreement with a major oil company providing for further research, development and testing of the process.

investigation and without receiving any technical or market data from Industries.

While we recognize that any attempt to evaluate future business and earnings of industrial companies for purposes of fixing an appropriate merger exchange ratio cannot be carried out with mathematical precision, and often involves a wide area of judgment, there must be an adequate basis for proposing a ratio which is different from that indicated by past and existing financial data.

We believe that in arriving at his earnings growth projections Osborn was not warranted in considering as most meaningful the "as reported" earnings figures of Industries showing a 150 percent compound annual growth rate. These figures compare the operations of Industries prior to any acquisitions with the present operation of the entire Industries complex which includes sizeable acquisitions of going businesses.[13] A fair examination of the growth of Industries' present earnings must view. the growth record of all the component parts of those earnings. Thus we consider the pooled figures reflecting the earnings of acquired companies in years prior to their acquisition to be more meaningful for purposes of an examination into what trend might be inferred. Nor is Osborn's rate of 75 percent using pooled figures appropriate because these figures did not include the acquisitions made by Talley in June 1969.[14]

In addition, while Osborn's rate of 53 percent, upon which he based his projection of 50 percent growth in Industries' earnings, was computed from earnings figures which included acquisitions by Industries through June 1969, that projection (based on the four year period 1965–1969) does not appear to be warranted. For purposes of analysis of earnings growth from the viewpoint of the common stockholders of each company, we consider the diluted earnings per common share (restated for poolings) to be the most significant figures, and have computed growth rates based on those figures (See Table above). On this basis, Industries' compound annual growth rate of earnings for the four-year period 1965–1969 was 46.6 percent, for the

[13] We note, moreover, that the 150 percent rate is reached in large measure through the selection of the particular period used. The reported earnings of Industries in the base year 1965 were less than half of Industries' reported earnings for the preceding year, thus providing an unusually low base year for Osborn's calculations and inflating the growth rate computed. For the five year period 1964-1969, Industries compound annual growth rate for "as reported" earnings was 76.3 percent; for the three year period 1966-1969, 93.3 percent; and for the two year period 1967-1969, 17.0 percent.

[14] Likewise, Murtagh's calculated rate of 75 percent for Industries' earnings growth is inappropriate because earnings of the June 1969 acquisitions were included only in Industries' 1969 earnings figure and were not pooled for prior years.

three-year period 1966–1969 was 18.8 percent, and for the 1967–1969 period was 7.5 percent. Moreover, an examination of yearly earnings figures for Industries shows an erratic pattern of growth including, in 1968, a decline of 9.46 percent from the preceding year. Thus while the growth record for Industries over the period chosen by the witness is impressive, the reliability of this rate for use in statistical projections is questionable in face of a significant slowing down of the rate in more recent periods and the variation in Industries' level of earnings from year to year.

GTC's growth rate, on the other hand, has been much more consistent. The three year rate (1965–1968) of 24.0 percent compares favorably with the four year (1964–1968) rate of 26.3 percent and a five year (1963–1968) rate of 27.0 percent. The rate in the two-year period 1966–1968 was 20.8 percent. Moreover, examination of the Table set out above shows a steady increase in earnings from year to year, without significant aberrations. We further note that, according to the latest published figures available, GTC's per share earnings for the 9 months ended September 30, 1969 are 29.7 percent over the comparable period in 1968 and Industries' per share earnings for the six months ended September 30, 1969, assuming full dilution, are 9.7 percent over the comparable 1968 period.[15]

Moreover, specific growth rate computations and projections aside, the conclusions of Osborn and Murtagh are bottomed essentially on their acceptance of the view that Industries is materially less vulnerable to a loss of military business than GTC. Military sales of Industries and GTC constitute roughly the same proportion of their total sales, 45 percent in the case of Industries and 43 percent in that of GTC. Such sales produced 58 percent of GTC's earnings, and the record indicates that Industries' military business also has a higher profit margin than its other operations.[16]

The bulk of GTC's military sales is in artillery shell fuses, while Industries sells among other things flares, smoke grenades, aircraft starters and escape systems, and ballistic and

[15] Osborn's assertion that a more efficient use of assets by Industries than by GTC is indicated by Industries' return on book equity of 16.3 percent as compared with a return of 12.1 percent for GTC, apparently does not take into account the fact that, as of December 31, 1968, GTC had $18,289,000 of debt outstanding constituting 28.7 percent of total capitalization and surplus, while debt of Industries (including notes to banks) totaled $32,174,000 at March 31, 1969 which was equal to 47.7 percent of total capitalization and surplus. Thus, it appears that Industries' larger return is attributable, at least in part to higher leverage, a factor which introduces additional risk.

[16] While no figures were introduced in the record from which a precise calculation can be made with respect to the percentage of Industries' earnings from its military business, the record does show a significant reduction in Industries' profit margin as non-military operations were merged with Industries' original military business.

rocket devices. Industries' president stated to Murtagh that if Vietnam hostilities ended Industries might lose around 10 percent of its earnings. Mitchell testified that GTC had given consideration to new products and other changes that it could put into effect to offset a decline in its fuse sales. Osborn and Murtagh viewed GTC's military earnings as subject to more risk than Industries', although Osborn recognized that the risk was related to a cessation of combat activity rather than merely a withdrawal of this country's forces from Vietnam. While we recognize that there is a basis for viewing GTC's uncertainties in this area as somewhat greater than those of Industries, they do not in our opinion warrant discounting the financial factors favorable to GTC to the extent Osborn and Murtagh have done.

The values which Osborn attributed to the Industries stock from a market viewpoint are similarly based on the growth and lesser military dependency he has attributed to that company. As has previously been stated, Osborn testified that Industries was currently selling at approximately 30 times earnings, which he considered an appropriate multiplier for a growth company with Industries' prospects. With respect to GTC, he applied a multiplier of 6–10 times to its earnings from defense business,[17] noting that the stocks of two large defense-oriented companies were selling at prices reflecting multipliers of 10 times or less, and a multiplier of 15–20 times to GTC's non-defense earnings, stating that this range was similar to that reflected in the stock prices of two large companies engaged in the timing field then selling at 18 times and 20 times earnings, respectively. In view of the substantial military business component in Industries' earnings and the uncertainties concerning Industries' growth prospects based upon new products, as set forth above, it would appear that Osborn was not warranted in using so high a multiplier as 30 times earnings with respect to Industries for purposes of testing the fairness of the merger plan.

The comparisons made by the witnesses of the market prices of Industries and GTC common stock do not afford material aid in resolving the fairness question here. Their principal comparisons, of prices as of January 10, 1969, immediately before Industries' nominees were legally permitted to take office in GTC, and as of February 11, 1969, just before the announce-

[17] Osborn estimated that $1.29 of GTC's $2.29 per share earnings (before extraordinary items) for 1968 was attributable to its military business.

ment of the merger terms, are not meaningful because of the sizeable acquisitions of new companies made by Industries since those times.[18] Moreover, while we have taken market prices into consideration as one element in assessing fairness, they are not entitled to be given controlling weight in the discharge of our responsibility to determine the question of fairness under Section 17 of the Act,[19] especially where, as here, the comparison involves companies one of which is controlled by the other.

We have carefully examined the various pertinent factors in reaching our conclusion as to what allocation to the GTC stockholders would satisfy the requirements of the fairness standard of Section 17.

A GTC common stockholder obtaining a share of Industries preferred stock in exchange for his GTC common stock would obtain a more junior asset position in view of Industries' larger debt, a reduced participation in earnings per share, and an investment in an enterprise an important part of whose prospective growth is based upon expectations from new products not yet realized. As compensation for these reductions and uncertainties, he would receive a cumulative preferred dividend of $1 per year as compared with the 80 noncumulative dividend that has been declared on his GTC stock, would participate in a broader diversification of activities in which any adverse impact on GTC's earnings of the cessation of the Vietnam hostilities would be diluted, and would have the opportunity to share in any future growth and profits through the conversion right attached to the Industries preferred stock. However, since the conversion right as provided for under the proposed merger terms would entitle a GTC stockholder to obtain only 9/10 of a share of Industries common stock, his ability to obtain dividends would in effect cost him 1/10 of a share of Industries stock.[20] He would thus have to choose at

[18] On the basis of the market prices on the two dates selected, a GTC common stockholder exercising the option to take a share of Industries common stock would have received premiums of 19.4 percent and 10 percent, respectively. Osborn also compared the price of GTC stock on January 31, 1968, about three weeks before it became known that Industries was seeking to acquire a large block of GTC stock, with the price of Industries stock on June 3, 1969, just prior to his testimony, on which basis the premium in favor of GTC under the plan would have been 40 percent. That comparison is not helpful because of the disparity in the dates used.

Based on market prices during the period July 8, 1969, the last day of the hearings, to November 19, 1969, a GTC common stockholder would under the plan have received an average premium of 14 percent. Thereafter the market differential widened, with the average premium during the period November 19, 1969–December 30, 1969 being 27 percent. At the time the 1⅓ proposal was made in April 1968, such proposal reflected a current market premium for the GTC common stockholders of about 19 percent.

[19] See *Atlas Corporation*, 37 S.E.C. 72, 88 (1956). *Cf. Pennzoil Company*, 43 S.E.C. 709, 736–37 (1968).

[20] The conversion rate is subject to adjustment for any stock dividends declared on the Industries common stock other than stock dividends of 3 percent or less paid in any one-year period after 3 years from the effective date of the merger.

the outset whether to forego a dividend or pay the price of 1/10 of an Industries common share. If he elected to take such preferred stock of the merged company he could be adversely affected in certain respects. Assuming that 50 percent of GTC's common stockholders accepted preferred stock of the merged company, the interest charges and preferred dividend requirements of such company would be covered 2.88 times for fiscal 1969, and assuming 100 percent acceptance would be covered 2.41 times, as compared to GTC's 2.18 times coverage of interest, preferred dividend requirements, and common stock dividend payments in 1968. However, GTC's coverage of interest for the year 1968 was 5.32 times whereas the merged company's interest and charges prior to the dividends on the new preferred would be covered 3.59 times. Consequently, the dividends on the new preferred may be less secure than the dividend on GTC common.

We think that under the circumstances, including the uncertainties presented by the record with respect to Industries' business and prospects, the standards of Section 17 of the Act require that the GTC common stockholders be given a longer-term choice between continuing to hold a dividend-paying security with a preferred status or accepting a common stock position in Industries, and that fairness requires that this be accomplished by providing that the new Industries Series B preferred stock be convertible into a full share of Industries' common stock, rather than into only 9/10 of a share as proposed, and eliminating the provision with respect to issuance of common stock in the merger to GTC stockholders other than Industries.

The issuance of 4 shares of new Industries preferred, each convertible into one share of Industries common, for each share of GTC preferred would satisfy the fairness standard. As noted, GTC now has outstanding 5,395 shares of preferred stock, each share of which is entitled to receive cumulative dividends payable quarterly at the rate of $4 a year and is convertible into four shares of GTC common stock. Such stock is entitled to a preference of $100 in the event of voluntary or involuntary liquidation and is redeemable after September 1972 at the option of GTC at $100 a share. While the new shares that the holder of GTC preferred would receive would have an involuntary liquidating preference of only $80, such holder would obtain a step-up in voluntary liquidating preference and in redemption price from $100 a share to $210 on the four shares of new preferred stock and those shares would not be callable for five years. Although GTC covers its interest charges and preferred stock dividend requirements 5.25 times while the merged company would cover its interest charges and preferred dividend requirements only 2.41 times on the basis of the maximum preferred requirement, the GTC preferred shareholder, whose stock currently has no active market, would benefit from the increased marketability of the shares he is to receive since it is contemplated that the new preferred will be listed on the New York Stock Exchange.

We find that if the merger plan is amended in accordance with the above it would be fair to the existing security holders of Industries. The existing Industries preferred stock would upon the merger have larger asset coverage. The present Industries common stockholders would benefit from a larger asset and earnings base as compensation for the inclusion in Industries' capitalization of the preferred stock to be issued to the GTC stockholders. As to the existing debt securities of the two companies, the coverages for those of Industries would be improved while those of GTC would not be materially adversely affected.

We conclude that we cannot approve the application unless the merger plan is amended to provide for the issuance to the GTC shareholders of Industries cumulative preferred stock having a $1 annual dividend and convertible into a full share of Industries common stock at any time, on the basis of one share of such stock for each share of GTC common stock and four shares for each share of GTC preferred stock; and for the elimination of the provision with respect to the issuance of Industries common stock in the merger to GTC stockholders other than Industries. If within 30 days applicant files an appropriate amendment providing for a merger, subject to shareholder approval, in accordance with this Opinion, we shall enter an order granting the application.[21]

By the Commission (Chairman BUDGE and Commissioner OWENS, Commission SMITH concurring), Commissioner NEEDHAM dissenting, and Commissioner HERLONG not participating.

[21] Section 17(b) also requires that the evidence establish that the proposed transaction is consistent with the general purposes of the Act and the policy of each registered investment company concerned. We find that the proposed merger is consistent with the Act's purposes. However, AIF's stated policy provides that it may not invest more than 5 percent of its gross assets in the securities of any one issuer. It appears that the merger could result in AIF's holding Industries securities in an amount slightly in excess of that permissible.

Our order will permit the acquisition by AIF of such securities but require that it take steps to dispose of any excess promptly.

Commissioner SMITH, concurring:

I concur in the opinion of the majority and in the conclusion that the merger would meet the standards of Section 17(b) if the terms are amended as stated in the opinion. While the record is not as complete as one might wish, I believe it is adequate to reach that conclusion.

In addition, it is my view we cannot ignore the fact that GTC's shareholders voted the Industries slate into office after the 1$^1/_3$ proposal had been made, and thereby rejected the competing proposal for a GTC-Seeburg merger. That proposal was made by Industries without any qualification that it was subject to change or limited as to time. The proxy material soliciting approval of the present terms by the GTC shareholders did not describe the terms of the earlier more favorable proposal. Under the circumstances, I believe that, while in no way controlling, we must weigh the 1$^1/_3$ proposal as one of the factors in determining what merger terms are fair and reasonable to GTC stockholders within the meaning of Section 17(b). By reason of that factor, the permissible range of fairness should be viewed as somewhat narrowed.

Commissioner NEEDHAM dissenting:

I cannot join in the decision of the Commission in this case. In my opinion the evidence presented with respect to the business and earnings of Industries, particularly as to the sources of Industries' earnings from military and non-military sales and the bases for its stated expectations from new products, does not set forth the essential details and breakdown that are required for an informed assessment of the fairness of any merger terms. Industries did not satisfy the burden of proof concerning the faireness of the proposed transaction which rested upon it in seeking an exemption from the Act's prohibitions respecting transactions of affiliated persons. See *Transit Investment Corporation*, 23 S.E.C. 415 (1946); *North River Securities Co., Inc.*, 37 S.E.C. 465 (1956); *Fifth Avenue Coach Lines, Inc.*, 43 S.E.C. 635 (1967).

APPENDIX A

TALLEY INDUSTRIES, INC. AND SUBSIDIARIES, GENERAL TIME CORPORATION AND SUBSIDIARIES

Pro Forma consolidated balance sheet

(000 omited)

	Per Books [1]		
	Industries March 31, 1968	GTC Dec. 31, 1968	Pro Forma [4]
Assets			
Current Assets:			
Cash	$ 6,209	$ 4,659	$ 10,509
Marketable securities	794	—	794
Receivables, net [1]	16,476	24,967	41,442
Inventories [1] and [2]	37,660	31,459	69,120
Deferred charges—income taxes	—	1,255	1,255
Prepaid expenses	723	603	1,326
Total current assets	$61,862	$62,943	$124,446
Investments and advances:			
Investment in General Time Corporation [6]	10,790	—	—
Foreign associated companies, net	—	1,217	1,217
Long-term receivable	44	—	44
Total investments and advances	10,834	1,217	1,261
Property, plant and equipment—net	16,634	17,754	34,388
Deferred charges and other assets	903	377	1,280
Start-up costs of a subsidiary [1]	1,082	—	1,802
	$91,315	$82,291	$162,457
Liabilities and Stockholders' Equity			
Current Liabilities:			
Notes payable principally to banks	$14,486	$ —	$ 14,486
Current installments on long-term debt	1,437	175	1,612
Due to broker	3,267	—	3,267
Dividend payable	—	468	468
Accounts payable	14,368	6,661	21,028
Accrued expenses	2,462	7,310	9,772
United States and Foreign income taxes	4,909	2,432	7,341
Total current liabilities	40,929	17,046	57,974

Long-term debt excluding current installments	14,421	18,289	29,834
Deferred Federal income taxes	427	636	1,063
Deferred investment credit	—	732	732
Minority interests in consolidated subsidiaries	227	217	443
Commitments and Contingent Liabilities [3]			
Stockholders' equity:			
Talley Industries, Inc. Preferred stock, authorized 1,000,000 shares:			
Series A Convertible, $1 par value, issued 320,000 shares, outstanding 206,983 shares (liquidation preference $5,174,575)	207	—	207
Series B Convertible, $1 par value, 2,188,443 shares proposed to be issued (involuntary liquidating value $43,768,869)[5]	—	—	2,188
Common stock, $1 par value, outstanding 3,723,114 shares (net of 257,937 treasury shares)	3,723	—	3,981
General Time Corporation Preferred stock, par value $100, Series A convertible, outstanding 5,395 shares	—	540	—
Common stock	—	5,799	—
Capital in excess of par value	10,716	10,959	28,084
Retained earnings [7]	20,665	28,076	48,741
	35,311	45,372	83,201
Treasury stock[6]	—	—	10,790
Total stockholders' equity	35,311	45,372	72,411
	$91,315	$82,291	$162,457

APPENDIX B

TALLEY INDUSTRIES INC. AND SUBSIDIARIES

and

General Time Corporation and Subsidiaries Pro Forma statement of consolidated earnings

(000 omitted)

	Per Books [1]		
	Industries Year Ended March 31, 1969	GTC Year Ended Dec. 31, 1968	Pro Forma [4]
Net sales	$118,258	$143,503	$261,761
Cost of sales, selling, general and administrative expenses [1] [2]	102,971	132,112	235,083
	115,287	11,391	26,678
Other income and (deductions) net	1,018	488	1,299
	16,304	11,879	27,977
Interest and debt expense	2,470	1,264	4,243
Earnings before Federal and State income taxes	13,834	10,615	23,734
Federal and State income taxes	7,102	5,042	11,874
	6,732	5,573	11,860
Less minority interests in consolidated subsidiaries	(12)	80	69
Income before extraordinary items	6,744	5,493	11,791
Extraordinary items-credit (charge)	54	(26)	28
Net earnings [1] [2]	6,798	5,467	11,819
Adjustment of Other Income:			
Industries, 10.64 equity in undistributed earnings (after preferred dividend) of GTC	580	—	—
Less dividend included above	206	—	—
	374	—	—
Net earnings	$ 7,172	$ 5,467	$ 11,819

Provision for dividends on preferred stocks:			
Industries Series A convertible $1.10 per share	$ 228	—	$ 228
GTC Series A	—	$ 17	—
Industries Series B convertible $1.00 per share	—	—	2,188
Total	228	17	2,416
Earnings after preferred dividends	$ 6,944	$ 5,450	$ 9,403
Add—Provision for dividends on preferred stocks	228	17	2,416
Earnings applicable to common stock and common stock equivalents	$ 7,172	$ 5,467	$ 11,819
Earnings per share [8]	[a] $1.85	$2.28	$1.95
	[a] $1.80	$2.28	$1.91

[a] These amounts include 9c per share representing an adjustment shown above for equity in earings of GTC.

NOTES TO APPENDICES A AND B

[1] The "Per Books" financial statements are as shown in the constituent companies. most recent annual reports—Industries at March 31, 1969 and GTC at December 31, 1968. The independent accountants' opinion on the Industries financial statements is qualified as to three separate matters, viz: (i) the outcome of a claim for $933,000 against the United States Government for additional costs incurred by the company to complete a fixed price contract (included in accounts receivable and no reserve provided); (ii) the company's ability to obtain sufficient future contracts to recover costs estimated as being applicable thereto; and (iii) the recovery of deferred start-up costs of a subsidiary dependent upon the future profitability of such subsidiary.

[2] With regard to clause (ii) to Note [1] above, the company bases its calculation of inventories ($20,321,436 at March 31, 1969) and of cost of sales applicable to fixed price United Ststaes Government contracts on the costs (including administrative overhead) incurred and estimated to be incurred on the relative production programs. For the purpose of computing cost of sales, these costs are prorated over the estimated total revenues for such programs. The estimates are based on actual contracts on hand and future contracts expected by management to be obtained. The resultant value of inventories on this basis is in excess of the prorated cost of actual contracts on hand as at March 31, 1969 but Industries' management expects sufficient future contracts to be received to recover such excess.

[3] COMMITMENTS AND CONTINGENT LIABILITIES:

Industries has undertaken a new plant and production facilities expansion program which is estimated to cost not in excess of $1,890,000 to complete.

Industries has assumed certain pension plans of an acquired subsidiary and at March 31, 1969 the actuarially computed value of vested benefits exceeded the total of the pension fund and balance sheet accruals by approximately $764,000.

Substantially all of Industries' sales are subject to renegotiation. Industries has received notices of clearance from the Renegotiation Board for all years prior to and including March 31, 1966. For the year ended March 31, 1967, the Renegotiation Board claims a refund of $250,000 net of tax credits. Management is of the opinion that such claim for refund is unwarranted and has made no provision for this amount in the accounts. GTC's renegotiation proceedings have been completed through 1966 and no refund was required.

[4] The pro forma financial statements are based upon the assumption that all public shareholders of GTC preferred stock (5,395 shares) and common stock (2,166,863 shares including 105,380 shares issued for conversion of GTC's 4³/₄ percent debentures) exchange their shares for 21,580 shares and 2,166,863 shares, respectively, of Industries' Series B preferred, and the 257,937 shares of GTC common held by Industries have been converted to 257,937 shares of Industries common stock and treated as treasury stock. Industries' dividend income of $206,350 on the GTC common has been eliminated, interest expense has been increased $509,688 to reflect a full year's interest on Industries investment of $10,575,781 in GTC stock, and taxes have been decreased $270,320 for the net tax effect of these adjustments.

[5] Voluntary liquidating value of Industries' Series B preferred is $52.50 per share aggregating $114,893,258.

[6] Although the 257,937 shares of GTC common held by Industries are pledged to secure amounts due to broker, according to the merger proxy statement it is expected the debt will be paid when the merger becomes effective from assets of the merged companies.

[7] Under the terms of a note agreement dated October 1, 1968, covering Industries' 5 percent convertible subordinated notes aggregating $10,000,000, Industries' earned surplus unrestricted as to dividends at March 31, 1969 was $4,571,000. GTC's loan agreements governing its outstanding notes contain restrictions with respect to payment of cash dividends. At December 31, 1968, the amount of earned surplus unrestricted as to cash dividends was approximately $8,500,000. If, as contemplated, the assets, business and liabilities of GTC are transferred to a subsidiary of Industries simultaneously with or shortly after the effectiveness of the merger, such subsidiary will become subject to the provisions of GTC's loan agreements.

[8] Earnings per share and diluted earnings per share are as reported in the contituent companies' annual reports to shareholders adjusted, however, in the case of Industries for its equity in earnings of GTC which adjustment results in an increase of 9c per share.

Pro forma per share amounts have been computed by applying to the earnings per share and diluted earnings per share of *$1.76* and $1.71, respectively, as reported by Industries, the *pro forma* adjustments of shares and earnings necessary to give effect to the proposed merger.

IN THE MATTER OF

HAWAIIAN ELECTRIC COMPANY, INC.

File No. 3-2048. Promulgated January 26, 1970

Public Utility Holding Company Act of 1935—Sections 9(a) and 10

ACQUISITION OF SECURITIES BY EXEMPT HOLDING COMPANY

Application by exempt holding company with respect to its proposed acquisition of outstanding common stock of nonassociate electric utility company *granted*, when proposal satisfies applicable standards of Sections 9 and 10 of the Public Utility Holding Company Act of 1935.

APPEARANCES:

Marshall M. Goodsill of Jenks, Goodsill, Kidwell and Anderson for Hawaiian Electric Company, Inc.

R. Moshe Simon and *H. Kennedy Linge* for the Division of Corporate Regulation of the Commission.

FINDINGS, OPINION AND ORDER OF THE COMMISSION

INTRODUCTION

Hawaiian Electric Company, Inc. ("HECO"), an exempt holding company, has filed an application pursuant to Sections 9(a) and 10 of the Public Utility Holding Company Act of 1935 ("Act"),[1] under which, in brief, HECO proposes to acquire all of the outstanding shares of common stock of Hilo Electric Company ("Hilo"), a nonassociate electric utility company. After appropriate notice,[2] a public hearing was held, at which evidence was adduced with respect to the proposed acquisition. No one appeared in opposition to HECO's proposal, and post-hearing procedures have been waived. On the basis of the record, we make the following findings:

THE COMPANIES INVOLVED IN THE PROPOSED TRANSACTIONS

HECO renders electric service on the Island of Oahu, State

[1] HECO is a holding company exempt pursuant to Rule 2 from the provisions of the Act except Sections 9(a) (2) and 10. It is also an electric utility company as defined in Section 2(a) (3).

[2] *Hawaiian Electric Company, Inc.*, Holding Company Act Release No. 16459 (August 25, 1969).

of Hawaii. It is the only electric utility company serving Oahu and has approximately 156,000 customers. Its wholly-owned subsidiary company, Maui Electric Company, Limited ("Maui"), is the only company which renders electric service on the Islands of Maui and Lanai, State of Hawaii. As at June 30, 1969, HECO had consolidated net utility plant of $227,946,000 and, for the year then ended, it had consolidated revenues of $62,626,000 and consolidated net income of $8,776,000. HECO had 3,669,573 shares of common stock outstanding, par value $6²/₃ per share, which are listed on the New York Stock Exchange. HECO also had outstanding 1,367,447 shares of several series of cumulative preferred stock, par value $20 per share. Consolidated long-term debt then totaled $104,381,000. It included several series of HECO's first mortgage bonds in principal amount of $92,000,000, due in 1970 through 1997, and $6,761,000 of 4¹/₈ percent convertible debentures, due in 1982. Maui had then outstanding first mortgage bonds in principal amount of $5,620,000 with serial maturities extending to 1993.

Hilo renders electric service on the Island of Hawaii, and has approximately 20,000 customers. As at June 30, 1969, net utility plant was $26,290,000 and, for the year then ended, it had revenues of $6,401,000 and net income of $646,000. Hilo has 525,000 shares of common stock outstanding, par value $10 per share, which are listed on the Honolulu Stock Exchange. Hilo then had outstanding several series of first mortgage bonds in principal amount of $8,220,000 due 1971 through 1989 and $832,156 of Second Mortgage Notes.[3]

Under the terms of the proposed merger HECO will issue 528,780 shares of its common stock in exchange for the outstanding 525,000 shares of Hilo common stock on the basis of 1.0072 shares of HECO common stock for each share of Hilo common stock.[4] No fractional shares of the common stock of HECO will be issued, and the common stockholders of Hilo entitled to less than a whole share will be paid in cash for any fractional shares. The Hawaii Public Utilities Commission has

[3] Appendices A and B present condensed balance sheets as at June 30, 1969 and income statements for the twelve months then ended for HECO and its subsidiary company on a consolidated basis (for Hilo per books as well as on a *pro-forma* consolidated basis) assuming acquisition by HECO of all of the outstanding shares of Hilo common stock.

[4] The mechanics of the merger are as follows: HECO, Hilo and New Hawn, Inc., a wholly-owned subsidiary company of HECO organized solely for the purpose of consummating the acquisition, have entered into agreements pursuant to which New Hawn will be merged into Hilo. Under these agreements, which have been approved by the stockholders of HECO and Hilo insofar as is necessary to effect the merger, New Hawn will initially exchange all of its issued and outstanding common stock for 528,780 shares of HECO common stock. Upon merger, HECO will convert its New Hawn common stock into 525,000 shares of Hilo common stock, and the present stockholders of Hilo will receive the 528,780 shares of HECO common stock.

approved the corporate merger and the exchange of the common stocks.

APPLICABLE STATUTORY STANDARDS

INTEGRATION ASPECTS OF THE PROPOSED ACQUISITIONS

Under Section 10(c)(2) of the Act, we may not approve HECO's proposed acquisition of Hilo common stock unless we affirmatively find that ". . . such acquisition will serve the public interest by tending towards the economical and efficient development of an integrated public-utility system," as defined in Section 2(a)(29)(A).[5] For the reasons noted below, we make such findings.

The proposed acquisition will produce significant economies and savings for Hilo as a subsidiary company of HECO. Pointing to the experience of Maui after it was acquired by HECO, HECO anticipates savings in purchasing by Hilo, which, like Maui, is substantially smaller than HECO. HECO estimates that, by using its central purchasing organization, Hilo will effect savings of $64,000 per year in the first five years, of which $40,000 per year would represent savings in fuel oil costs, which presently are lower for HECO than for Hilo. For the 12 months ended June 30, 1969, fuel costs amounted to about $1.1 million which is about 17 percent of Hilo's revenues and about 22 percent of total expenses for the year then ended.

Savings are also anticipated in the cost of engineering services for Hilo, which has only one engineer. HECO's engineering department, which has about 50 engineers and a total staff of about 180, would perform services for Hilo at cost (including overhead), with annual savings estimated at $40,000. It is also expected that Hilo will obtain economies with respect to data processing for customer billing and accounting and other matters. HECO's equipment, it is stated, can be adapted and enlarged to meet the needs of Hilo at estimated savings of $80,000 per year.

HECO also estimates annual savings of $30,000 in charges for short-term bank borrowings by Hilo as a subsidiary company of HECO. It is stated that Maui has been able to borrow

[5] Section 2(a) (29) defines "Integrated public-utility system" to mean

"(A) As applied to electric utility companies, a system consisting of one or more units of generating plants and/or transmission lines and/or distributing facilities, whose utility assets, whether owned by one or more electric utility companies, are physically interconnected or capable of physical interconnection and which under normal conditions may be economically operated as a single interconnected and coordinated system confined in its operations to a single area or region, in one or more States, not so large as to impair (considering the state of the art and the area or region affected) the advantages of localized management, efficient operation and the effectiveness of regulation."

at the prime rate and that Hilo, as a subsidiary company of HECO, should be able to do likewise. However, while some savings may be expected for Hilo, the dollar amount of such savings would depend on future bank borrowings, as to which the record contains no projections, and on the state of the money market.

An "integrated public-utility system" is defined in Section 2(a)(29)(A) to mean, among other things, a system whose utility assets are "physically interconnected or capable of physical interconnection and which under normal conditions may be economically operated as a single interconnected and coordinated system . . ." The electric utility facilities of Hilo on the Island of Hawaii are not interconnected with the electric facilities on the islands served by HECO and the underwater distance between the islands of Hawaii and Maui is 30 miles; Maui is 11 miles from Molokai which is served by a nonaffiliated public-utility company; and Molokai is 25 miles from Oahu which is served by HECO. A witness for HECO states that at the present time it is technologically feasible to establish interconnections between the islands of Hawaii and Oahu by submarine cable and intermediate overland routes through Maui and Molokai.[6] The estimated cost of such interconnection is $12 million for the submarine cable and $3.2 million for the overland routes. However, since the Island of Hawaii is largely undeveloped at the present time, the demand for electric energy would not justify this expense,[7] such an interconnection, according to a company witness, will not be economically feasible for a period that might be as long as ten years.

In 1935, when the Act was passed, Hawaii was a territory, and Section 10(c)(2) would not have applied to the proposed

[6] The record notes that there are several sub rine cables throughout the world crossing comparable underwater distances, among them the followin

Location	*Load (mw)*	*Distance (miles)*
Island of Sardinia and Italian Mainland	200	72
Island of Gotland and Swedish Mainland	20	60
Scandanavian Peninsula with European Continent	250	40 & 20
North and South Islands of New Zealand	600	25
Vancouver Island and Vancouver, B.C.	312	17.4 & 2.4

[7] Until the interconnection is constructed, any increment in demand will be met on the Island of Hawaii by additions to Hilo's present facilities.

acquisition by HECO.[8] When Hawaii became a state pursuant to the Hawaii Statehood Act of 1959, the Holding Company Act became applicable to Hawaii in all respects, including Section 10(c)(2). Nonetheless, we take into consideration this legislative background in our application of Section 10(c)(2) to the proposed acquisition insofar as we may exercise our administrative judgment and discretion. The "capable of interconnection" clause in Section 2(a)(29)(A) calls for an assessment of economic and geographic factors, and in general we would consider a 10-year span for economic and coordinated interconnection too remote to satisfy the provisions of Sections 10(c)(2) and 2(a)(29)(A).[9] But in assessing the practicalities of economic and physical integration in this case, we give particular weight to the unique geography of the State of Hawaii in light of the legislative history.

After the acquisition, there will be some expansion of the boards of directors of HECO and Hilo but localized managements of the companies will not be affected. Nor will the acquisition impair the effectiveness of local regulation. As the Hawaii Commission said, "[T]he merger proposal would not affect the rate bases of the separate companies nor the regulatory jurisdiction . . ." of that Commission.

In the light of the foregoing we make the necessary findings with respect to Section 10(c)(2).

THE APPLICATION OF SECTION 10(b)(1)

Under Section 10(b)(1) we are required to approve the proposed acquisition unless we find that "such acquisition will tend towards . . . concentration of control of public utility companies, of a kind or to an extent detrimental to the public interest or the interest of investors or consumers. . . ." This provision requires us to consider the proposed acquisition in light of Federal antitrust policies.[10]

[8] The last sentence of Section 10(c) (2) provides that the requirements therein specified do not apply to the acquisition of securities of a public-utility company "operating exclusively outside the United States." Section 2(a) (25) specifies that "United States," when used in a geographical sense, means "the States," and under Section 2(a) (24) the word "State" is defined to mean "any State of the United States or the District of Columbia." Since Hawaii was a territory in 1935, a holding company, like HECO, with an Hawaiian subsidiary company, would have been exempt under Section 3(a) (5) of the Act as a foreign holding company, and an acquisition of securities of another Hawaiian public-utility company like Hilo would not have been subject to Section 10(c) (2) at all.

The omission of the Territory of Hawaii from the definition of "State" was not inadvertent. *Cf.* Section 3(a) (16) of the Securities Exchange Act of 1934 which as originally enacted included Hawaii and other possessions within the definition of "State" (48 Stat. 884).

[9] See *General Public Utilities Corporation*, 32 S.E.C. 807, 824–825 (1951); *Cities Service Power & Light Company*, 14 S.E.C. 28, 45–46 (1943); *The North American Company*, 11 S.E.C. 194, 242–243 (1942).

[10] *Municipal Electric Association of Massachusetts, et al.* v. *S.E.C.*, 413 F.2d 1052 (C.A. D.C. 1969); *Northern Natural Gas Company* v. *Federal Power Commission*, 399 F.2d 953 (C.A. D.C. 1968).

The State of Hawaii is comprised of 11 inhabited and 111 uninhabited islands in the mid-Pacific Ocean with a total population of 632,772 and an area of 6,421 square miles. All of the islands are separated by large expanses of water. The major islands are Oahu, Maui, Lanai, Hawaii, Molokai and Kauai. The relative size of these islands, population and the number of electric customers of the public-utility companies serving these islands are:

TABLE I

Island	Electric Utility Company	Square Miles	Population	Electric Customers (12/31/68)
Oahu	Heco	598	500,000	156,380
Maui	Maui	728	36,000	13,253
Lanai	Maui	141	2,100	825
Hawaii	Hilo	4,021	61,000	20,400
Molokai	Molokai	259	5,000	1,686
Kauai	Kauai	551	28,000	9,617

Oahu is the most populous of the islands and, as noted, is served by HECO, the largest electric utility company in the State of Hawaii. The Islands of Maui and Lanai are substantially smaller in population and have less customers, while the Island of Hawaii, served by Hilo, though almost three times the area of the other three islands has only a population of about 61,000. The other two islands, also substantially smaller than Oahu, are served by two public-utility companies not affiliated with HECO or Hilo.

Hawaii is primarily an agricultural State. It has a substantial tourist trade but very little industry. For these reasons, and because of the relatively small size and isolation of the islands, there is not the kind of competition among electric utility companies that exists on the United States mainland. HECO's competitor is the Honolulu Gas Company, which operates exclusively in the State of Hawaii, and it appears that such competition will not be affected by the acquisition. In these circumstances we do not find that the proposed acquisition involves the consequences proscribed by Section 10(b)(1).

Fairness of the Exchange Offer

Under Section 10(b)(2), we may not approve the proposed acquisition if the terms of the exchange offer, including the fees and expenses incident thereto, are not fair and reasonable. Table II, below, presents, for the years indicated, the per-share earnings, actual and estimated, applicable to the present common shares of HECO and Hilo, the *pro forma* earnings per share of HECO and per 1.0072 shares of HECO, and book values as of June 30, 1969, actual and *pro forma*.[11]

TABLE II

Earnings per Share

	HECO		Hilo	
	Present Share	Pro Forma	Present Share	Pro Forma (1.0072 HECO Shares)
1965	$1.43	$1.47	$1.79	$1.48
1966	1.64	1.62	1.46	1.63
1967	1.63	1.59	1.32	1.60
1968	1.82	1.76	1.25	1.77
12 mos. ended 6/30/69	1.90	1.82	1.23	1.83
Estimated				
1969	2.00	1.94	1.48[a]	1.95
1970	2.26	2.26[b]	2.27[b]	2.27[b]
1971	2.24	2.24[b]	2.21[b]	2.25[b]
	Book Value			
6/30/69	$18.60	$18.35	$16.57	$18.48

[a] Hilo has filed an application with the Hawaii Public Utilities Commission for authority to increase its rates by approximately $870,000 annually. Had the rate increase been in effect for a full year 1969, its per-share earnings would have been $1.97 per share.

[b] Reflects fully the anticipated rate increase described in note (a), above.

HECO, the larger company, has experienced continuing growth which has been reflected in increasing earnings, while the earnings of Hilo, the smaller company, have declined. Hilo's rate of return has fallen below 6 percent, and Hilo has applied to the Hawaii Public Utilities Commission for a rate increase, designed to provide a rate of return of approximately 7 percent. As Maui was recently granted a similar rate increase, Hilo anticipates approval of its application. If Hilo receives such approval there will be no dilution of the HECO's estimated *pro forma* share earnings for 1970 and 1971.

Table III, below, presents, for the years indicated, a comparison of dividends per share paid by HECO with dividends per share paid by Hilo and the *pro forma* amount applicable to 1.0072 shares of HECO.

[11] All computations assume conversion of all outstanding convertible securities of HECO.

TABLE III

DIVIDENDS PER SHARE

	HECO	Hilo	
	Present Share	Present Share	1.0072 Shares of Heco
1965	$1.00	$1.025	$1.007
1966	1.04	1.10	1.048
1967	1.08	1.10	1.088
1968	1.20	1.10	1.209
12 mos. ended 6/30/69	1.23	1.10	1.239

The Hilo stockholder on a *pro forma* basis would receive an increase of approximately 11 cents per share for 1968 and 14 cents for the twelve months ended June 30, 1969. On April 15, 1969, the directors of HECO increased the quarterly dividend on the common stock of HECO from 30 cents to 33 cents per share, or the equivalent of $1.32 per year. On this basis the Hilo stockholder will receive an annual dividend for 1.0072 shares of HECO stock of approximately 23 cents per share more than presently paid by Hilo on its common stock. The proposed exchange will not affect HECO's ability to pay the new dividend rate even if its earnings per share were slightly diluted in the event the rate increase which Hilo requests is not granted.

In examining the fairness of the proposed exchange ratio we also note the relationship between the market prices of the common stocks of the respective companies. During 1967, the market prices of HECO common stock, traded on the New York Stock Exchange, ranged from a low of $22\frac{7}{8}$ to a high of $29\frac{5}{8}$ per share, compared with a range of 24 to 30 for the Hilo common stock which is traded on the Honolulu Stock Exchange. During 1968, HECO common stock ranged from a low of 25 to a high of $36\frac{1}{2}$ per share, compared with a range of $25\frac{1}{8}$ to $34\frac{1}{4}$ for the Hilo common stock. For the first eight months of 1969, the range was from a low of $31\frac{5}{8}$ to a high of $37\frac{1}{8}$ for HECO compared with a range of 29 to $35\frac{1}{2}$ for Hilo.

Considering all relevant facts, we conclude that the proposed exchange ratio, the terms of which were determined by arm's length bargaining, is fair and reasonable to the stockholders of both HECO and Hilo. The Hilo shareholders may expect greater earnings and dividends per share, a slightly greater book value per share and a stock with a wider market. The HECO shareholders may benefit from the expected growth of

Hilo and at most a slight dilution in earnings per share, if the proposed rate increase to Hilo is not approved, but to an extent such dilution would be offset by savings to Hilo after the acquisition.

OTHER MATTERS

We find that the proposed acquisition by HECO of Hilo common stock meets all other applicable standards of the Act and that no adverse findings are necessary. The Hawaii Public Utilities Commission has expressly approved the proposed transactions and hence Section 10(f) is satisfied. The estimated fees and expenses of $115,000, including counsel fees of $56,000, in connection with the proposed transactions appear to be reasonable. We make no adverse findings under Section 10(b)(3).[12]

The proposed accounting treatment is appropriate. HECO proposes to record its investment in the common stock of Hilo at an amount equal to the underlying book value of such stock on the effective date of the merger and the exchange. HECO will credit its capital stock account in an amount equal to the aggregate par value of the shares of stock it will issue and it will credit its earned surplus in an amount equal to the earned surplus of Hilo on the effective date of the merger. The excess of the par value of Hilo's common stock over the proposed recorded value of HECO's common stock will be credited to HECO's premium on common stock account.[13]

CONCLUSION

We conclude that the applicable statutory standards are satisfied, that no adverse findings are necessary, and that it is appropriate in the public interest and in the interest of investors and consumers that the application be granted.

IT IS ORDERED, accordingly, pursuant to the applicable provisions of the Act, and the rules thereunder, that said application, be, and it hereby is, granted, effective forthwith, subject to the terms and conditions prescribed in Rule 24 under the Act.

By the Commission (Chairman BUDGE and Commissioners OWENS, SMITH, NEEDHAM and HERLONG).

[12] See Appendix C for statement of capitalization and earnings coverages.

[13] This pooling of interests method of accounting for an acquisition has been approved in other cases. *Illinois Power Company*, 44 S.E.C. 139, 151; *National Fuel Gas Company*, 44 S.E.C. 115, 121 (1969); *Consolidated Natural Gas Company*, 43 S.E.C. 1120 (1969); *The Peoples Gas Company*, 42 S.E.C. 624 (1967).

APPENDIX A

HAWAIIAN ELECTRIC COMPANY, INC. (CONSOLIDATED) AND HILO ELECTRIC LIGHT COMPANY, LIMITED

Actual and pro forma condensed balance sheet
June 30, 1969

(000 omitted)

	HECO (Consolidated)	Hilo	Pro Forma [a]
Assets			
Utility Plant	$277,551	$36,158	$313,709
Less: Accumulated depreciation	49,605	9,868	59,473
	227,946	26,290	254,236
Other property (net)	1,380	—	1,380
Current assets	11,507	1,144	12,651
Deferred charges	1,730	233	1,963
Total	$242,563	$27,667	$270,230
Capitalization and Liabilities			
Preferred stock	$ 27,349	$ —	$ 27,349
Common stock	24,464	5,250	27,989
Premium on common stock	14,098	1,565	17,388
Earned surplus	26,238	1,883	28,121
Total Equity	92,149	8,698	100,847
Long-term debt	[b] 104,381	[c] 9,052	113,433
Current liabilities	18,252	5,689	23,941
Deferred credits	19,214	2,911	22,125
Contributions in aid of construction	8,567	1,317	9,884
Total	$242,563	$27,667	$270,230

[a] The pro forma balance sheet has been adjusted to give effect to the issuance of HECO common stock, par value of $\$6^{2}/_{3}$ a share, in exchange for the outstanding $10 par value common stock of Hilo. To reflect this exchange, $1,724,800 has been transferred to premium on common stock to recognize the resulting decrease in the pro forma par value of common stock outstanding.

[b] Subsequent to June 30, 1969, HECO sold an additional $18,000,000 of 9 percent first mortgage bonds pursuant to a registration statement (File No. 2–35300). Maui, paid off $500,000 of its bonds due July 1, 1969 and borrowed on a bank note, on which $2,130,000 was outstanding at September 30, 1969.

[c] Since June 30, 1969, Hilo sold to institutional investors $2,000,000 principal amount of $7^{3}/_{4}$ percent first mortgage bonds and $2,000,000 principal amount of $6^{1}/_{2}$ percent convertible subordinated notes. Upon merger the notes will be converted into an aggregate of 52,980 shares of common stock of HECO. Hilo agreed to increase the interest rate on its $8,220,000 of outstanding bonds by 1 percent per annum to obtain bondholders consent.

APPENDIX B

HAWAIIAN ELECTRIC COMPANY, INC. (CONSOLIDATED) AND HILO ELECTRIC LIGHT COMPANY, LIMITED

Actual and pro forma statement of income
Twelve months ended June 30, 1969

(000 omitted)

	HECO (Consolidated)	Hilo	Pro Forma
Operating Revenues:	$62,626	$6,401	$69,027
Operating Expenses:			
Cost of fuel oil	12,115	1,116	13,231
Other production expense	3,390	595	3,985
Transmission and distribution	2,167	216	2,383
Maintenance and repairs	2,883	345	3,228
Customers accounts and promotion	2,700	320	3,020
Administrative and general	3,354	247	3,601
Depreciation	6,337	1,092	7,429
Taxes other than income	6,699	606	7,305
Deferred investment credit adjustment—net	504	33	537
Income taxes:			
Current:			
Federal	5,029	328	5,357
State	687	46	733
Deferred:			
Federal	1,699	184	1,883
State	207	23	230
Pensions	1,170	—	1,170
Amortization of depreciation-adj.	(65)	—	(65)
	48,876	5,151	54,027
Operating income	13,750	1,250	15,000
Other Income (deduction)	(326)	18	(308)
Gross Income	13,424	1,268	14,629
Other Deductions:			
Interest on long-term debt	4,692	409	5,101
Other interest	403	337	740
Interest charged to construction	(447)	(124)	(571)
	4,648	622	5,270
Net income	$ 8,776	$ 646	$ 9,422

APPENDIX C

HAWAIIAN ELECTRIC COMPANY, INC. (CONSOLIDATED) AND HILO ELECTRIC LIGHT COMPANY, LIMITED

Actual and pro forma statement of capitalization and earning coverages
June 30, 1969

(000 omitted)

Statement of Capitalization

	HECO (Consolidated)		Hilo		Pro Forma [a]	
	Amount	*Percent*	*Amount*	*Percent*	*Amount*	*Percent*
Long-term debt	$104,381	53.1	$ 9,052	51.0	$113,433	52.9
Preferred stock	27,349	13.9	—	—	27,349	12.8
Common stock and surplus:						
Common stock	24,464	12.4	5,250	29.6	27,989	13.1
Capital surplus	14,098	7.2	1,565	8.8	17,388	8.1
Earned surplus	26,238	13.4	1,883	10.6	28,121	13.1
Total common stock and surplus	64,800	33.0	8,698	49.0	73,498	34.3
Total capitalization	$196,530	100.0	$17,750	100.0	$214,280	100.0

[a] After adjustment to reflect debt issued by both companies subsequent to June 30, 1969, debt retirements and treating the $2,000,000 received for the convertible subordinated notes as common equity, the pro forma ratios would be as follows:

	Percent
Long-term debt	56.8
Preferred stock	11.5
Common equity	31.7
Total	100.0

Statement of Earning Coverages

	HECO (Consolidated)	Hilo	Pro Forma
Income after taxes and before interest expense	$13,424	$1,268	$14,692
Interest expense	4,648	622	5,270
Preferred stock annual dividend requirements	1,444	—	1,444
Total	$ 6,092	$ 622	$ 6,714
Times earned:			
Interest expense	2.89	2.0	2.79
Interest expense and preferred dividend requirements	2.20	2.0	2.19

In the Matter of

LOEB, RHOADES & CO. and

LOEB, RHOADES MANAGEMENT CO., INC.

File No. 3-2109. Promulgated January 27, 1970

Investment Company Act of 1940—Sections 9(a) and 9(b)

MEMORANDUM OPINION AND ORDER

Loeb, Rhoades & Co. ("Loeb Rhoades") and Loeb, Rhoades Management Co., Inc. ("Management"), hereinafter referred to collectively as "Applicants", have applied for an order pursuant to Section 9(b) of the Investment Company Act of 1940 ("Act") exempting Applicants and their affiliated persons from the provisions of Section 9(a) of the Act.

We issued a notice of filing of said application (Investment Company Act Release No. 5903), giving interested persons an opportunity to request a hearing and stating that an order disposing of the application might be issued upon the basis of the information stated therein unless a hearing should be ordered. No request for a hearing has been received, and we have not ordered a public hearing. We have considered the application based upon the representations made therein and upon Applicants' prior history.

Loeb Rhoades, a registered broker and dealer with principal offices in New York City, is the owner of all of the outstanding capital stock of Management, which Loeb Rhoades organized in 1969 to act as the investment adviser to, and principal distributor for, Chelsea Fund, Inc. ("Chelsea"). Chelsea registered under the Investment Company Act on May 6, 1969, as an open-end management investment company. Several partners of Loeb Rhoades and employees of affiliated companies of Loeb Rhoades are proposed as officers and directors of Chelsea and of Management.

Section 9(a) of the Act makes it unlawful for any person who, by reason of any misconduct, is permanently or temporarily enjoined by order, judgment or decree of any court of competent jurisdiction from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security, or a company any affiliated person of which is ineligible for the same reasons, to serve or act in the capacity of officer, director, member of an advisory board, investment adviser, or depositor of any registered investment company, or principal underwriter for any registered open-end company.

Section 9(b) of the Act provides that any person who is ineligible by reason of subsection (a) to serve or act in the capacities enumerated therein may file an application with us for an exemption from the provisions of that subsection. It further provides that we shall by order grant such application, either unconditionally or on an appropriate temporary or other conditional basis, if it is established that the prohibitions of subsection (a), as applied to such person, are unduly or disproportionately severe or that the conduct of such person has been such as not to make it against the public interest or protection of investors to grant the requested application.

On November 14, 1968, we instituted a civil action in the District Court of the United States for the Southern District of New York, seeking to enjoin twenty-six defendants, including Loeb Rhoades, and one of its employees, Gerard L. Burchard ("Burchard") who was in charge of the firm's Canadian trading department, from further violating Section 5 of the Securities Act of 1933 in connection with the sale of securities of Lynbar Mining Corporation, Ltd. ("Lynbar"). Upon the consent of Loeb Rhoades and Burchard a final judgment was entered enjoining them from offering to sell, selling, or delivering after sale the securities of Lynbar in violation of Section 5 of the Securities Act of 1933.[1]

As a consequence of the injunction and the self-operating provisions of Section 9(a), Management is disqualified from acting as investment adviser to, or principal distributor for, Chelsea, and affiliated persons of Loeb Rhoades are disqualified from acting as officers and directors of Chelsea.

The sole question before us at this time is whether there is sufficient evidence to warrant the issuance of an exemptive order under Section 9(b). In reviewing this question, we must determine whether under all the circumstances Applicants

[1] Although the court's judgment stated it "does not constitute an adjudication of any wrongdoing or liability on the part of Loeb, Rhoades & Co. or Gerard L. Burchard by reason of the matter alleged in the said complaint, and neither said Consent nor this judgment may be used against Loeb, Rhoades & Co., Gerard L. Burchard or others in any other action", statutory ineligibility arises automatically from the entry of an injunction within the scope of Section 9(a). Only we can grant an exemption from such ineligibility and any provision in the decree attempting to achieve a contrary result is ineffectual.

have sustained the burden of proving that the prohibitions of Section 9(a) as applied to them are unduly or disproportionately severe or that their conduct has been such as not to make it against the public interest or protection of investors that they be permitted to serve in the capacities enumerated in Section 9(a).

To determine this question we look at the entire record of Applicants' conduct including that involved in earlier disqualifications even though Section 9(b) orders may have been granted with respect to such earlier conduct. On two earlier occasions it was necessary for Loeb Rhoades to apply for and receive Commission orders under Section 9(b).[2]

We note in connection with the circumstances which gave rise to the latest injunction that on November 14, 1968, we accepted an offer of settlement from Loeb Rhoades disposing of issues raised by the Lynbar transactions under Section 15(b) of the Securities Exchange Act of 1934 (Securities Exchange Act Release 8450). In so doing we determined that it was in the public interest to accept the offer of settlement in view of Loeb Rhoades' consent to the injunction, certain mitigating factors,[3] and upon the assurance that appropriate and effective procedures would be placed in effect prior to resumption by Loeb Rhoades of trading in Canadian over-the-counter securities.

Under all these circumstances, the bar automatically raised by Section 9(a) would appear to be unduly or disproportionately severe. We, therefore, are granting the exemption requested, except that Gerard L. Burchard will, of course, be exempted only to the extent that his continued employment would be a bar to Applicants under Section 9(a)(3); it is not

[2] On December 12, 1958, a final judgment by consent was entered permanently enjoining Loeb Rhoades and others from further violating Section 5(c) in connection with the sale of securities of Arvida Corporation. Thereafter, Loeb Rhoades applied for exemption from the prohibitions of Section 9(a). The application was granted by order dated January 19,1959 (Investment Company Act Release 2820).

On March 10, 1961, a permanent injunction by consent was entered against Loeb Rhoades in connection with the purchase of stock of Fruit of the Loom. Relief from the prohibitions of Section 9(a) was granted upon application filed by Loeb Rhoades pursuant to Section 9(b) by order dated May 15, 1961 (Investment Company Act Release 3250).

Contrary to our present practice these Section 9(b) orders were granted without the showing of an immediate need for exemption.

[3] Loeb Rhoades asserted that in the transactions leading to the above-mentioned civil action, it had no intent to violate any provisions of law, it had purchased the securities through its Canadian correspondent which had specific instructions not to purchase any stock for Loeb Rhoades which was in distribution in Canada; the activities in the stock were infinitesimal in relation to Loeb Rhoades' overall Canadian trading activities during the same period; all transactions were with other broker-dealers and no sales were made to public customers; upon its own initiative, Loeb Rhoades halted trading in all over-the-counter Canadian securities as soon as it was apprised of the concern of the staff of the Commission with the distribution of unregistered securities from Canada into the United States; it made a complete review of its compliance procedures with respect to Canadian securities; and Loeb Rhoades had not been charged with violations of any of the anti-fraud provisions of the Securities Act although certain other respondents had been so charged.

being granted as to him personally so that he will continue to be barred from serving in the capacities set forth in Section 9(a).

Accordingly, IT IS ORDERED, effective forthwith, pursuant to Section 9(b) of the Act, that Applicants and their affiliated persons be, and they hereby are, exempted from the provisions of Section 9(a) of the Act to the extent that such Section precludes Management from acting as investment adviser to and principal underwriter for Chelsea and prevents affiliated persons of Loeb Rhoades from acting as officers and directors of Chelsea, except that Gerard L. Burchard is exempted only to the extent that his continued employment would be a bar to Applicants under Section 9(a)(3).

By the Commission (Chairman BUDGE and Commissioners OWENS, SMITH and HERLONG), Commissioner NEEDHAM absent and not participating.

IN THE MATTER OF

LASER NUCLEONICS,INC.

File No. 3-2145. Promulgated February 2, 1970

Securities Act of 1933—Section 8(d)

STOP ORDER PROCEEDINGS:

Misleading Statements and Omissions

Where registration statement was materially misleading in that, among other things, it failed adequately and accurately to disclose education and business background of registrant's president who was also its sole stockholder; that similar company while operated by president of registrant sustained extensive losses and was subject of Regulation A suspension order; that basic laser patents are held by other firms; and that registrant had no patent, prototype or production equipment for device for which a major portion of proceeds was designated, *held*, stop order will issue suspending effectiveness of registration statement.

APPEARANCES:

Ralph H. Tracy, *Thomas N. Holloway* and *Mario V. Mirabelli*, for the Division of Corporation Finance of the Commission.

Edward N. Gadsby of Gadsby and Hannah, for Laser Nucleonics, Inc.

FINDINGS AND STOP ORDER

This is a proceeding instituted under Section 8(d) of the Securities Act of 1933 to determine whether a stop order should issue suspending the effectiveness of a registration statement filed by Laser Nucleonics, Inc. on November 29, 1968 and amended on February 10, 1969. The registration statement, which has not become effective, relates to a proposed public offering of 250,000 shares of Laser's $.10 par value common stock at $12.50 per share.

After appropriate notice, a public hearing was held. Prior to the filing of proposed findings registrant and the Division of Corporation Finance of the Commission entered into a stipulation in which they waived post-hearing procedures and registrant, solely for the purpose of this proceeding, admitted the accuracy of various allegations in the Division's Statement of Matters and consented to the entry of a stop order suspending the effectiveness of the registration statement. Registrant submitted an offer of settlement embodying the stipulation.

Upon consideration of all the circumstances, including the recommendation of the Division, the Commission determined to accept the offer of settlement. Accordingly, on the basis of the Statement of Matters, the evidence adduced at the hearing, and the stipulation and consent, it is found that the registration statement filed by registrant contained untrue statements of material facts and omitted to state material facts required to be stated therein or necessary to make statements therein not misleading, with respect to the following matters.

The prospectus filed as a part of the registration statement states that registrant, a new company organized in April 1968, is engaged in activities involving the use of laser techniques and in certain other fields. The prospectus further states that registrant's success will depend entirely upon the ability of its personnel to apply abstruse scientific techniques, that much of the available technical knowledge is dependent upon the knowledge and experience of Harry E. Franks, its president and sole stockholder, and that it is highly doubtful that registrant could operate successfully in the event of his disability or death. With respect to the president's background, the prospectus states that he is a graduate of Massachusetts Institute of Technology, and that in 1961 he founded, and until his resignation in December 1967 he was the administrative head, of Maser Optics, Inc., a company formed to do research and development in laser technology and to construct laser equipment.

The prospectus failed to disclose that the degree Franks received was one as a Bachelor of Science in Engineering Administration, that he received it in 1927, and that from 1927 to 1961 he was engaged in various businesses not related to lasers. The prospectus further failed to disclose that while Franks was president of Maser Optics, that company was the subject of a permanent suspension of a claimed Regulation A exemption from registration under the Securities Act with respect to a 1964 public offering of Maser Optics stock, on the basis of charges that the Maser Optics offering circular contained false and misleading statements.[1] Moreover, the pros-

[1] Securities Act Release No. 4779 (may 4, 1965).

pectus failed to disclose Maser Optics' substantial losses while Franks was its administrative head. Maser Optics had net losses of $464,922 and $517,000 for the fiscal years ending June 30, 1965 and 1966, a net loss of $689,177 for the six months ended December 31, 1967, and accumulated losses at that date of $2,591,661. Also not disclosed was the fact that Franks' resignation as president of Maser Optics in December 1967 was a result of stockholder action instituted because of his alleged mismanagement and refusal to hold stockholders' meetings.

The prospectus stated that registrant's personnel have been involved with the development of laser techniques since the laser principle was discovered and that registrant accordingly expects to expend relatively little in research and development and that what activities of this nature it does become involved in will be at a relatively highly sophisticated level. It further stated that some of registrant's personnel were formerly employed by Maser Optics, stated to have spent about $1,500,000 in research and development, and that the experience gained by such personnel will enable registrant to avoid duplicating the research and development expenses incurred by Maser Optics. In this regard the prospectus is materially deficient in failing to disclose the technical expertise, or lack thereof, of the officers and personnel of registrant who were formerly employed at Maser Optics. There are no facts presented which demonstrate the ability of registrant's personnel to perform at a highly sophisticated level, such as their educational background at the undergraduate and graduate level as well as their standing in the field of laser technology. The prospectus further fails to disclose that there has been no demonstrable carry-over to the registrant either by way of patents, equipment, data, experimental notebooks or product samples of the research and development for which Maser Optics assertedly spent $1,500,000, except that some of the former employees of Maser Optics who became employees of the registrant were familiar with the production methods used in connection with the work of Maser Optics.

The prospectus stated that the registrant has a substantial inventory of specialized tools and machinery much of which was donated to registrant by Franks, its president. This statement is materially deficient in that the equipment donated by Franks consisted primarily of used furniture and fixtures, only a small portion of which consisted of laboratory and manufacturing equipment.

Under the heading "Patents," the prospectus stated that the underlying principles and techniques involving the use of the laser are in the public domain, and that registrant has filed patent applications covering some of its apparatus and techniques, which it believes will be of importance to it although it has no way of determining whether its applications interfere with other pending application or will be eventually granted. These statements are deficient because of the failure to disclose that a number of nationally known corporations and others hold basically important and comprehensive patents relating to the laser and its improvements, and that production and sale of laser products in competition with such patent holders might require registrant to obtain licenses from them. Also, the "Patent" section is materially deficient in failing to disclose the existence of an agreement granting to General Laser Corporation, the successor to Maser Optics, an exclusive royalty-free license for the use of a patent assigned by Franks to registrant for which application is now pending.

Under the heading "Laser Manufacturing" the prospectus lists certain apparatus which it states that registrant "has developed and is presently offering for sale." This statement is materially deficient in view of the facts that registrant is not manufacturing a number of such items but is only offering them for sale from inventory, that one of the listed items is not being offered for sale at all, and that certain items listed as different items are really the same items described in different terms.

The prospectus states with respect to the use of microcircuitry that the "management estimates that the Company can profitably operate in this field at a cost of about 50 percent of that involved in prior techniques" and under the heading "Competition" that "the Company believes that the equipment which it has designed can be marketed profitably at a price materially below that which has been announced as the price range for competing equipment." The prospectus, however, fails to disclose any facts to substantiate these statements.

The prospectus is also materially deficient in that it fails to disclose that during the fiscal year ended March 31, 1969, registrant's income from sales, including the sale of three lasers for approximately $17,000, was $18,495 while its cash disbursements for the same period were $203,661.

The registration statement stated that it is not contemplated that there will be any underwriter but that the company will offer the shares through its own officers and directors, although it will pay a commission to broker-dealer members of the National Association of Securities Dealers, Inc. who buy shares for resale. The registration statement was designed to create a situation whereby officers and employees of registrant could sell stock to the public whenever registrant needed funds or whenever customers were available. Under the circumstances, particularly in view of the size of the offering and the fact that it will be made principally by registrant itself, there is a failure to disclose a plan of distribution for all of the 250,000 shares, and a failure to comply with Section 6(a) of the Securities Act which in effect requires that there be a representation that there is a present intention that all shares covered will be publicly offered within a reasonable period of time after the effective date of the registration statement.[2]

The prospectus stated that one of the first uses of the proceeds of the proposed stock offering, will be to pay registrant's current liabilities to 89 Brighton Avenue, Inc., its landlord and to Franks, in the amount of $48,055 as of August 31, 1968, representing money advanced, unpaid rent and salary. It failed to disclose that registrant's landlord was wholly owned by Franks and that the amount currently owed them was approximately $150,000.

The prospectus listed estimated proposed uses of proceeds in the amounts of $785,000 in connection with the development of a new spark plug concept, $108,000 for optics and thin film laboratories, and $28,000 for cancer research. The prospectus is materially deficient in that it fails to disclose that there is no patent, prototype or production equipment for the new spark plug, that claims in an application for a patent covering registrant's spark plug were rejected by the United States Patent Office on or about January 9, 1969, that the only samples or models of registrant's spark plug in existence were made by modifying standard spark plugs produced by other manufacturers, and that the only tests made of the new spark plug were conducted by Franks in three personal cars or cars under his personal control. The "Use of Proceeds" section is also deficient in that there is no explanation of what the optics and thin film laboratories are and what their connection is with the principal business of registrant, and no disclosure that some of the cancer research referred to is being done outside of registrant on a fellowship sponsored by Franks and has no apparent connection with lasers or nucleonics.

[2] See *Red Bank Oil Company*, 25 S.E.C. 334,342 (1947); Securities Act Release No. 4936, pp. 5–6 (December 6, 1968).

Based on the numerous material deficiencies set forth above which were dispersed throughout the registration statement, the registration statement as a whole is misleading.

In view of the above deficiencies, a stop order should issue suspending the effectiveness of the registration statement.

Accordingly, IT IS ORDERED that the effectiveness of the registration statement filed by Laser Nucleonics, Inc. be, and it hereby is, suspended.

For the Commission (pursuant to delegated authority).

IN THE MATTER OF

SPIRO SIDERIS

doing business as

OLYMPIC INSURANCE & SECURITIES AGENCY

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

File No. 3-1820. Promulgated February 13, 1970

Securities Exchange Act of 1934—Sections 15A(g) and (h)

REGISTERED SECURITIES ASSOCIATION—REVIEW OF DISCIPLINARY PROCEEDINGS

Violations of Rules of Fair Practice

Rebates to Customers on Sales of Mutual Funds

In proceedings for review of action by registered securities association censuring member and fining him $1,000, association's finding that member's rebates to four customers of half of his commissions on sales of mutual fund shares to them violated association's Rules of Fair Practice *sustained*, but under all the circumstances, including small number of transactions involved and member's otherwise clean record, fine reduced to $700.

APPEARANCES:

Spiro Sideris, pro se.

Lloyd J. Derrickson and *John F. Mylod, Jr.*, for the National Association of Securities Dealers, Inc.

FINDINGS, OPINION AND ORDER

This is an application pursuant to Section 15A(g) of the Securities Exchange Act of 1934 by Spiro Sideris, doing business as Olympic Insurance & Securities Agency, a member of the National Association of Securities Dealers, Inc. ("NASD"), for review of disciplinary action taken against him by the association. The NASD found that between November 1965 and July 1966, Sideris remitted to four customers, to whom he had made five sales of shares of The Dreyfus Fund, Incorporated, a registered open-end investment company, at the total public offering price of $23,100, approximately 50 percent of the total "dealer's commissions" of $1,400 realized by him on those sales. The NASD concluded that the rebates, which it considered to be in contravention of Section 22(d) of the Investment Company Act of 1940,[1] violated Sections 1 and 24 of Article III of the NASD's Rules of Fair Practice.[2] It censured Sideris, increased a $700 fine imposed upon him by the NASD District Committee to $1,000, and assessed costs against him. He and the NASD filed briefs with us and presented oral argument. Our findings are based upon a review of the record.

Sideris admits the basic facts, and at the NASD hearings stated that he would not dispute the charges of violations and would address himself solely to the question of sanctions. On review, however, he appears to contend that no violations should be found and urges that the complaint be dismissed. He asserts that he properly offered the mutual fund shares to customers at their "net asset value," that the customers were benefitted by his rebates of a portion of the commissions earned by him in such transactions, and that such rebates are not specifically prohibited.

It is clear, however, that Section 22(d) expressly prohibits a dealer from selling mutual fund shares at prices below the "public offering price," which includes the sales load fixed by the fund that is added to net asset value. Sideris' rebates of part of the sales load in effect reduced the price of the Dreyfus shares sold by him. Moreover, the purposes of Section 22(d) as stated by the Commission "are to prevent discrimination among purchasers and to provide for orderly distribution of such shares by preventing their sale at a price less than that fixed in the prospectus."[3] Accordingly, while Sideris' customers were financially benefitted in their particular purchases from him, Section 22(d) seeks to prevent the adverse effect upon investors generally which would result from discriminatory pricing and disorderly distribution.[4]

[1] Section 22(d) of the Investment Company Act in pertinent part prohibits a dealer from selling a redeemable security issued by a registered investment company to customers at any price other than the current public offering price described in the prospectus.

[2] Section 1 of Article III of the NASD rules requires members to observe high standards of commercial honor and just and equitable principles of trade. Section 24 in pertinent part prohibits a member from giving selling concessions, discounts or other allowances to anyone other than a broker or dealer.

[3] Investment Company Act Release No. 2798 (December 2, 1958).

[4] There is no merit in Sideris' charges of bias against the NASD which is apparently based on the NASD's opposition to certain recommendations in the Commission's *Report on the Public Policy Implications of Investment Company Growth* (H. Report No. 2337, 89th Cong., 2d Sess. (December 2, 1966)). That report urged the adoption of a statutory ceiling on sales loads below the sales loads prevailing in the industry. We see no inconsistancy between opposing a particular ceiling on sales loads and applying the applicable legal principles proscribing price discrimination.

We conclude, as did the NASD, that Sideris' rebates contravened Section 22(d) of the Investment Company Act and violated Sections 1 and 24 of Article III of the NASD rules, and that his conduct was inconsistent with just and equitable principles of trade.

Sideris further contends that the $1,000 fine is excessive and harsh and should be reduced or set aside. He asserts that he believed in good faith that it was permissible to give a discount on commissions earned. He states that because of his regular employment as an estate tax examiner for the State of New York and his limited activities in selling mutual fund shares, he did not devote much time to study of the NASD's rules and was unfamiliar with them. He claims that he was informed by a Commission employee over the telephone that he "could collect less than due commissions," and that to "overcharge" was prohibited, but charging "less" was not. He stresses that he thereafter voluntarily disclosed the rebates in a financial statement filed with the Commission, and halted such rebates when they were questioned.

The fact that the violations resulted from Sideris' asserted ignorance of the applicable requirements or that he devoted only part of his time to the securities business does not, however, diminish the violations, particularly since they related to the only type of securities being sold by him and he had been a registered representative since 1962. It was incumbent upon him to know of and comply with those requirements, which had been established to govern the conduct of persons engaged in the securities business including NASD members and registered representatives, and it was appropriate that the NASD in the exercise of its self-regulatory functions should enforce those requirements by imposing a disciplinary sanction upon him as a member. We find no basis for disturbing the NASD's findings that his recollection of the time and substance of his telephone conversation was "somewhat vague" and that, even if the conversation occurred prior to the time of the violations, it did not constitute sufficient inquiry under the circumstances.[5] On the other hand, in view of the

[5] Sideris did not state whether he asked the staff employee specifically about rebates of commissions received on sales of mutual fund shares.

We also disagree with Sideris' contention that Section 24 of Article III of the NASD rules is not applicable to his rebates because, unlike Section 26 of Article III, it does not specifically refer to mutual fund shares or to sales of such shares at the public offering price. Section 26 does not deal with customer rebates, and the fact that Section 24 does not contain those specific references would not affect its applicability to his rebates.

small number of transactions, the relatively small amounts of commissions involved, and the fact that he has no record of any previous violations, we are of the view that the public interest would be adequately protected by censure and a fine of $700 as assessed by the District Committee.

Accordingly, IT IS ORDERED that the censure and $1,000 fine imposed upon Spiro Sideris, doing business as Olympic Insurance & Securities Agency be, and they hereby are, modified to censure and a fine of $700.

By the Commission (Chairman BUDGE and Commissioners OWENS and SMITH), Commissioner NEEDHAM dissenting in part, and Commissioner HERLONG not participating.

Commissioner NEEDHAM, dissenting in part:

In my opinion, censure is an adequate penalty for the derelictions shown here. As noted by the majority, Sideris voluntarily reported his rebates, discontinued them when he learned they were unlawful, and has no prior record of securities violations. It appears that he acted in good faith and has given assurance that there will be no repetition of the violations. Under all the circumstances, I cannot agree that a fine is either appropriate or necessary in the public interest.

IN THE MATTER OF

KENNEDY, CABOT & CO., INC.

DAVID PAUL KANE

LINDA D. TALLEN

File No. 3–326. Promulgated February 16, 1970

Securities Exchange Act of 1934—Section 15(b)

BROKER-DEALER PROCEEDINGS

Grounds for Suspension of Registration
Grounds for Suspension and Bar from Association with Broker-Dealer
Offer, Sale and Delivery of Unregistered Stock
Fraud in Offer and Sale of Securities
Bids and Purchases While Engaged in Distribution
Excessive Markups

Where registered broker-dealer and associated persons participated in unlawful distribution of unregistered stock, made fraudulent representations and predictions in connection with offer and sale of securities concerning, among other things, increases in price, investment quality, value and exchange listing of stock, and issuer's operations, assets, income and financial condition, bid for and purchased securities while engaged in distribution, and charged excessive markups, *held*, in public interest to suspend broker-dealer's registration and suspend and bar associated persons from association with any broker-dealer.

APPEARANCES:

Joseph C. Daley, *D. J. Silman*, *Roberta S. Karmel*, *Judith G. Shepard*, *Robert M. Berson*, *William Nortman* and *Ralph K. Kessler*, for the Division of Trading and Markets of the Commission.

Clark van der Velde, for Kennedy, Cabot & Co., Inc. and David Paul Kane.

George J. Nicholas, of Glickman, Nicholas & Burford, for Linda D. Tallen.

FINDINGS AND OPINION OF THE COMMISSION

These were private proceedings, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act"), in which after hearings before a hearing examiner he issued an initial decision concluding, among other things, that the registration as a broker and dealer of Kennedy, Cabot & Co., Inc. ("registrant") should be suspended for 120 days; that David Paul Kane, president of registrant, should be suspended from association with any broker or dealer for six months; and that Linda D. Tallen, a saleswoman and for most of 1961 secretary of registrant, should be suspended from such association for one year, with the proviso that following her suspension she may be associated with a broker-dealer only in a non-supervisory capacity under such supervision as we deem appropriate.[1]

Petitions for review of the initial decision were filed by respondents which did not take exception to the examiner's findings of fact and conclusions of law, and we ordered review with respect to certain procedural issues and the appropriateness of the sanctions imposed by the examiner. Briefs were filed by respondents and the Division of Trading and Markets ("Division") and we heard oral argument. On the basis of a review of the record and the initial decision, and for the reasons set forth herein and in that decision, we make the following findings.

Registrant was organized in May 1960 with Kane as its sole stockholder, and became registered with us the following month. Tallen became associated with registrant in December 1960.

OFFER AND SALE OF UNREGISTERED STOCK, AND BIDS AND PURCHASES DURING DISTRIBUTION

We agree with the finding of the hearing examiner that during 1961 respondents willfully violated the registration provisions of Sections 5(a) and 5(c) of the Securities Act of 1933 ("Securities Act") in the offer, sale and delivery of the stock of American States Oil Company ("ASO") when no registration statement had been filed or was in effect under the Securities Act as to those securities.

During the period under consideration, one J. Tom Grimmett was president and controlling person of ASO, which had been organized in Illinois in 1952 to own, develop and deal in oil, gas and mineral properties. From October 1959 to January 1960

[1] Two other respondents named in the instant proceedings were the subject of prior disciplinary action taken pursuant to their consents. One was barred from being associated with any broker-dealer and the other was suspended from such association for 10 months. (Securities Exchange Act Release Numbers 7781 and 8105, January 4, 1966 and June 23, 1967).

ASO issued 550,000 shares of its stock to The Mid-State Drilling Company ("Mid-State") for Mid-State's interest in certain Oklahoma oil and gas leases which Grimmett had assigned to it. During 1960 and 1961 Mid-State also purchased over 100,000 shares of ASO stock on the open market. Mid-State, like ASO, was controlled by Grimmett, and had as its president Grimmett's son-in-law, Larry Gulihur. The examiner found that between 1959 and 1962 Grimmett, through Mid-State and Gulihur, offered, sold and delivered over 600,000 unregistered shares of ASO stock, including over 500,000 of the shares issued to Mid-State described above.[2]

As the examiner further found, during 1961 registrant bought through Kane, Tallen and another employee about 19,000 shares of ASO stock, of which at least 7,200 emanated from the block of 550,000 shares issued to Mid-State, and around 5,500 shares from an account with another broker-dealer in the name of Gulihur who was acting as nominee for Mid-State and Grimmett. Between January and September 1961 registrant sold over 17,000 shares of which Tallen sold over 6,000. In March and May 1961 Tallen accepted 7,500 ASO shares in partial repayment of substantial loans previously made by her to Grimmett. Those shares emanated from the Mid-State block and her certificates were obtained directly from Mid-State. In August and October 1961 she sold to registrant 1,300 shares out of her account with registrant, including at least 600 shares reflected in a confirmation listing Kane as the salesman. In addition, in January and around March 1961 Tallen arranged for the sale of 4,000 shares of ASO stock to a customer directly from Mid-State. Kane arranged for the customer to sell 500 of those shares on February 27, 1961, and the customer received a confirmation from registrant reflecting such transaction.

Respondents by acquiring with a view to its distribution ASO stock held by Mid-State, which with ASO was under the common control of Grimmett,[3] participated in a distribution and became underwriters within the meaning of Section 2(11)

[2] On the basis of a complaint filed by this Commission, Grimmett was enjoined in July 1956 by the United States District Court for the Southern District of New York from further violations of the registration provisions of the Securities Act in the sale of unregistered ASO stock. On November 21, 1956 we issued an order temporarily suspending an exemption from the registration requirements of the Securities Act under Regulation A with respect to an offering of ASO stock by Grimmett on the grounds that, among other things, ASO and Grimmett failed to disclose Grimmett's sale of a substantial number of unregistered ASO shares within one year prior to the filing of the notification and that he was subject to the above injunction.

[3] Under Section 2(11) "issuer" includes any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

of the Securities Act.[4] That they took only a small portion of the stock distributed does not alter the fact that they participated in the distribution. As statutory underwriters, respondents were subject to the prohibitions embodied in Section 5 of the Securities Act.

Respondents knew or should have known that they were participating in an unlawful distribution of ASO stock by Grimmett. Tallen knew that Grimmett was the president and largest single stockholder of ASO and controlled Mid-State, and that large blocks of ASO stock including shares received by her were emanating from Mid-State. Indeed, she accepted ASO stock in part payment of a debt owed her by Grimmett and received shares directly from Mid-State after Grimmett told her that since his own stock was "locked up" and under scrutiny by our staff he would have Mid-State give her the shares.[5] She also arranged for a customer to acquire ASO shares directly from Mid-State and for payment for shares purchased by a part-time salesman for registrant to be made by a check with the payee's name left blank, which was thereafter stamped with Mid-State's name and endorsed by it.[6] In addition, Tallen participated with Grimmett and a customer acquainted with Grimmett, in a transaction in which the customer borrowed and then loaned to Gulihur $100,000 to enable Gulihur to pay for 36,000 ASO shares, with the customer's loan being secured by 100,000 ASO shares transferred from Mid-State's name to Tallen's at Grimmett's direction.[7] The customer defaulted in payment of the loan, and some of the shares were subsequently sold by the pledgee.[8]

Kane, who was a trader for registrant and in control of its operations, knew of Grimmett's connection with ASO and the circumstances surrounding Tallen's acquisition of ASO stock from Mid-State, that Mid-State owned a considerable amount of ASO stock, and that registrant had obtained such stock from Mid-State. He handled the purchase by registrant of ASO stock from another broker-dealer which came from Mid-State, and the record contains a number of sight drafts drawn by Mid-

[4] *Cf. S.E.C.* v. *Chinese Consolidated Benevolent Association, Inc.*, 120 F.2d 738 (C.A. 2, 1941) *cert. denied* 314 U.S. 618; *S.E.C.* v. *Guild Films Company, Inc.*, 279 F.2d 485 (C.A. 2, 1960), *cert. denied sub nom Santa Monica Bank* v. *S.E.C.*, 364 U.S. 819; *Sutro Bros. & Co.*, 41 S.E.C. 470, 477-78 (1963).

[5] The record contains a March 1961 letter from Mid-State to Tallen in care of registrant enclosing a certificate for 5,000 shares and signed by Gulihur as president of Mid-State.

[6] The salesman testified that Tallen did not write up an order for his purchase, stating that she was getting his stock from the president of ASO, although he apparently received his stock certificate from registrant.

[7] Tallen was reimbursed by Mid-State for legal expenses incurred in connection with the transaction.

[8] *Cf. S.E.C.* v. *Guild Films Company, Inc.*, 279 F.2d 485 (C.A. 2, 1960), *cert. denied sub. nom. Santa Monica Banks* v. *S.E.C.*, 364 U.S. 819.

State on registrant in payment for purchases from that broker-dealer. Under all the circumstances Kane was at least alerted to make adequate inquiry and obtain reliable information with respect to the source of the stock registrant was selling. He did not do so, however, and did not even communicate with Grimmett with respect to the source of the stock notwithstanding the fact that he was acquainted with Grimmett through prior dealings and knew of Grimmett's connection with ASO and dealings with Tallen. Nor did he check to see whether a registration statement was filed under the Securities Act with respect to such stock.

As further found by the hearing examiner, respondents also willfully violated and willfully aided and abetted violations of Section 10(b) of the Exchange Act and Rule 10b–6 thereunder in that Kane and Tallen bid for and purchased ASO stock for registrant's account during the period that they participated in the distribution of such stock by Grimmett.[9]

FRAUD IN OFFER AND SALE OF STOCK

The record establishes, as found by the hearing examiner, that in connection with the offer and sale of ASO securities respondents willfully violated and willfully aided and abetted violations of the antifraud provisions of Section 17(a) of the Securities Act and Sections 10(b) and 15(c)(1) of the Exchange Act and Rules 10b–5 and 15c1–2 thereunder.

In connection with the sale by registrant of ASO stock between January and July 1961 at from 3$^1/_2$ to 6$^1/_4$ per share, Tallen represented that such stock was "better than American Telephone & Telegraph," would be listed on the New York Stock Exchange very soon or when ASO started to drill a certain Wilmington off-shore oil field near Long Beach, California, was worth at least 50, would rise in price to 10 within six months, or up to 15 to 50 in three or six months, and Tallen expected it would rise to the upper 20's upon the acquisition of the right to drill around Long Beach, or to 25 or 30 within a very short time; that ASO was a producing company with good potential in the Wilmington area and was "financially sound"; and that millions of dollars were involved in the Wilmington oil fields and registrant had oil holdings worth $70 per share. In February 1961 she told a customer she thought the stock was a

[9] Rule 10b–6 provides that it is a manipulative or deceptive device for an underwriter in a distribution of securities, or issuer or other person on whose behalf such a distribution is being made, or a broker-dealer or other person participating in such distribution, to bid for or purchase such securities until he has completed his participation in the distribution.

"very good buy" because the company had just completed a well in the Long Beach tidelands area.

Kane told a customer in May 1961 who had purchased ASO stock from registrant through Tallen, that he had just spoken to Grimmett who had convinced him that ASO stock was good and that he (Kane) now believed in it. In that month another customer bought 50 shares from registrant at 5½ after Kane had recommended that he buy that number of shares, and the following month registrant sold ASO stock to another person at 4 following the buyer's telephone conversation with Tallen and Kane in the course of which Kane represented that ASO stock was a "good deal to buy" because the company was involved with oil leases in the Long Beach area, and that its price had a good chance to double in six months. In connection with a sale by Kane in November 1961 at 1¼ to a customer, who had previously bought ASO stock at 6¼, Kane stated that she should not worry about the decline in its price because another oil well had come in, and she should average down her costs by purchasing more stock. And in December 1961 Kane told a customer, who had purchased ASO stock from registrant, that there had been some difficulty with the oil leases which was expected to be cleared up soon, and that he still felt ASO would be a good deal.

Between March and June 1961 other salesmen of registrant effected sales of ASO stock to its customers at 3¾ to 6¼. In connection with such sales they represented that the stock was a "good deal" on which the customer could not lose, and would be listed on a securities exchange; that the price should rise to around 11 or 12 in possibly a year or longer, or would go to 10 to 20 within a year; and that ASO was a good stable company and was an important off-shore drilling company in Long Beach and expected to derive $10,000,000 of earnings through leases there.

The highly optimistic representations and predictions listed above concerning ASO and its stock were not warranted by the facts. ASO was not in any sense a stable or financially sound company. It was organized in Illinois in 1952, was dissolved by that State in 1957 but reinstated the following year, and in November 1961 was "ousted" by the State of Oklahoma for failure to comply with requirements relating to the payment of that State's fees.[10] For the fiscal years ending April 30, 1960, 1961 and 1962, respectively, it suffered losses of $15,588, $19,-

[10] In November 1964 ASO was again dissolved by the State of Illinois.

016 and $116,997, and had earned surplus deficits of $1,071,164, $1,090,180 and $1,207,000. No off-shore oil leases in the Wilmington field were ever acquired by ASO or Grimmett.[11] While ASO did ultimately acquire three other leases on California oil properties in July and August 1961 and obtained some oil production from two wells on those properties, all such leases were sold in May 1962 at a loss of $60,838. ASO lacked basic qualifications for listing its stock on the New York Stock Exchange and the record does not show that it had undertaken any steps to secure any exchange listing.

Kane and Tallen had no current financial information on ASO during the period when a large number of the sales were effected. Kane was advised in November 1960 that ASO had had inadequate capital and around the end of February 1961 that financial statements were not available, and such statements were not received by registrant until June 1961. Nevertheless, Kane took no effective steps to obtain reliable financial data, and his asserted reliance on Tallen for other information was misplaced in view of her inexperience in the securities business.[12] Tallen assertedly relied primarily on information from Grimmett despite his failure to perform on prior business dealings with her and Kane or repay loans she made and the fact that he had given his checks unsupported by sufficient funds. In any event, none of the information assertedly furnished by Grimmett or others warranted the predictions and extravagant statements she made, and she knew of ASO's losses. Moreover, as we have repeatedly held, it is inherently fraudulent to predict specific and substantial increases in the price of a speculative security, as Kane and Tallen did in this case.[13]

EXCESSIVE MARKUPS

In 34 principal transactions with customers in ASO stock effected by registrant between January and July 1961, registrant's markups ranged from 8.3 percent to 95.7 percent over its contemporaneous costs of the stock. Such markups were excessive and not reasonably related to prevailing market prices, and by charging them respondents willfully violated and willfully aided and abetted violations of the antifraud

[11] In December 1959 Grimmett entered into a contract to purchase all the stock of Dynamic Industries Company, which had in June 1959 lost a legal action to enforce a purported contract giving it the right to drill on certain off-shore lands near long Beach. In a legal action instituted in March 1960, however, Dynamic shareholders recovered the escrowed shares purchased by Grimmett because of non-performance of his obligations under the December 1959 contract.

[12] Tallen admitted she did not even know during 1961 how to read a financial statement.

[13] See, *e.g.*, *Crow, Brourman & Chatkin, Inc.*, 42 S.E.C. 938, 942 (1966).

provisions of Section 17(a) of the Securities Act and Sections 10(b) and 15(c)(1) of the Exchange Act and Rules 10b–5 and 15c1–2 thereunder.[14]

Procedural Matters

Registrant and Kane renew their objection to the hearing examiner's denial of their motion for his disqualification based on the fact that he had previously presided in a prior proceeding relating to another broker-dealer who purchased ASO shares from Grimmett in 1954 and 1955 which involved assertedly related issues. We reaffirm our prior order upholding his ruling on the grounds that even if there were common issues of law or fact in these and the prior proceedings, which we indicated was not the case, that circumstance would not disqualify the examiner from presiding in these proceedings.[15]

Tallen also objects to certain other rulings of the hearing examiner. He denied a request by her attorney for a postponement made at the commencement of the hearings on the ground that she was ill and unable to attend, noting that the motion was untimely, and directed the Division to make the transcript available for examination by Tallen's counsel at the Commission's branch office, and to notify counsel in advance of calling a witness who had direct dealings with Tallen. The examiner indicated a willingness to grant liberal recesses to enable counsel to confer with Tallen, and even to hold a portion of the hearings in her home if it was accessible. At the opening of the afternoon session Tallen's counsel advised that he had been discharged because Tallen did not want representation when testimony is given in her absence. At a later stage of the proceedings the same counsel again represented Tallen, and he requested that the Division recall four specific witnesses for cross-examination. The examiner denied that request, noting that any party was free to ask for the issuance of subpoenas, and stated that if counsel called the witnesses, he would "make rulings in cognizance of the actual situation." Counsel declined to call the four persons as Tallen's witnesses.

In our opinion the examiner did not abuse his discretion in denying postponement, and the accommodations he was willing to extend to Tallen and her counsel would if accepted have enabled counsel to cross-examine the witnesses effectively when they were testifying. Any examination by Tallen's coun-

[14] *Cf. Norman J. Adams*, 41 S.E.C. 993 (1964); *Powell & Mc-Gowan, Inc.*, 41 S.E.C. 933 (1964).

[15] *Transamerica Corporation*, 10 S.E.C. 454, 473–4 (1941). *Cf. Federal Trade Commission* v. *Cement Institute*, 333 U.S. 683, 703 (1948); *Barnes* v. *United States*, 241 F.2d 252, 254 (C.A. 9, 1956); *Lyons* v. *United States*, 325 F.2d 370, 375–6 (C.A. 9, 1963).

sel would naturally have related to the subject-matter covered on direct examination, so that in substance such examination would have been in the nature of and equivalent to cross-examination.[16] Indeed, Tallen's counsel recognized that he could in effect cross-examine the witnesses if called by him, and counsel for the Division pointed out that Tallen's counsel could elect to have them declared hostile. There is no indication that the examiner would have restricted any attempt by Tallen's counsel to impeach the testimony of those witnesses.[17] While it might have been preferable for the examiner to grant counsel's request for recall of the four witnesses, in the circumstances his denial did not prejudice Tallen.

PUBLIC INTEREST

On the question of what remedial action is appropriate in the public interest, respondents claim that the sanctions ordered by the hearing examiner are excessive. They stress that the alleged violations stemmed from the activities of Grimmett, who was an experienced manipulator of unregistered securities and, as found by the hearing examiner, engaged in an elaborate scheme to defraud, and that they were inexperienced in the securities business at the time.

Registrant and Kane state that Tallen was primarily responsible for registrant's activities in ASO stock, that Kane himself did not sell any ASO stock, and that Kane relied on the information concerning ASO given him by Tallen and others and on the existence of active trading in the stock by reputable firms. They state that they have not engaged in the general securities business for over seven years and do not intend to do so in the future, and that since February 1964 Kane's activities in the securities business have been limited to serving as president of a registered investment company, its investment adviser and registrant, which now acts solely as its principal underwriter. Tallen states that since July 1961 she has limited her activities to acting as a finder and selling a small amount

[16] *Cf. Giant Food Inc.* v. *F.T.C.*, 322 F.2d 977 (C.A.D.C., 1963), *cert. dismissed* 376 U.S. 967 (1964). In that case, after the examiner had ruled cross-examination closed, the respondent refused to examine witnesses with respect to subsequently obtained documents even though the examiner stated that leading questions could be asked and counsel should not be concerned about being "bound" because the testimony would be appraised objectively. The Court rejected respondent's contention that it had not been accorded and adequate opportunity for cross-examination, pointing out that administrative agencies are afforded "some leeway" as to application of rules of evidence, as long as "accepted standards of fairness" are observed, and that the examiner was willing to afford all the benefits of cross-examination, "though hesitating to apply the name."

[17] Allowance of impeachment of a party's own witness is within the discretion of the trier of facts who heard him and saw him testify. See *Journeymen Plasterers' Protective and Benevolent Society of Chicago* v. *N.L.R.B.*, 341 F. 2d 539 (C.A. 7, 1965).

of mutual fund securities, and has undertaken to acquire the knowledge necessary to adequately inform investors concerning the value and potential of securities.

We agree with the hearing examiner that the misconduct engaged in by respondents was serious and requires the imposition of sanctions, but we consider that the sanctions he would impose are not adequate for the protection of investors and the public interest in light of such misconduct. As has been seen, respondents made false and misleading statements and predictions in connection with the sale of unregistered shares of a highly speculative security while participating in an unlawful distribution of such shares during which they improperly bid for and purchased shares, and charged customers excessive markups. We have given recognition to the fact that, with the exception of the excessive markups, the violations stemmed in large part from Grimmett's activities including false and misleading information emanating from him and ASO. However, respondents could not reasonably place reliance upon such statements in view of Tallen's and Kane's previous dealings with Grimmett who defaulted on his obligations and in the repayment of substantial loans made by Tallen. As to Kane's participation in the sales activities, we have found that he made misrepresentations in a sale which he effected himself as well as in connection with sales by other representatives of registrant.

We are of the opinion that the maintenance of required standards of honest dealing and compliance with necessary statutory protections requires that respondents be subjected to a more extensive exclusion from the securities business. With respect to Tallen, we agree with the Division that she played the key role in registrant's activities involving ASO stock and in her representations and predictions as well as in all other respects demonstrated a flagrant indifference to the basic duty of fair dealing required of securities salesmen and that she should be indefinitely barred from association with any broker or dealer.

With respect to registrant and Kane we are satisfied that under all the circumstances an indefinite bar is not necessary. While we consider a six-month suspension as recommended by the examiner inadequate in light of the misconduct, we conclude that the public interest will be adequately served by imposing upon those respondents a suspension of nine months, coupled with a grant of their request to permit sales of shares of the mutual fund of which Kane is president through a named broker-dealer in which respondents have no financial interest, provided that respondents are to receive no commissions, directly or indirectly, on such sales.

An appropriate order will issue.[18]

By the Commission (Chairman Budge and Commissioners OWENS and SMITH), Commissioners NEEDHAM and HERLONG not participating.

[18] We have considered the initial decision of the hearing examiner and the exceptions thereto, and to whatever extent such exceptions involve issues which are relevant and material to the decision of the case, we have by our Findings and Opinion herein ruled upon them. We hereby sustain such exceptions to the extent. that they are in accord with the views set forth herein, and we overrule them to the extent they they are inconsistent with such views.

IN THE MATTER OF

NEW ENGLAND ELECTRIC SYSTEM

File No. 3–1985. Promulgated February 24, 1970

Public Utility Holding Company Act of 1935—Sections 11(b)(1) and 11(c)

MEMORANDUM OPINION AND ORDER

New England Electric System ("NEES"), a registered holding company, has filed an application, pursuant to Section 11(c) of the Public Utility Holding Company Act of 1935 ("Act"), for an additional period of six months from October 3, 1969, in order to comply with our order of March 19, 1964 (41 S.E.C. 888). That order directed, pursuant to Section 11(b)(1), that NEES dispose of all interests, direct or indirect, in its subsidiary gas utility companies.[1]

On May 14, 1964, NEES filed with us an application for a stay of our order pending review pursuant to Section 24(a) of the Act and the next day filed a petition for review in the Court of Appeals for the First Circuit. By order issued on June 25, 1964, we granted the application for a stay (Holding Company Act Release No. 15096). The Commission's order of March 19, 1964 was set aside by the Court of Appeals, 346 F.2d 399 (1965), but the Supreme Court of the United States reversed and remanded the case for further consideration, 384 U.S. 176 (1966). On remand the Court of Appeals again set aside the Commission's order, 376 F.2d 107 (1967), but the Supreme Court reversed and directed affirmance of the Commission's order, 390 U.S. 207 (1968). On April 3, 1968, the Court of Appeals entered a judgment affirming the Commission's order of divestment.

Section 11(c) of the Act provides that any order under Section 11(b) shall be complied with within one year from the date of such order. It further provides that the Commission shall grant an extension of time not exceeding one additional year if it finds the extension of time "necessary or appropriate

[1] Reference to "NEES" includes also the gas-utility subsidiary companies to whom our order also extended.

in the public interest or for the protection of investors or consumers," provided that it is shown, "that the applicant has been or will be unable in the exercise of due diligence to comply" with the Commission's order within the time allowed by Section 11(c) or by order of the Commission thereunder. Section 11(c) does not authorize us to grant any additional extension of time.

When, on April 3, 1968, the Court of Appeals entered its judgment affirming our order, such judgment foreclosed all avenues of further judicial review, and the stay, which we granted by order on June 5, 1964, was terminated. NEES, accordingly, had one year from April 3, 1968 to carry out the divestment of its interest in the gas utility subsidiary companies. Within that year NEES applied for an additional six months, which we granted by order of July 11,1969 (Holding Company Act Release No. 16424). Within the time as so extended NEES applied for an additional period of six months from October 3, 1969.

NEES has organized a new company, Massachusetts Gas System ("Mass Gas"). NEES will transfer to Mass Gas all the debt and equity securities of its gas-utility subsidiary companies owned by NEES, in exchange for which Mass Gas will issue its common shares to NEES. In that connection, NEES stated that the ultimate dispositon of the gas properties would be subject to a further plan or plans to be filed with the Commission and that the organization of and transfer to Mass Gas in no way indicated the particular method or methods by which divestment would be carried out. This proposed exchange was approved by order issued January 19, 1970 (Holding Company Act Release No. 16583).

Section 11(c) is not a two-year moratorium on compliance. Its purpose is to afford a company sufficient time for compliance with an order under Section 11(b) but only on the assumption, as Section 11(c) itself emphasizes, that the company shall proceed with "due diligence" during the one-year period automatically allowed by statute and during any additional time allowed by order of the Commission. The stay we granted on June 25, 1964 expired on April 3, 1968, and we note that in its request for a stay NEES represented that such stay would result in only a relatively short delay in carrying out our Section 11(b) order.

On the record before us it is clear that no such diligence has been exercised by NEES and that the creation of Mass Gas, the new subholding company, has been only a modest token in the direction of compliance. We shall reluctantly grant the pending application of NEES, but with the understanding that NEES will promptly take steps towards compliance with our order of March 19, 1964. Otherwise, we shall give serious consideration to initiate proceedings under Section 11(d) of the Act.

IT IS ORDERED, accordingly, that the application be, and it hereby is, granted and that the time for compliance with the order of this Commission, issued on March 19, 1964, be, and it hereby is, extended to April 2, 1970.

By the Commission (Chairman BUDGE and Commissioners OWENS, SMITH, NEEDHAM and HERLONG.

IN THE MATTER OF

ALFRED BRYANT TALLMAN, JR
and
PETER J. SLATER

File No. 3-1694. Promulgated March 2, 1970

Securities Exchange Act of 1934—Section 15(b), 15(A), 19 (a)(3)

BROKER-DEALER PROCEEDINGS

Grounds for Bar from Association with Broker-Dealer

Fraud in Offer and Sale of Securities

Failure of Supervision

Where salesman of registered broker-dealer in offer and sale of speculative securities, made fraudulent representations and recommended such securities to customers for whom they were unsuitable in light of investment needs and objectives, and without making reasonable and diligent inquiry and in disregard of information as to the past and current financial condition and business operations of the issuers; and where employee designated compliance director but not given authority to enforce compliance failed reasonably to supervise such activities of salesmen *held*, salesman willfully violated antifraud provisions of securities acts and in public interest to bar him from association with broker-dealer, but under circumstances presented no sanction imposed on compliance director.

APPEARANCES:

Mortimer Gerber, *Donald N. Malawsky*, *Dennis Block* and *Marvin G. Pickholz*, of the New York Regional Office, for the Division of Trading and Markets.

Eugene T. Rossides, of Royall, Koegel, Rogers and Wells, for Alfred B. Tallman, Jr.

Arnold I. Burns and *Malcolm H. Bell*, of Mermelstein, Burns and Lesser, for Peter J. Slater.

FINDINGS, OPINIONS AND ORDER

In these proceedings pursuant to Sections 15(b), 15A and 19(a)(3) of the Securities Exchange Act of 1934 ("Exchange Act"), Alfred Bryant Tallman, Jr., a registered representative and branch manager of the Baltimore office of First Hanover Corporation ("FHC"), a registered broker-dealer, and Peter J.

Slater, Compliance Director of FHC, have submitted offers of settlement. Under the terms of the offers respondents waived a hearing and post-hearing procedures, and agreed that the record on which finding may be based may include certain designated testimony; and solely for the purposes of these or any other proceedings pursuant to Sections 15(b), 15A and 19(a)(3) of the Exchange Act and Section 203(d) of the Investment Advisers Act of 1940, Tallman consented, without admitting or denying the allegations in the order for proceeding, to findings of willful violations as alleged in such order, and to an order barring him, with certain qualifications, from being associated with a broker-dealer, and Slater consented, without admitting the allegations in the order for proceedings, to a finding of failure of supervision as alleged in the order for proceedings and to an order censuring him.

On the basis of the order for proceedings, Tallman's offer of settlement and the testimony specified in that offer, we find that Tallman willfully violated and willfully aided and abetted violations of the antifraud provisions of Section 17(a) of the Securities Act of 1933 and Sections 10(b) and 15(c)(1) of the Exchange Act and Rules 10b–5 and 15c1–2 thereunder, in connection with the offer, sale and purchase of the securities of American Beryllium and Oil Corporation ("ABO"), Azalea Mobile Homes, Inc., and Moviematic Industries.

Tallman, during the period from about September 1967 to about February 1968, offered, recommended the purchase of, and sold the speculative and unseasoned securities of ABO, Azalea and Moviematic to customers for whom such securities were unsuitable in light of their investment needs and objectives, and without first making reasonable and diligent inquiry and in disregard of information as to the past and current financial condition and business operations of those companies. Tallman also made false and misleading statements and omissions of material facts concerning the financial condition and an anticipated increase in the market price of the common stock of those companies, the nature and extent of the operations of ABO and Azalea, negotiations by Azalea to acquire or merge with a large manufacturer of mobile homes, and an anticipated tender offer to Azalea stockholders, the new issuance of Azalea stock, Tallman's ownership of ABO stock and the source and price paid in acquiring it, the public market for ABO stock, the suspension of ABO's offering pursuant to Regulation A under the Securities Act, and the source of Tallman's information as to Moviematic.

In view of the foregoing misconduct by Tallman, it is in the public interest to bar Tallman from being associated with a broker-dealer. However, under all the circumstances including the fact that it does not appear that Tallman has previously been the subject of any complaint, we consider that we may appropriately accept the qualification provided in his offer of settlement that after one year we will consider a request, if made by him, to permit his employment in the securities business in a non-supervisory capacity under appropriate supervision by a broker-dealer capable of demonstrating its ability to supervise his activities.

With respect to Slater, we find that during the above period he failed reasonably to supervise Tallman and Joseph Davis, manager of FHC's Hollywood, Florida branch office, who we found made false and misleading statements and willfully violated the same antifraud provisions as did Tallman during the same period in connection with transactions in certain speculative securities in that office.[1]

Slater became employed by FHC in May 1966 at the age of 23 and was designated Compliance Director, a position which he held during the period of Tallman's and Davis' activities. His stated compliance duties covered a wide range, including supervision of salesmen for compliance with federal, state and exchange regulations, branch office supervision and inspection, interpretation of rules and regulations as they applied to salesmen, cooperation with regulatory bodies, internal compliance, and acting as director of training and performing some other personnel duties. But although he was clothed with apparently broad compliance responsibilities, he in fact had very limited authority,[2] and the power to implement his recommendations concerning compliance was retained by FHC's president and a vice-president.[3] He was not assigned anyone to

[1] The findings were based on Davis' consent, without admitting the violations, in an offer of settlement providing for a suspension of Davis from association with a broker-dealer which we accepted. *Joseph Davis*, Securities Exchange Act Release No. 8541 (February 28, 1969).

[2] Slater did not have authority to visit branch offices outside the immediate area of FHC's main office except with special permission, and did not visit the branch office where Davis was employed until May 1968, after Davis' violations.

[3] FHC's president and two vice-presidents were sanctioned pursuant to an offer of settlement in which they consented to findings that they failed reasonably to exercise their supervisory duties to prevent antifraud violations in connection with the securities sold by Davis and Tallman. *First Hanover Corporation*, Securities Exchange Act Release No. 8525 (February 7, 1969).

assist him other than a secretary, and did not effectively carry out the supervisory duties he was supposed to perform.[4]

Thus, in October 1967, shortly after the Baltimore branch office opened with Tallman as its manager, Slater visited it to observe its operations. When he learned of Tallman's transactions in ABO and Azalea stock, which he was aware were solicited by Tallman, he urged Tallman not to deal in such speculative stocks. However, he did not undertake to ascertain from Tallman's customers what Tallman had been telling them in making the recommendations, or to determine from FHC's Research Department whether there was an adequate basis for the information Tallman told him he had about the stocks or whether Tallman had made any inquiry about the stocks to that Department. Slater reported to the FHC principals following the October 1967 visit that the Baltimore office was "terible from a supervisory standpoint" and recommended that in view of the ,compliance problems the office be closed. FHC decided that the office should be sold and ordered increased surveillance, but it was continued in operation without change in management until February 1968 when it was sold.

Broker-dealers have a responsibility to take effective measures to insure compliance with the statutory standards and requirements. That responsibility is not discharged by the setting up of a compliance program with the creation of a position designated Compliance Director which does not confer the authority and provide the personnel, procedures and means necessary to accomplish its objectives. In such case there is created merely an appearance of an effective compliance mechanism. Persons who are assigned to positions of Compliance Directors should be accorded the powers to initiate and implement steps required to achieve compliance. In the case of FHC it is clear that Slater was not accorded such authority.

Although Slater consented in the offer of settlement to being censured, after careful consideration we have determined that under all the circumstances, including Slater's young age and inexperience and the fact that this is the first case involving

[4] According to the testimony of Slater's superiors he examined the daily computer runs of transactions. However, Slater denies seeing such runs from the Baltimore or Hollywood branch offices during the relevant period and states that the runs themselves, which bear the initials of those who saw them, are no longer available at FHC.

One of Slater's duties was to send compliance manuals to FHC personnel, for which they were required to sign a receipt. Slater delegated the function to his secretary and did not verify whether the manuals were in fact received. Tallman and Davis claimed that they never received the compliance manuals, and no signed receipts for the manuals could be located.

charges against a compliance employee as such, public interest does not require that we censure him in this instance.

Accordingly, IT IS ORDERED that Albert Bryant Tallman, Jr., be, and he hereby is, barred from being associated with a broker-dealer, subject to the qualification described above.

IT IS FURTHER ORDERED that the proceedings insofar as they relate to Peter J. Slater be, and they hereby are, discontinued.

By the Commission (Chairman BUDGE and Commissioners SMITH, NEEDHAM and HERLONG), Commissioner OWENS absent and not participating.

IN THE MATTER OF

THE EQUITY CORPORATION

File Nos. 3-1800. Promulgated March 5, 1970

Investment Company Act of 1940—Section 8(f)

DEREGISTRATION OF INVESTMENT COMPANY

Change in Nature of Business

Where registered investment company, in advance of stockholder approval, definitively changed nature of its business so as to cease to be an investment company as defined in Investment Company Act of *1940* and thereby violated Section 13(a)(4) of Act, *held*, investment company not entitled to order pursuant to Section 8(f) of Act declaring that it has ceased to be investment company and terminating its registration.

APPEARANCES:

Milton V. Freeman, *Werner Kronstein*, and *Richard S. Ewing*, of Arnold & Porter, and *William A. Metz*, of Palmer & Serles, for The Equity Corporation.

Stanley Nemser, *Norman S. Nemser*, and *Martin Portnoy*, of Nemser & Nemser, for Albert Kaufman et al., stockholders of The Equity Corporation.

Eugene B. Casey, *pro se*.

Edward B. Wagner, *Robert E. Olson*, and *Jerold H. Rosenblum*, for the Division of Corporate Regulation of the Commission.

FINDINGS AND OPINION OF THE COMMISSION

The Equity Corporation, a Delaware Corporation registered as a closed-end, non-diversified investment company under the Investment Company Act of 1940, has filed an application pursuant to Section 8(f) of the Act for an order declaring that it has ceased to be an investment company and terminating its registration. After appropriate notice a public hearing was held, at which a group of objecting stockholders ("Nemser" group) was granted leave to be heard. An initial decision by the hearing examiner was waived, briefs were filed by Equity, the Nemser group, and our Division of Corporate Regulation

("Division"), and we heard oral argument. Our findings are based upon an independent review of the record.

Equity's application as amended in November 1968 alleges that on March 7, 1967 the stockholders of Equity authorized management to take appropriate steps to change the nature of Equity's business so that it might cease to be an investment company under the Act; that such action constituted compliance with the requirement of shareholder authorization in Section 13(a)(4) of the Act;[1] and that Equity is no longer an investment company as defined in the Act in that it does not engage, or propose to engage, or hold itself out as being engaged, primarily in the business of investing or trading in securities (Section 3(a)(1)), and does not own investment securities having a value exceeding 40 percent of the value of its total assets exclusive of government securities and cash items (Section 3(a)(3)). As used in Section 3(a)(3), "investment securities" includes all securities except, among others not here pertinent, securities issued by majority-owned subsidiaries which are not investment companies.

As of December 31, 1968, Equity had total assets of about $93 million. Over 77 percent represented holdings in wholly or majority-owned subsidiary companies and over 20 percent consisted of investments in the stock of two affiliated companies and a note receivable. Its two principal subsidiaries, Bell Intercontinental Corporation ("Bell") (51.72 percent owned) and General United Group, Incorporated (80.35 percent owned), are engaged in manufacturing and insurance, respectively; five subsidiaries (four of which are wholly owned) are engaged in various businesses; and the remaining subsidiary services the others. The stock of one affiliated company has since been sold and Equity stated that it plans to sell the stock of the other when market conditions are favorable.

The principal issue presented by the application and the contentions of the parties and the Nemser group is whether Equity changed the nature of its business so as to cease to be an investment company prior to obtaining stockholder approval for such change on March 7, 1967, in violation of Section 13(a)(4) of the Act.

Equity's investment policy as described in its registration statement as amended is declared to be not to concentrate its investments in a particular industry or group of industries

[1] Section 13(a)(4) of the Act provides that no registered investment company shall change the nature of its business so as to cease to be an investment company unless "authorized" by the vote of a majority of its outstanding voting securities.

with the proviso that it may concentrate not in excess of 60 percent of the value of its gross assets in "special situations" which may be within a particular industry or group of industries.[2] The registration statement further states that Equity has no policy with respect to making investments in companies for the purpose of exercising control or management as such, although it may in certain situations in order to protect and improve an investment incidentally acquire control.

The application recites that Equity's objective after World War II "until recently" was to achieve capital appreciation and long-term gain in its investments rather than income from operations, and that while it sponsored its controlled companies through financial assistance and otherwise, it customarily assumed little responsibility for the active management and operation of these companies. From time to time, according to the application, Equity also acquired minority interests in several companies with a view toward ultimate sponsorship, but such interest did not constitute a majority of Equity's assets, and Equity had never been active in the frequent trading of general market securities. As of June 30, 1965, Equity had approximately 45.5 percent of its assets, other than cash, committed to minority-held investments, and 54.5 percent of its assets to controlled situations and accounts receivable. As of December 31, 1965, minority-held investments represented 42.6 percent and controlled situations 57.4 percent of Equity's assets.

As stated in the application, as well as the proxy statement for the March 1967 stockholders' meeting, Equity's management determined subsequent to February 1, 1966, that it was in Equity's best interests to divest itself of investments in minority situations where its relatively small vote did not afford it an opportunity to manage and operate the companies involved. Accordingly, a program to dispose of these investments was instituted, and many were sold, with proceeds of the sales being applied to reduce Equity's bank loans. By August 31, 1966, only 33.9 percent of Equity's assets was committed to investment securities and Equity no longer met the 40 percent mathematical test for an investment company in Section 3(a)(3) of the Act.

During the same period, the management of Equity also determined that it would be desirable for the company to cease

[2] The objective of an investment in a special situation is to operate the business of the company with a view of improving it so the investment can be sold at a profit, rather than to continue to operate the business for the purpose of obtaining income. See *Atlas Corporation*, 41 S.E.C. 144, 146 (1962)

conducting its business as an investment company and instead concentrate on the profitable development and management of a limited number of subsidiary companies in an operating capacity. In the development of Equity's operations, emphasis was to be laid on two fields where Equity, through its 99.47 percent subsidiary, United Security Life Company ("USL"), and Bell, already had a strong position, namely life insurance and industrial manufacturing.

Pursuant to the program for concentration in manufacturing, which involved the policy of divestment of certain non-industrial interests of Bell, Bell prior to March 1967 sold its interest in a bank and applied the proceeds to reduce indebtedness, entered into agreements to sell its shares in an oil company and certain real property held by a wholly-owned subsidiary, and organized a new subsidiary to engage in the aluminum manufacturing business and operate an aluminum reduction facility for which construction plans were under way.

On September 20, 1966, Equity contributed a substantial portion of its remaining investment securities (valued at the market price on September 19, 1966) to the capital of USL. This contribution enabled Equity to exchange its holdings of USL stock for stock of General Life of Iowa Investment Company ("GLIC"), as a result of which Equity acquired control, through GLIC, of four life insurance companies.[3] Following such contribution to USL, only 16.5 percent of its assets were represented by its remaining investment securities as of October 31, 1966. By December 31, 1966, only 14.4 percent of Equity's assets were represented by minority-held investments, and 72 percent by its investments in Bell and USL. The divestments and concentration of assets in the controlled companies resulted in a substantial change during 1966 in Equity's sources of dividend and interest income. For the first half of 1966, Equity's dividend and interest income from controlled companies was only 8.7 percent as contrasted with 91.3 percent from other companies. For the last two months of 1966, controlled companies accounted for 64 percent and other companies for only 36 percent of such income.

The application states that since the date of the proxy statement (February 8, 1967) "additional steps" have been

[3] The agreement with GLIC for the exchange was approved by the Iowa Commissioner of Insurance after a hearing in December 1966 and subsequently be GLIC's stockholders, and thereafter Equity's holdings in USL were transferred into GLIC, then renamed General United Group, Incorporated.

taken to further the Equity program to change the nature of its business from that of an investment company to that of an operating company. Among such steps was the sale by Equity of its holdings in several minority situations, and Bell continued to concentrate its resources in the field of industrial manufacturing.

Equity asserts that no firm decision was made by its management to change the nature of its business until late 1966, and the requisite approval of the stockholders was promptly sought; that is divestment of minority holdings in 1966, including the contribution to USL, was made for good business reasons as well as being consistent with Equity's program to change the nature of its business so that it may cease being an investment company; and that, notwithstanding the reduction in Equity's holdings of investment securities to less than 40 percent of its assets without shareholder approval, no violation of Section 13(a)(4) was involved because prior to March 1967 Equity held itself out as being "primarily" engaged in the business of investing in securities and therefore was an investment company within the definition in Section 3(a)(1). The Division supports deregistration, being of the view that Equity's divestments of minority investments were not inconsistent with its fundamental investment policies and did not require advance stockholder approval.

The Nemser group asserts that by March 1967 Equity had already changed the nature of its business so as to cease to be an investment company and that the stockholders of Equity were presented with a *fait accompli.* It argues that such change in advance of stockholder approval violated Section 13(a)(4) and the change could not be ratified by the subsequent vote.

In our opinion, the evidence establishes that Equity violated Section 13(a)(4) in that, without stockholder authorization, it definitively changed the nature of its business so as to cease to be an investment company. Such a change was forecast in October 1965 when American Export Industries, Inc. ("AEI") was considering a proposal to acquire control of Equity. Jacob Isbrandtsen, who was presedent of AEI and on February 1, 1966 succeeded David M. Milton as Equity's chief executive, testified:

> "My views at that time, and they have continued to be, and this is certainly what I . . . substantially gave to the board [of AEI], and that is that Equity's assets, if concentrated in fewer endeavors, would do more for the company than the split-up that the balance sheet indicated at that

> time, namely holdings in many, many different categories for which any organization would find impossible to attend properly to their well-being."[4]

Shortly after Isbrandtsen assumed office in Equity, he told his co-officers that unproductive assets would be eliminated, that the company would try to maintain operations in strong subsidiaries which would not be too numerous, and that manufacturing and life insurance appeared to be the best areas in which to concentrate. He stated that if the company's activities were limited to operating entities, it would "undoubtedly cease to really be an investment company." He also discussed with a vice-president of Equity the "selling off" of its miscellaneous investment securities in order to dispose of securities in which Equity did not have a management position.

We have already discussed the substantial divestments of minority holdings in 1966, including the large contribution to USL, and the steps taken in advance of the March 1967 stockholders' meeting by Equity, whose management is also largely Bell's management, to divest Bell of certain interests unrelated to industrial manufacturing and to place Bell in the aluminum manufacturing business. The concentration of assets in these insurance and industrial subsidiaries was clearly for the purpose of operating them on a permanent basis rather than as special situations. As stated in reports dated September 6 and 8, 1966, by a vice-president to the board of directors of Equity with respect to the proposed contribution to USL:

> "Whatever the need for 1940 Act controls in the past, Equity's new route does not involve the buying and selling of companies as previously (except to clean-up) but in the development of controlled subsidiaries. Thus we are working to develop Bell as a primary aluminum producer with future development in other metals, and are working to develop the insurance into a broad-spectrum life company of very substantial size. Thus Equity's course has shifted from Investment Company to diversified holding company. * * * Thus the first reason for the contribution is to permit Equity to make application forthwith for exemption from the 1940 Act."
>
> "The reason for the increase in capital contribution from $7,000M net to $11,204M net has already been stated to the Board. To repeat them:

[4] In a deposition given by Isbrandtsen in December 1968 in certain litigation involving Equity, he testified:

> "Q . . . had you prior to the October 29, 1965 board meeting [of AEI] discussed the objectives of the program [with respect to reorganizing the assets of Equity] with Mr. Milton?
>
> "Answer: In a general sort of way, I probably made known that it would be rather cumbersome, in my estimation, to be involved in a company that was subject to the Investment Company Act . . . I thought its usefulness had outlived its original intention."

At the instant hearing, however, Isbrandtsen could not recall making such a statement to Milton, and testified that the deposition did not refresh his recollection.

> "1) Equity desires to get out from under the 1940 Act at the earliest possible time. For this it must remove from its direct ownership its holdings in minority situations. To sell them immediately is not practical or desirable because of the current market situation. However, the insurance situation will need at least $7,000,000 (net) to support the volume of insurance that is anticipated and this was part of the previous plan.
>
> "2) The . . . difference . . . can readily be utilized in the near future for cash acquisitions of insurance properties."

On the basis of these reports, Equity, as previously indicated, made the larger contribution to USL without any vote of Equity's stockholders.[5]

That Equity carried out its program to change the nature of its business without regard to the requirement of a prior stockholder vote is further evidenced by a memorandum dated September 14, 1966, prepared by the same official on the plans of Equity with respect to its investment company status and addressed to the executive vice-president of Bell. It stated:

> "The basis of the planning so that Equity may cease to be an investment company under the Act of 1940 lies in the following:
>
> "a) To cause Equity to have over 60 percent of its assets, less cash, in controlled assets—i.e., held over 50 percent.
>
> "b) To have the principal activity of Equity be the holding of permanent operating interests with Equity involved in the operations.
>
> "Thus Equity will clearly be exempt under the two tests of the Investment Company Act definition of an Investment Company.
>
> "It is recognized that merely the statement of a program will not bring the exemption about but that demonstration is necessary. To this end, we have been working to make Equity be, in fact, not an investment company but a diversified operating company.
>
> "Bell and the life insurance operations (including the contribution) together will comprise 67.7 percent of Equity's assets ex cash. These are permanent investments and Equity personnel is already heavily involved in the operation of Bell and will be in the operation of the insurance."

Not only had Equity, prior to March 1967, ceased to qualify as an investment company under the mathematical test in Section 3(a), and clearly was not engaged nor proposed to engage primarily or otherwise in the investing business, but, contrary to its assertion here, it no longer held itself out as being primarily engaged in such business. The proxy statement itself in effect announced that Equity was not primarily so engaged. It disclosed Equity's substantial divestments of investment securities, including those contributed to USL, and the reduction of its minority-held investments to 16.5 percent

[5] By March 7, 1967, the securities contributed to USL, which had been valued at over $12 million as of September 19, 1966, had risen in value by $2,298,454.

of total assets as of October 31, 1966, as well as Equity's planned emphasis on industrial manufacturing and life insurance operations through Bell and USL and its intent to take a dominant part in the operating responsibilities.

Our finding that Equity violated Section 13(a)(4) by changing the nature of its business prior to obtaining stockholder authorization is not precluded by our decision in *Atlas Corporation*,[6] cited by Equity and the Division. In that case, we granted deregistration to an investment company which had been principally engaged in investing in special situations, but which, prior to stockholder authorization, had embarked upon a policy of continuing to operate the business of its controlled companies rather than selling its controlling interest in them at a profit. Thus the change in policy in essence merely involved the retention of special situation companies pending a stockholder vote on a proposal to merge all the subsidiaries into Atlas, whereas in the present case the change involved the affirmative divestment of the bulk of Equity's investment securities including the concentration of assets in USL, with participation in management being the primary purpose of, rather than incidental to, the investment.[7] No one objected to deregistration, and we did not address ourselves to the question whether Section 13(a)(4) was violated. The Division recognizes the desirability of advance shareholder approval of any changes, even if consistent with stated policies, if their purpose is to change from an investment company to an operating company, and suggests that perhaps the *Atlas* decision should be overruled on a prospective basis. It is apparent, however, that Equity's program was not consistent with its stated investment policies and that a violation of Section 13(a)(4), which has been established in a contested context, should be found. We do not view the *Atlas* decision as a precedent for deregistration under facts such as those present here, but to the extent that any such implication might be drawn from it we overrule it.

Equity's argument that, assuming Section 13(a)(4) was violated, the shareholders' vote constituted ratification, is untenable. Even assuming, as it asserts and Nemser controverts, that the proxy statement adequately set forth all relevant

[6] 41 S.E.C. 144 (1962).

[7] With respect to such concentration, effected as part of the program to change the nature of its business, Equity in our opinion also violated Section 13(a) (3) of the Act which requires stockholder authorization for a deviation from its policy in respect of concentration of investments in any particular industry or group of industries as recited in its registration statement. See *S.E.C.* v. *Aldred Inv. Trust*, 58 F. Supp. 724, 732 (D. Mass. 1945), *aff'd* 151 F.2d 254, 260 (C.A. 1, 1945), *cert. denied* 326 U.S. 795.

facts,[8] the vote of the stockholders could not curatively ratify the change in the nature of Equity's business since Section 13(a)(4) calls for authorization, not ratification. In our opinion, shareholder ratification of conduct violative of the Act is precluded under general principles of federal law[9] as well as by Section 47(a) of the Act which voids waivers of compliance with the Act, whether before or after the violation. In *Green* v. *Brown*,[10] a shareholder of a registered investment company brought an action claiming that the directors had violated Section 13 of the Act by causing the company, without the required shareholder authorization, to make certain loans which deviated from its stated investment policy. Thereafter, the shareholders voted approval of the loans. The District Court dismissed the action, holding among other things that stockholder ratification of the loans, pursuant to a proxy statement the court found satisfactory, was a good defense. On appeal, the Court of Appeals, without deciding the questions involved, remanded the case to the District Court for further consideration. The Court of Appeals indicated, however, that to permit ratification would deprive minority shareholders of the opportunity to dissuade management from pursuing a proposed change or to dispose of their holdings before the change occurs, and characterized these considerations as "weighty in view of the policy of the Act to give shareholders an opportunity to pass upon changes in investment policy in advance." [11] We believe that to permit ratification might also encourage directors of an investment company who wished to change the nature of the business or the company's investment policies to do so without authorization on the expectation of subsequent shareholder approval and would nullify the express statutory requirement of prior approval of such change.[12]

[8] In view of our conclusion with respect to Section 13(a) (4), we do not reach the question whether, as alleged by the Nemser group, the proxy statement falsely represented that Equity intended to change the nature of its business and was false and misleading in other respects.

[9] See *Rogers* v. *American Can Co.*, 187 F. Supp. 522, 537 (D.N.J. 1960), *aff'd* 305 F.2d 297 (C.A. 3, 1962); *Gottesman* v. *General Motors Corporation*, 268 F.2d 194, 197 (C.A. 2, 1959).

[10] 398 F.2d 1006 (C.A. 2, 1968).

[11] *Id.*, at 1010. (There has been no further decision reported in the District Court since the remand.) *Cf. S.E.C.* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 857 (C.A. 2, 1968), *cert. denied* 394 U.S. 976, which held that a member of top management of a company who failed to disclose to the directors, before accepting a stock option granted by them, material inside information bearing on the market value of the stock, in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b—5 thereunder, must rescind the option notwithstanding the directors' ratification of the option after full disclosure of the information to them.

[12] These proceedings raise no issue as to the business merits of Equity's divestments of investment securities and its concentration of assets in the industrial and insurance fields, and we express no opinion in the regard. Nor do we here make a determination as to the responsibility of the directors to Equity with respect to the actions which were taken to change the nature of Equity's business.

Finally, we cannot agree with the contentions that a violation of Section 13(a)(4) is irrelevant in determining whether to grant deregistration and a matter for the courts to deal with, and that the sole issue here is whether Equity, at the time of its application filed 19 months after the stockholder vote, had ceased to be an investment company. Were these contentions to be accepted, we would be compelled to deregister an investment company that had changed the nature of its business and revoked the investment policies recited in its registration statement even where the stockholders were not told about the changes at all or even after there was an unfavorable vote, and to leave it to the stockholders to discover and enforce the violation of Section 13(a)(4). We consider that since we have primary jurisdiction to determine under Section 8(f) whether a registered investment company has ceased to be an investment company we also have jurisdiction to determine whether it complied with Section 13(a)(4) in changing the nature of its business so as to cease to be an investment company.[13] And assuming non-compliance, in our opinion our function under the Act to protect investors and implement the policy of the Act expressed in Section 1(b) is best served by denying deregistration and thereby continuing the safeguards provided under the Act. That policy declares that the national public interest and the interest of investors are adversely affected when investment companies "change the character of their business . . . without the consent of their security holders." that the Act must be interpreted in accordance with this declaration of policy, and that such conduct must be mitigated and, so far as is feasible, eliminated.[14]

The case of *Southeastern Investment Trust, Incorporated*,[15] does not call for a contrary conclusion as Equity claims. In that case the investment company had reduced the number of its shareholders to less than 100, which pursuant to Section 3(c)(1) took it out of the Act's definition of an investment company, through repurchases of its shares in a manner that

[13] *Cf. Foundation Industrial Engineering Company, Inc.*, 13 S.E.C. 744, 748 (1943); *Setay Company, Incorporated*, 14 S.E.C. 814, 816—17, 824—25 (1943).

[14] See Also H. R. Rep. No. 2639, 76 Cong., 3d Sess., p. 9 (June 18, 1940), which in commenting on the bill to provide for the registration and regulation of investment companies, referred to the "many abuses" in the management of investment company assets, including the managers' "power to change, without the prior approval of the security holders, investment policies originally undertaken. The security holder has, therefore, no assurance of the stability of any announced investment policies of his company and no voice in the determination of any desire of the management to change such policies." To the same effect is S. Rep. No. 1775, 76th Cong., 3d Sess., p. 7 (June 6, 1940). *Cf. S.E.C.* v. *Aldred Inv. Trust*, 58 F. Supp. 724, 732 (D. Mass. 1945), *aff'd* 151 F.2d 254, 260 (C.A. 1, 1945), *cert. denied* 326 U.S. 795.

[15] 24 S.E.C. 686 (1946).

did not comply with the procedures prescribed under Section 23(c) of the Act to prevent discrimination as between selling security holders. We permitted deregistration without prejudice to the rights of the former shareholders to rescind, and subject to revocation or modification of our order if applicant's shareholders thereafter increased in number to over 100. We note that in that case the approval of stockholders was not required, no change in fundamental investment policy was involved, the violations were allegedly inadvertent and the requirements not complied with were not designed to control a change in investment company status, and the authority of management to apply for deregistration was not attacked. The violations affected persons who were no longer shareholders of the company and who might not desire to regain that status, and, if only a few of them did rescind, the number of security shareholders would exceed 100 and the company's Section 3(a)(1) exemption from the definition of an investment company would cease.

On the basis of the foregoing, we conclude that Equity's application for deregistration should be denied. We do not address ourselves to the particular steps that must be taken by Equity to establish satisfactory compliance with the Act. If Equity's management still desires that it not be an investment company, at the least it would, prior to any further effort to obtain stockholder authorization to cease investment company status, have to present to the stockholders, no later than its next annual meeting, a concrete plan prepared in good faith sufficient to constitute a real alternative of a viable investment company business. If the stockholders should vote, pursuant to an appropriately clear and explicit proxy statement accompanied by a copy of our findings and opinion herein, not to utilize that alternative but instead to pursue the non-investment company activities, such vote could be viewed in these circumstances as an authorization for a change in status meeting the requirements of the Act rather than merely an impermissible ratification.

An appropriate order will issue.

By the Commission (Commissioners OWENS, SMITH, NEEDHAM and HERLONG), Chairman BUDGE not participating.

IN THE MATTERS OF

MATES FINANCIAL SERVICES

MATES MANAGEMENT COMPANY

FREDERICK S. MATES

File No. 3-2024. Promulgated March 9, 1970

Securities Exchange Act of 1934—Section 15(b)
Investment Advisers Act of 1940—Section 203(d)

INVESTMENT ADVISERS ACT PROCEEDINGS
BROKER-DEALER PROCEEDINGS

Grounds for Remedial Sanctions

Misrepresentations Concerning Investments in Restricted Securities and Performance of Fund

Misstatements to Clients and Prospective Clients Concerning Fees and Commissions of Registered Investment Adviser

Use of Inside Information in Purchase of Securities

Manipulation

Where officer and director of registered investment company, who was also officer and director of its investment adviser, caused company to acquire contrary to representation to shareholders, securities which could not be publicly offered for sale without first being registered under the Securities Act of 1933, to value such securities improperly under the Investment Company Act, and to redeem securities at prices based on such improper valuation; and held out performance of investment company to attract clients to registered investment adviser of which he was sole proprietor; and where such investment adviser received payments from brokers for directing brokerage business of managed accounts to them, effected purchases of stock prior to public release of material information relating to issuer, and engaged in manipulative activities with respect to such stock, *held*, in public interest to impose sanctions upon respondents pursuant to offer of settlement.

APPEARANCES:

Allan S. Mostoff, *David M. Butowsky* and *Herbert E. Milstein*, and *Michael S. Leo* of the New York Regional Office, for the Division of Corporate Regulation, and *Stanley Sporkin*, *Leonard H. Rossen* and *Stephen W. Arky*, for the Division of Trading and Markets, of the Commission.

Milton V. Freeman and *Werner J. Kronstein*, of Arnold and Porter, and *Harvey J. Klaris* and *Sheldon Curtis*, of Feiner, Klaris & Curtis, for respondents.

FINDINGS AND OPINION OF THE COMMISSION

We heretofore in these proceedings pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Section 203(d) of the Investment Advisers Act of 1940 accepted an offer of settlement submitted by Mates Financial Services ("MFS"), a registered investment adviser; Mates Management Company ("MMC"), the investment adviser until August 5, 1968 to Mates Investment Fund, Inc. ("Fund"), a registered investment company;[1] and Frederick S. Mates, sole proprietor of MFS and president and a director of Fund and MMC. The order for proceedings alleged that in the period beginning in April 1968, among other things, Mates, contrary to representations to Fund shareholders, caused Fund to purchase substantial amounts of "restricted securities" which could not be offered for sale to the public without first being registered under the Securities Act of 1933, valued such securities improperly, and then held out to the public that the performance of the Fund was caused solely by the investment advice he furnished. The order further alleged that MFS and Mates allocated execution of securities transactions on behalf of MFS advisory clients to brokers who gave MFS and Mates substantial rebates, and that MMC and Mates purchased certain stock without disclosing material non-public information concerning the issuer and engaged in manipulative activities with respect to that stock.

Pursuant to the offer of settlement, an order was issued finding, for the sole purpose of these proceedings, that respondents willfully violated or willfully aided and abetted violations of various statutory provisions and rules as alleged in the order for proceedings. As provided in the offer of settlement, the order directed that Mates shall not become associated with a broker-dealer without our approval; suspended the registration of MFS as an investment adviser for a period of 100 days commencing at the opening of business on June 16, 1969, subject to the terms and conditions specified in the offer; prohibited MFS and Mates from issuing research reports and performing similar services for broker-dealers for

[1] Prior to August 5, 1968 Mates owned approximately 50 percent of the stock of MMC and on that date he acquired the balance. As a result, an assignment of the advisory contract between the Fund and MMC occurred and, as a consequence, the advisory contact terminated. Thereafter, Fund was managed by its officers and directors.

compensation without our prior approval; and prohibited the receipt by MMC of any fees from Fund for the first 60 days of any investment advisory contract which may be concluded between MMC and Fund.[2]

Respondents in their offer of settlement further consented to findings of violations as alleged in the order for proceedings, and we now issue our findings and opinion with respect to the issues in the case.[3]

INVESTMENT IN AND VALUATION OF RESTRICTED SECURITIES

Fund registered with us under the Investment Company Act on June 9, 1967 as a no-load diversified open-end management investment company. Since its inception Mates dominated the investment policies of the Fund. On February 7, 1968 Mates sent to Fund's shareholders along with the Fund's financial report dated January 31, 1968, a letter by him as president of Fund stating:

> "In recent months, there has been a tendency among several mutual funds to take positions via 'investment letter' directly from the issuing companies or principal stockholders. This limits the liquidity of these positions since the shares so purchased must be registered with the Securities & Exchange Commission or held for a period of time before they can be resold to the public. Since 'investment letter' stock is generally available at a substantial discount from market, mutual funds which engage in this sort of activity can show quite remarkable results over the shorter term. Although we would not hesitate to step off the beaten path in search of unusual investment values, we believe that deliberately locking oneself into a position delegates too much of management's responsibilities to the vagaries of the market. Thus, you may be pleased to know that there is nothing in our portfolio that we could not sell immediately if we so choose."

Mates continued to mail the letter to new Fund shareholders through May 1968.

Despite the representations in the letter, between April 15 and July 23, 1968, Mates acquired for the Fund substantial amounts of various issues of restricted securities. Six of those

[2] Securities Exchange Act Release No. 8626; Investment Advisers Act Release No. 247 (June 12, 1969).

[3] Respondents have consented that in making our findings we may take notice of and use our public files and the testimony, exhibits and other materials obtained by our staff in its investigation of this matter.

issues, which had an aggregate cost of $3,610,000,[4] were assigned a value of $7,161,250 when first placed in the pricing sheets for the purpose of determining the net asset value of the Fund. Four of the six securities were valued at the market price for unrestricted securities of the same issuer and class. Two, shares of stock of Omega Equities Corporation and of Giffen Industries, Inc., were valued pursuant to certain methods, which in effect resulted in a constant dollar discount from the fluctuating market price for the corresponding unrestricted shares.[5]

Because of bookkeeping and administrative difficulties, the Fund in June 1968 stopped issuing its own shares and undertook in the ensuing months to reconstruct its books and records. At about the same time the Fund borrowed more than $7,000,000 from two banks and collateralized the loans with the Fund's entire portfolio. The borrowed money was used in part to purchase the restricted securities and in addition to satisfy Fund shareholders who presented their shares for redemption.

At no time during the period of April 18 through December 20, 1968, when as discussed below Fund applied to us for an order permitting it to suspend the right of redemption of its outstanding shares, was any disclosure made to the investing public of Fund's acquisition of restricted securities or its valuation procedures. Letters sent to the Fund shareholders in August and September 1968 made no mention of these facts, or of the Fund's borrowing of over $7,000,000. During the April-December 1968 period, Mates gave at least three press interviews in which he referred to the market performance of Fund without adverting to the restricted securities. Thus, a story

[4] These six issues were:

Issuer	*Securities*	*Cost*
Bell Television, Inc.	15,000 shares	$ 90,000
	$60,000 bond convertible into 6,000 shares	60,000
Longchamps, Inc.	45,000 shares	405,000
Process Plants Corp.	$25,000 bond convertible into 3,000 shares	125,000
Zimmer Homes, Inc.	50,000 shares	875,000
Omega Equities Corp.	300,000 shares	975,000
Giffen Industries, Inc.	36,000 shares	1,080,000
		3,610,000

Fund had in April 1968 also purchased 15,000 restricted shares of Oxford Financial Comapny for $240,000, approximately 5.2 percent of Fund's assets at that time.

[5] During the period May 20 to November 28, 1968, the Omega stock was valued at a discount not exceeding $2.75 per share from the market price of unrestricted Omega stock, and the Giffen stock was valued at a discount of $6 per share. During this period brokers offered as much as $34 and $67 per share, respectively, for unrestricted shares of Omega and Giffen.

carried in the New York Times on July 28, 1968, reported that Mates pointed out that Fund had appreciated more than 100 percent during the period of August 1967 through July 28, 1968.[6] During this same period Mates caused the Fund to publish its net asset value on a daily basis in various news publications throughout the country.

Mates continued through November 1968 to value the restricted securities as if they were unrestricted, except for the Omega and Giffen shares which, as noted, were valued at constant dollar amount discounts from the market price for unrestricted shares. As of November 26, 1968, the six issues of restricted securities were carried in Fund's portfolio at a value of $13,459,000, more than $10,000,000 in excess of their cost. As of that date, more than $10,800,000 of the more than $13,600,000 of indicated unrealized appreciation on all securities in Fund's portfolio represented indicated appreciation in restricted securities on the basis of the valuation procedures used by Mates.

On November 18, 1968 the accountants certified Fund's financial statements as of May 31, 1968.[7] On November 20, 1968 certain individuals brought suit against Mates and Fund alleging violations of the securities laws in connection with the Fund's acquisition of certain other securities. As a result of the ensuing publicity, the Fund's independent accountants, on about November 21, 1968, withdrew their certification of Fund's financial statement as of May 31, 1968. Thereafter Mates informed the accountants for the first time of the substantial acquisitions of restricted securities subsequent to May 31, 1968. Following this disclosure the accountants began a study of Fund's acquisition and valuation of restricted securities and at about this time the board of directors first gave special consideration to the valuation of Fund's restricted securities, and lowered the valuation of the six restricted securities on December 19, 1968 to $11,576,085, or $3,223,165 below the market price of the corresponding unrestricted shares.[8]

On December 20, 1968, we announced the issuance of an order temporarily suspending trading in the securities of Om-

[6] During the entire year 1968 Fund was widely heralded as the country's leading performance Fund. Certain indices quoted Fund's appreciation during 1967 and 1968 as in excess of 170 percent.

[7] Pursuant to the request of the accountants, Mates and two other officers of the Fund provided the accounts on November 18 with a statement purporting to describe events subsequent to May 31, 1968 which would materially affect the Fund's financial position, but which did not mention the Fund's acquisitions of restricted securities after May 31, 1968.

[8] In the portfolio valuation as of November 26, 1968, the restricted securities had been valued at a discount of only $882,000 from the market price of the corresponding unrestricted securities.

ega pending clarification of information relating to Omega's financial condition, product lines and acquisition program and pending further inquiry with respect to whether that company's recent offers and issuances of its unregistered securities were in violation of the registration and antifraud provisions of the securities laws.[9] On the same day upon the application of Fund we issued an order permitting it to suspend the right of redemption of its outstanding redeemable securities.[10] In support of that application Fund referred to our suspension of trading in Omega securities and stated that such securities represented a substantial portion of Fund's portfolio and were held by Fund pursuant to investment letter,[11] and that such factors created a situation contemplated by Section 22(e) of the Investment Company Act of 1940.[12] Subsequently, we permitted resumption of trading in Omega securities, following the entry of a consent decree permanently enjoining Omega from violations of the Federal securities laws.[13] Thereafter, we rescinded the order permitting Fund to suspend the right of redemption of its shares, effective July 22, 1969,[14] and on the same date Fund resumed sales of its shares.

We have recently commented on the problems raised by the acquisition of restricted securities by investment companies.[15] Among other things, such acquisitions present problems of valuation, with the dangers that distortion in valuation will distort the prices at which the companies' shares are sold or redeemed and will indicate an investment performance that will mislead investors. In addition, since restricted securities may not be publicly sold unless they are first registered under the Securities Act, the acquisition of such securities reduces the flexibility and liquidity needed particularly by open end companies which are required to redeem shares within seven days on demand. These factors underscore the importance of full disclosure of an investment company's policy and practice

[9] Securities Exchange Act Release No. 8474 (December 20, 1968).

[10] *Mates Investment Fund, Inc.*, Investment Company Act Release No. 5571 (December 20, 1968).

[11] Restricted securities are sometimes referred to as "investment letter" securities because of the practice frequently followed by an issuer or a person in control of an issuer in selling such securities, —in order to substantiate the claim that the transaction does not involve a public offering and is within the so-called "private offering" exemption from registration under Section 4(2) of the Securities Act,—of requiring the buyer to furnish a so-called "investment letter" representing that the purchase is for investment and not for resale to the general public.

[12] Section 22(e) of the Investment Company Act provides, insofar as here relevant, that the right to redeem shares may be suspended for any period during which an emergency exists as a result of which disposal by an investment company of securities owned by it is not reasonably practicable or it is not reasonably practicable for such company fairly to determine the value of its net assets, or for such period as we may permit for the protection of securities holders of the company.

[13] Securities Exchange Act Release No. 8584 (April 24, 1969).

[14] Investment Company Act Release No. 5706 (June 12, 1969).

[15] Investment Company Act Release No. 5847 (October 21, 1969).

with respect to the acquisition and valuation of restricted securities.

Section 2(a)(39) of the Investment Company Act and Rule 2a-4 thereunder require that in determining net asset value, "securities for which market quotations are readily available" must be valued at current market value while other securities and assets must be valued at "fair value as determined in good faith by the board of directors." Readily available market quotations means reports of current public transactions or current public offers for securities similar in all respects to the securities in question. No current public transactions or current public offers can exist in the case of restricted securities. For valuation purposes, therefore, restricted securities constitute securities for which market quotations are not readily available. Accordingly, their fair values must be determined in good faith by the board of directors. Such a determination includes more than looking at the market values of the unrestricted securities of the same class. It requires an attempt to determine the inherent value of the securities, taking into consideration all relevant material and data, including current financial data of the issuer, and making adjustments for any diminution in value resulting from the restrictive feature.[16] The board of directors has a continuing obligation to make that determination at appropriate intervals throughout the period the restricted securities are retained in the investment company's portfolio.

In the instant case, during the period of April through August 1968 the Fund's board of directors did not even purport to value the Fund's holdings in restricted securities. In August 1968 the directors apparently were advised of Mates' valuation methods and made no objections. Mates continued through November 1968 to value those holdings at the market price for unrestricted securities of the same class or at a small discount from such prices, without regard for other factors which might have indicated lower valuations. Thus, it does not appear that Mates gave adequate consideration to the price paid by the Fund, the relationship between the amount of the restricted securities in Fund's portfolio and that of the freely traded securities, or the possible difficulties in reselling the restricted securities. Moreover, insofar as the Fund's Omega stock was concerned—which, as valued, comprised more than 20 percent

[16] The data and information considered and analysis thereof should be retained, so that they may be available for inspection by the company's independent auditors and our staff.

of the value of Fund's portfolio by late November 1968[17]—Mates knew that Omega was making other private placements of its restricted securities.[18] Prior to November 28, 1968 Mates valued Fund's holding in Omega at a discount of not more than $2.75 per share, which at times during this period was less than 10 percent of the market price for unrestricted Omega stock.

In acquiring the securities described above, Mates followed a policy of orally committing Fund to purchase restricted securities, and then having the Fund value such securities in its portfolio at some subsequent date. During the period of April 15 through July 26 there were intervals of between 6 to 53 days between the time the Fund committed itself to purchase a restricted security and when it first included that security in its portfolio. In such intervals, the market prices of the unrestricted shares of several of the securities increased significantly, and such increases were reflected in the first valuations of the restricted securities in Fund's portfolio. Thus, Fund on July 8 agreed to purchase 300,000 restricted shares of Omega for $3.25 a share, reflecting a discount of about 46 percent from the market price of approximately $6 a share for the unrestricted stock of Omega.[19] However, Fund valued these securities in its portfolio for the first time on July 18, 1968, giving them a value of $5.75 per share, the market price for the unrestricted securities having risen by that date to approximately $8.125 a share. On May 31, 1968, Fund agreed to purchase 36,000 restricted shares of Giffen at $30 a share, reflecting a premium over the then market price for the unrestricted stock of Giffen of approximately $23.00 a share. However, Fund did not value these securities for portfolio purposes until July 23, 1968 when the market value for unrestricted stock had increased to $58.00 a share, at which time the restricted stock was assigned a value of $49.00 per share.[20]

The valuation of restricted securities at the market quotations for unrestricted securities of the same class, or at slight discounts from such quotations, is improper except in most

[17] As of November 26, 1968, Fund reported net assets of $25,378,798.

[18] See Securities Exchange Act Release No. 8584 (April 24, 1969). The private placements were generally at discounts of 50 percent from the market price for unrestricted securities. Because of increases in market prices in the intervals between the times agreements to purchase Omega shares were signed and the dates sales were actually consummated, the prices actually paid were approximately 25 percent of market prices on the dates the stock was acquired.

[19] The market price for unrestricted Omega stock increased from approximately 60 ¢—70 ¢ a share on April 30, 1968 to about $33—$35 per share on December 9, 1968. In February 1970 such stock was at about $.75—$1.00 per share.

[20] Portfolio valuations of the Giffen stock on all other dates through November 26, 1968 were at a discount of only $6 per share from the market price, in accordance with the method used by Mates.

unusual circumstances not present here. The valuation procedures followed by Mates not only gave the Fund, whose investment policy and attendant publicity stressed performance, the appearance of a greater appreciation in value than was justified had proper valuation procedures been followed, but the delay in valuing the restricted securities in the Fund's portfolio showed such appreciation to have been achieved over shorter periods of time than was actually the case. There was thus created a distorted picture of the Fund's performance which affected investors' decisions to redeem or to continue to hold their shares. The Fund's reported net asset value rose from approximately $9 a share in early June 1968, when the Fund stopped sales of its shares because of the back office problems, to $16.88 a share in early December of that year. To the extent that such asset values were inflated by the Fund's improper valuation procedures, holders who did not redeem their shares were also adversely affected as a result of redemptions that were made by some 300 shareholders during this period at redemption prices based on those asset values.[21]

The importance of a full disclosure with respect to the acquisition of restricted securities and the possible consequences thereof is further underlined by the other serious problems which confronted the Fund in this case. By November 1968, more than 20 percent of the Fund portfolio assets as valued by Mates were in Omega stock and an additional 22 percent were in other restricted securities. The Fund thereby became dependent upon developments in the affairs of several of its portfolio companies and at the same time lost much of its flexibility with respect to choosing securities which could best be sold where necessary to meet redemptions. Moreover, on December 20, 1968, when we suspended trading in Omega stock, the Fund was unable to value its portfolio. As we already noted, it therefore had to suspend redemptions of its outstanding shares.

Thereafter, in order to put itself in a more liquid position and also to obtain cash to pay off the bank loans of approximately $7 million, the Fund was forced to sell a number of restricted securities at prices substantially less favorable than the portfolio values previously assigned to them.[22] For example, Fund sold its Giffen holdings at $41 per share on December 31, 1968, only a little over a month before a registration statement

[21] In this period approximately 160,000 shares were redeemed for about $2,100,000.

[22] We have recently pointed out some of the dangers of acquiring restricted securities. See Investment Company Act Release No. 5846, *supra*, p.6.

which included those holdings became effective under which Giffen shares were offered at $55 per share. The $41 price obtained by Fund on December 31 was approximately $11 per share less than the portfolio figure as of December 19 (the day before the suspension of redemption rights) and only about two-thirds of the market price of unrestricted Giffen shares as of December 31. Also on December 30, 1968, the Fund sold its holdings in Longchamps, Inc. at $25 per share, being almost $12 less than their portfolio valuation as of December 19 and reflecting a substantial discount from the market value of the unrestricted stock as of December 30.

In July 1968, after the Fund ceased selling its shares, MFS, a sole proprietorship wholly owned by Mates, registered as an investment adviser. Wide publicity accompanied the opening of this business. In addition, Mates provided prospective clients of MFS with material emphasizing the performance of the Fund. Mates and MFS continually brought to the attention of prospective clients of MFS that Fund had the highest reported performance of any registered investment company in the United States. During the period of July through December 1968, MFS and Mates told investors who inquired about investing in the Fund that the Fund was not then selling its shares but that MFS would provide the investor with management similar to that provided to the Fund. The Fund's apparent performance was thus used to lead investors to believe that with MFS's advisory management their own investments would also produce spectacular results. In the period of July through December 20, 1968, a total of 717 individuals became clients of MFS, entrusting to MFS and Mates more than $17,000,000.

In summary, contrary to his representation to Fund shareholders that the Fund would not acquire securities which could not be sold without registration under the Securities Act, Mates caused the Fund to acquire substantial amounts of such securities. In so doing, he created a situation which could adversely affect the ability of the Fund to comply with the requirements of the Investment Company Act relating to the Fund's shareholders' rights of redemption, contrary to the representations with respect thereto. Thereupon Mates improperly valued such restricted securities in the Fund's portfolio in violation of the valuation provisions of Sections 2(a)(39)(B) and 22(e) of the Investment Company Act and Rule 2a–4 thereunder, and thereby misrepresented to Fund shareholders and to clients and prospective clients of MFS the extent and the cause of the reported increase in the Fund's net assets and net asset value per share. We conclude that in these respects, Mates and MFS willfully violated or willfully aided and abetted violations of the antifraud provisions of Sections 206(1) and 206(2) of the Investment Advisers Act and of Section 10(b) of the Exchange Act and Rule 10b–5 thereunder.

REBATE PRACTICES

During the period July–October 1968, MFS and Mates also willfully violated Sections 206(1) and (2) of the Investment Advisers Act and Section 10(b) of the Exchange Act and Rule 10b–5 thereunder, in that they allocated the execution of securities transactions on behalf of MFS advisory clients to brokerage firms which gave MFS and Mates rebates. These rebates took the form of payments purportedly for an investment advisory publication of MFS and were made contrary to representations to the clients with respect to fees and commissions.

By October 1968 MFS was the investment adviser to over 700 clients for whom Mates made investment decisions on a discretionary basis. A brochure distributed to clients and prospective clients of MFS sta.ed that MFS was not a broker and collected no commissions on clients' accounts; that MFS's fee was based on the net value of a client's portfolio; and that such fee was paid out of the client's account every quarter at rates of 1/4 of 1 percent to 1/2 of 1 percent of the client's equity depending on the amount of such equity.

MFS also published an advisory service for brokers for a monthly fee of $5,000 (subsequently reduced to $3,000) which offered subscribers five or six research reports per month, individual reports on specific securities on request, and seminars to be conducted by Mates. However, very few brokers requested special reports and no seminars were held. The advisory reports that were furnished were merely rather brief market letters, each of which covered one recommended security and presented a very general description of the issuer and its assets with a minimum of financial information. The principal aspect of the arrangement with brokers subscribing to the service was that they were given to understand that if they subscribed to the Mates advisory service, they would be allocated brokerage business arising from the accounts managed by MFS from which they could realize substantial commissions. During the relevant period, MFS allocated a substantial number of brokerage transactions in the accounts of its clients to seven broker-dealer firms and two registered representatives who subscribed to the Mates advisory service. During that period the subscription payments received from such firms and representatives exceeded $90,000, which was more than twice as much as MFS received during the same period from the fees charged clients for managing their investment accounts.

It is evident that the subscriptions offered to brokers were a subterfuge for obtaining rebates from such subscribers in connection with commissions generated by transactions in the portfolios of clients whose accounts were managed by MFS, and the omission to disclose such commission rebates made misleading the representations to clients that no commissions would be collected on their accounts and that MFS annual investment advisory fees would not exceed 2 percent of the equity in their accounts. Moreover, MFS and Mates were fiduciaries in their relationship to their clients in that they acted as investment adviser and directed the execution of securities transactions for them. The arrangement with subscribers to the broker advisory service that they would receive orders for transactions in the accounts of MFS clients enabled MFS and Mates to derive undisclosed personal benefits from the clients. It gave MFS and Mates a personal interest in the volume of the transactions and the selection of executing broker which conflicted with the duty of serving only the clients' best investment interests. The abuse of position and conflict of interests inherent in the making of such arrangements were inimical to the MFS clients.[23]

USE OF INSIDE INFORMATION

During April 1968, MMC and Mates willfully violated Section 17(a) of the Securities Act and Sections 9(a)(2) and 10(b) of the Exchange Act and Rule 10b–5 thereunder, in the purchase of shares of common stock of Ramer Industries, Inc., which were listed on the American Stock Exchange. MMC and Mates obtained through a Ramer director certain non-public material information concerning a rise in the sales, earnings and earnings projections of Ramer. They thereupon purchased Ramer stock without disclosing the information, then disclosed the information to certain registered representatives and others who also purchased Ramer stock without disclosure, and engaged in manipulative activities with respect to Ramer stock.

During the first quarter of 1968, Ramer's financial position and prospects improved significantly, Ramer's sales for that

[23] *Cf. Consumer-Investor Planning Corporation*, 43 S.E.C. 1096 (1969).

quarter being its highest on record. Whereas Ramer had shown a $.03 per share loss for the first quarter of 1967, a press release issued April 16, 1968 estimated first quarter 1968 earnings for Ramer at $.15 per share, and on April 17, 1968 actual first quarter earnings of $.16 per share were announced.

The minutes of the April 3, 1968 meeting of the Board of Directors of Ramer recited that the treasurer of the company reported on the first quarter's earnings and that the Board expressed pleasure with the results. A director of Ramer, who had attended the meeting, began purchasing Ramer stock for his own account the following day. On April 9, 1968, Mates met with that director, who was a registered representative with a broker-dealer firm and with whom Mates had a close relationship, and in the three following business days, Mates placed orders with the director for the purchase of a total of 27,000 shares of Ramer stock on behalf of the Fund and two other mutual funds. Prior to this time none of the three funds had ever transacted any business with the Ramer director.

Mates also spoke to certain registered representatives who generally followed his recommendations, and told them that he was buying Ramer stock, that Ramer's earnings would be up and that Ramer was a turn-around situation. As a result of this recommendation and the purchase activity that had already taken place, Mates was able, directly or indirectly, to induce the purchase by these representatives for their clients of approximately 65,000 shares of Ramer prior to the public announcement of the 1968 first-quarter earnings. Thereafter Mates continued to recommend Ramer stock and induced purchases of the stock.

Ramer had approximately 750,000 shares of stock outstanding as of April 1, 1968. During March 1968 and the first few days of April, trading in Ramer stock on the American Stock Exchange amounted to about 1,000 shares or less per day. In the three week period ending May 3, 1968, the total volume of trading in Ramer stock on the exchange was 1,169,000 shares, and during this period the price of the stock rose from about $\$5^{3}/_{8}$ to $14 per share. Mates through his own transactions and his recommendations to others was responsible directly and indirectly for the purchase of at least 151,000 shares of Ramer stock during the last three weeks of April 1968 and was thereby able to affect appreciably the market value of the Fund's portfolio holdings of Ramer stock.

It is clear that through his relationship with a director of Ramer, Mates had access to non-public material information which he used for his own advantage and that of his clients.[24] This information was of such importance that it could reasonably be expected to affect the judgment of investors whether to buy, sell, or hold the stock. If generally known, such information could reasonably be expected to affect materially the market price of the stock.[25] We concluded that Mates' and MMC's advance use in market purchases of the favorable information concerning Ramer for their own or their customers' benefit and to the detriment of public investors to whom the information was not known constituted conduct violative of the designated antifraud provisions.[26]

We further concluded that by directly and indirectly effecting a series of transactions on the exchange which created active actual and apparent trading in Ramer stock and which raised the price of such stock for the purpose of inducing purchases by others, Mates engaged in conduct which constituted a manipulation of securities prices in violation of Section 9(a)(2) of the Exchange Act.

CONCLUSION

In view of the foregoing, we concluded that it was in the public interest to accept the offer of settlement and to impose the sanctions permitted under such offer, as recommended by our staff.

By the Commission (Chairman BUDGE and Commissioners OWENS, SMITH and NEEDHAM), Commissioner HERLONG not participating.

[24] Following public disclosure of the information on April 16, 1968 the price of the stock generally rose from 7 7/8 on that date to 13 1/4 on April 29, 1968.

[25] *Merrill Lynch, Pierce, Fenner & Smith, Inc.*; 43 S.E.C. 933, 936 (1968); See also *Blyth & Co.*, 43 S.E.C. 1037 (1969); *Van Alstyne, Noel & Co.*, 43 S.E.C. 1080 (1969).

[26] *S.E.C.* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (C.A. 2, 1968), *cert. denied*, 394 U.S. 976 (1969); *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961); *Merrill Lynch, Pierce, Fenner & Smith, Inc., supra; Blyth & Co., supra; Van Alstyne, Noel & Co., supra.*

IN THE MATTER OF

FEDERATED PURCHASER, INC.

File No. 3-2164. Promulgated March 30, 1970

Securities Exchange Act of 1934—Section 15(c)(4)

REPORTING COMPLIANCE PROCEEDING

Reports filed under Securities Exchange Act of 1934, *held,* materially misleading and deficient, where among other things annual report contained certified balance sheet showing substantial value for promissory note received from an affiliated company in exchange for assets carried at no value and registrant failed to disclose that basis on which accountants certified such balance sheet ceased to exist prior to filing of report.

APPEARANCES:

Ralph H. Tracy and *Robert M. Steinbach,* for the Division of Corporation Finance of the Commission.

Milton V. Freeman, Werner Kronstein and *Richard Fairbanks* of Arnold & Porter, and *Mark Geraghty* of Burke & Burke, for Federated Purchaser, Inc.

FINDINGS, OPINION AND ORDER OF

This is a proceeding instituted under Section 15(c)(4) of the Securities Exchange Act of 1934 ("Exchange Act") to determine whether Federated Purchaser, Inc. ("registrant"), whose common stock is listed on the American Stock Exchange ("AMEX") and registered under Section 12(b) of the Exchange Act, failed to comply with Sections 12 and 13 of the Exchange Act by filing an annual report on Form 10-K for the fiscal year ended October 31, 1968 and a current report on Form 8-K for the month of March 1969, which contained information which was materially misleading and which omitted to state material facts required to be stated therein.

Registrant submitted an offer of settlement, pursuant to which it entered into a stipulation of facts, waived a hearing and post-hearing procedures, and consented to findings consistent with the allegations in the Statement of Matters filed by our Division of Corporation Finance that registrant had filed reports which were misleading and deficient.[1] Registrant, among other things, also agreed to file correcting amendments on Form 8 to such reports, to mail to its shareholders a brief factual statement concerning this proceeding, including a summary of the Division's Statement of Matters and notice of registrant's stipulation and settlement agreement, and to provide all its shareholders with a copy of our Findings and Opinion herein if so directed.

Upon consideration of all the circumstances, including the recommendation of the Division, we determined to accept the offer of settlement and to direct that copies of these findings and opinion be sent by registrant to its shareholders.

We find that registrant's reports filed with us included untrue statements of material facts and omitted material information required to be stated therein or necessary to make the statements therein not misleading, with respect to the valuation of a note receivable obtained from an affiliated company in exchange for stock of three of registrant's subsidiaries which had no assets.

On October 22, 1968, control of registrant was acquired by The Dekcraft Corporation ("Dekcraft"), and Dekcraft's president and controlling shareholder, Melvin D. Skolnik, became president of registrant. After assuming control, the new management became aware of problems which might cause registrant's net tangible assets to fall below $1,000,000 and thus possibly affect the continued listing of registrant's stock on the AMEX.[2] In view of this possibility, registrant's new management sought a means to increase the company's net tangible assets so that its balance sheet for the fiscal year ending October 31, 1968 would reflect net tangible assets in excess of $1,000,000.

For this purpose, registrant, by a contract dated October 28, 1968, entered into an agreement with Reed Printing and Packaging Corp. later renamed Computer Tools, Inc. (hereinafter referred to as Computer Tools). Skolnik was also president and a controlling shareholder of Computer Tools and he signed the contract on behalf of both parties. Pursuant to the terms of the contract, registrant sold two-thirds of the stock of each of three wholly-owned subsidiaries to Computer Tools in ex-

[1] Registrant has consented that our findings may be based on matters in the public record of this proceeding as well as on the transcripts, exhibits and documents obtained by our staff in its investigation of this matter.

[2] It is the policy of the AMEX to consider delisting the shares of an issuer when the issuer has net tangible assets of less than $1,000,000 and has sustanied losses in its two most recent fiscal years. American Stock Exchange Guide, CCH, Vol. 2 § 10, 951.

change for a $300,000 note payable by Computer Tools on October 28, 1969. The remaining one-third of the shares in each of the subsidiaries was distributed to registrant's shareholders.[3] Prior to these stock transfers, all assets were transferred out of the subsidiaries into registrant and registrant carried its investment in the three shell subsidiaries at no value on its books.

The Computer Tools $300,000 note bore interest of 7 percent and was convertible into 60,000 shares of Computer Tools common stock. Registrant carried the note on its books at $300,000, thereby increasing registrant's net tangible assets as recorded on its books to a figure in excess of $1,000,000 at the end of the fiscal year.

During the course of the audit for the fiscal year ended October 31, 1968 the accounting firm auditing registrant's books had numerous discussions with registrant's management with respect to the valuation of this note on registrant's books as of October 31, 1968. The accountants were informed by management that Computer Tools was an affiliate of registrant and that it was then unable to repay the note and had no substantial assets. This information led the accountants to conclude that they could not rely on the financial resources of Computer Tools in placing a value on the note, and that the $300,000 valuation could not be sustained. The accountants further concluded that the note's convertibility into stock was not of itself sufficient to support a valuation in view of the facts that Computer Tools stock was traded over-the-counter and that there was a thin market with relatively little trading and the stock into which the note was convertible was not registered.

In view of these discussions with the auditors, registrant on January 10, 1969 obtained a guarantee of the note from Dekcraft. Subsequently the accountants advised that they did not consider this guarantee sufficient to establish a value for the note, because registrant and Dekcraft were under common control and because they were not satisfied with Dekcraft's financial capacity. The accountants took the position that in the absence of an ascertainable value for the note, it should be carried at no value, which was the book value of registrant's investment in the shell subsidiaries given in exchange for the note. Registrant attempted, but was unable, to obtain a guar-

[3] The subsidiaries which registrant sold to Computer Tools were Federated Purchaser, Inc. of Pennsylvania, Federated Electronics, Inc. of New Jersey and Federated Electronics, Inc. of Maryland. After the transfer they were renamed E.B. Enterprises, Inc., The Byron Corporation and Dek Electronics, Inc.

antee from an independent financially responsible third party.

Finally, after further discussion with the accountants, registrant, in an effort to demonstrate a value for the note, on March 5, 1969 sold the note back to Computer Tools for $260,000 cash, which Computer Tools raised by borrowing $68,000 from Skolnik and $150,000 from East Side Tennis Club which Skolnik personally guaranteed, and by borrowing an additional $42,000 from Educational Applications, Inc., another company controlled by Dekcraft. Also on that date and in order to satisfy the auditors that the repurchase was bona fide, registrant executed a letter to the auditors representing that the $260,000 would be used for its own purposes and not for or on behalf of Computer Tools or any other affiliate. On March 6, 1969 the auditors certified registrant's balance sheet as of October 31, 1968 showing the note with a value of $260,000 with an explanatory footnote relating to the March 5, 1969 transaction.

On March 11, 1969 registrant returned the $260,000 to Computer Tools in exchange for 60,000 shares of Computer Tools stock and during that same month, Computer Tools used the $260,000 to repay its debt to Skolnik and East Side Tennis Club and a portion of the debt to Educational Applications. On March 28, 1969, registrant filed its annual report on Form 10–K for fiscal 1968, including the October 31, 1968 balance sheet which carried the note at a value of $260,000.

In July 1969 the accountants, in a letter to the Commission, sought to withdraw their certification of registrant's financial statements for the year ending October 31, 1968. They stated that the March 11 transaction[4] whereby registrant bought 60,000 shares of Computer Tools stock was in contravention of their understanding of the representations made by registrant on March 5 that it would use the $260,000 for its own purposes and not on behalf of Computer Tools or any other affiliate. Registrant states that in the latter part of July 1969 it sold 54,589 of the 60,000 shares of Computer Tools stock for an aggregate of $245,000 and that it still retains the other 5,511 shares. The sale was privately made to business and family acquaintances of Skolnik and was arranged shortly after the accountants' letter to the Commission. In the circumstances we do not attach any value significance to this after-the-fact transaction.

The March 11 transaction was clearly in violation of the

[4] The auditors stated they they did not learn of the March 11 transaction until July. In this connection it is noted that registrant replaced the auditors shortly after completion of the fiscal 1968 audit.

representation in registrant's letter to the accountants issued only six days earlier which was an essential prerequisite to the accountants' certification of registrant's financial statements. Registrant's return of the $260,000 in exchange for Computer Tools stock benefited Computer Tools and permitted it to repay its debts to East Side Tennis Club and Skolnik. It also benefited Skolnik, who was an affiliate of both registrant and Computer Tools, since the funds were used to discharge Computer Tools' debt to him and to East Side Tennis Club, whose debt he had personally guaranteed. In return for these direct and substantial benefits to its affiliates, registrant received shares of unregistered stock in a company with no substantial assets.

The combined effect of the March 5 and March 11 transactions was to cancel the note and leave registrant with 60,000 shares of Computer Tools stock. The same result would have occurred had registrant converted the note into Computer Tools stock. As previously discussed, however, the convertibility of the note into such stock had been considered by the accountants as insufficient to support valuation of the note as of October 31, 1968. Under all the circumstances, it would appear that the note should have been carried at no value as of October 31, 1968, in view of the facts that it was taken in a non-arm's length transaction from an affiliate company, which at that time had minimal assets, in exchange for stock of three subsidiary companies which had no assets and had been carried on registrant's books at no value. At the time registrant filed its report with us it was clear that the valuation of the note at $260,000 was improper and that the basis for the accountant's certificate, to which the Commission attaches great importance, no longer existed. In the absence of any other bona fide demonstration of value acceptable to the certifying auditors, it was materially misleading to file the report with the certified financial statements without a full disclosure of the above facts. For the reasons indicated above, the subsequent sale of Computer Tools stock some months later in July 1969 (after the accountants sought to withdraw their certification of registrant's financial statements for the year ending October 31, 1968), does not affect the misleading nature of the report as filed in March 1969.

On April 9, 1969 registrant filed its current report on Form 8-K for the month of March 1969. That filing mentioned the "purchase" of 60,000 shares of Computer Tools stock for $260,000 but it failed to mention the facts, described above, concerning Skolnik's loan and his personal guarantee of the East Side Tennis Club loan which enabled Computer Tools to repurchase its note. Neither did it mention that upon return of the money to Computer Tools, that company used the funds to discharge Skolnik's loan as well as the loan he had guaranteed. These facts were necessary in order adequately and accurately to describe the repurchase of the note and the purchase of Computer Tools stock.

In view of the foregoing, it is appropriate in the public interest to accept the offer of settlement and to impose the conditions agreed to by registrant.

Accordingly, IT IS ORDERED, pursuant to the undertakings in registrant's stipulation, that registrant file correcting amendments to its reports, and that it send copies of these Findings, Opinion and Order to all of its shareholders.

By the Commission (Chairman BUDGE and Commissioners OWENS, SMITH, NEEDHAM and HERLONG).

IN THE MATTER OF

GREAT NORTHERN MANAGEMENT CO., INC.

File No. 3-1458. Promulgated April 3, 1970

Securities Exchange Act of 1934—Section 15(c)(4)

REPORTING COMPLIANCE PROCEEDING

Reports filed pursuant to Securities Exchange Act of 1934 *held*, materially misleading and deficient, where they failed adequately or accurately to disclose that registrant's initial capitalization had consisted in part of debt obligations which were to be repaid out of proceeds of public sale of registrant's stock purportedly offered by selling stockholders; that registrant had made public offerings of unregistered securities and incurred contingent liabilities thereby; that a purportedly unaffiliated company had been organized and dominated by persons in control of registrant and used to sell registrant's stock; and that proceeds from such sales and other funds derived from registrant were used by such controlling persons to purchase, through nominees and another purportedly unaffiliated company in fact controlled by the same persons, shares of another issuer.

APPEARANCES:

Thomas N. Holloway, *Ralph H. Tracy* and *Neal S. McCoy*, for the Division of Corporation Finance of the Commission.

James C. Sargent and *Robert S. Newman*, of Parr, Doherty, Polk & Sargent, for Great Northern Management Company, Inc.

FINDINGS AND OPINION OF THE COMMISSION

INTRODUCTION

This is a proceeding instituted under Section 15(c)(4) of the Securities Exchange Act of 1934 ("Exchange Act") to determine whether Great Northern Management Company, Inc. ("Great Northern" or "registrant"), a company whose securities are registered under Section 12(g) of the Exchange Act, failed to comply with Sections 13 and 15(d) of the Exchange Act by filing annual reports on Form 10-K for the years ended December 31, 1965 and December 31, 1966 and a current report on Form 8-K for October 1967 which contained materially misleading statements and omitted required material information.

The instant proceeding had been consolidated with a proceeding pursuant to Sections 8(c) and 8(d) of the Securities Act of 1933 ("Securities Act") instituted to determine whether a registration statement of Great Northern dated November 17, 1965 contained untrue statements of material facts or omitted required facts required to be stated therein, and whether a post-effective amendment of Great Northern dated July 26, 1966 was inadequate and inaccurate in material respects. Great Northern submitted an offer of settlement of the proceedings in which it consented to the entry of a stop order suspending the effectiveness of the registration statement and to findings that the post-effective amendment was inadequate and inaccurate and that registrant had filed reports containing materially misleading statements and omitting required information. Registrant among other things agreed to file correcting amendments to such reports, to mail to all its shareholders a brief factual statement concerning the proceedings and the settlement provisions and copies of our findings and opinions if so directed.

We determined to accept the offer of settlement and issued our Findings, Opinion and Stop Order in the Securities Act proceeding (Securities Act Release No. 4941, December 23, 1968) which we directed registrant to send to all of its stockholders. Subsequently amended reports were filed and the instant findings and opinion relate to the deficiencies in registrant's reports as originally filed.

On the basis of registrant's consent and the record, we find that the three reports in question contained materially misleading statements and omitted material information, with respect to the initial capitalization of Great Northern, sales of unregistered securities, the securities described in the registration statement, and the relationship and transactions between registrant, certain of its officers and directors, and two corporations, Oneida Holding Company, Inc. ("Oneida") and Candlewood Management Corporation ("Candlewood"), organized and controlled by certain of registrant's officers or directors.

THE ANNUAL REPORTS

SALES OF SECURITIES

In response to the items in its annual reports on Form 10–K for 1965 and 1966 relating to its outstanding securities, Great

Northern among other things referred to the registration statement for a description of the transactions involved in Great Northern's initial capitalization and the public offering. However, as more fully set forth in our Findings and Opinion in the stop-order proceeding,[1] the registration statement was materially misleading with respect to those matters.

Among other things, we found that contrary to the representations in the registration statement and the items in its balance sheet reflecting an initial capitalization of 560,000 shares issued for a total of $1,680,000, in fact registrant's initial capitalization consisted of $886,500 received for stock and $793,500 representing borrowings by registrant; that 264,500 shares purportedly issued in the names of registrant's president, William V. Licht and its secretary, Harold Dougherty, were issued to those persons with the intent that they would be sold to the public through a purported secondary offering to raise funds with which to retire the $793,500 debt; and that this plan was ultimately carried out by means of the registration statement in which Licht and Dougherty were named selling shareholders.

We also found in our earlier opinion that registrant's initial capital of $1,680,000 was not raised by selling stock to eleven individuals as stated in the registration statement but was in fact effected by a public offering of registrant's stock and debt securities to more than seventy investors which was in violation of Section 5 of the Securities Act and gave rise to contingent liabilities to the purchasers of the securities. We also found that the financial statements in the registration statement, which included the balance sheet contained in the 1965 Form 10–K, were materially deficient in the presentation of the capitalization of registrant and in failing to disclose such contingent liabilities.

Further, in the stop order opinion we found that the registration statement failed to disclose that Oneida, a corporation formed and controlled by Licht and Albert V. Bianco, another controlling person of registrant, was used as a conduit through which approximately 150,000 shares of registrant's stock were sold at $3 per share to approximately 175 persons, the shares to be delivered after the effective date of Great Northern's registration statement; that these sales were disguised as loans to Oneida by the purchasers of Great Northern's stock; and that such sales also were in violation of Section 5 of the

[1] See Securities Act Release No. 4941, pages 4-6.

Securities Act and gave rise to contingent liabilities undisclosed in the text or financial statements in the registration statement.

We find that the annual reports for 1965 and 1966 were materially misleading and deficient in failing to disclose the facts and circumstances regarding Great Northern's initial capitalization and its public offerings of securities in violation of Section 5 of the Securities Act and the contingent liabilities arising therefrom. The financial statements in the 1965 annual report were further deficient in reflecting $285,000 as a receivable from Oneida as at December 31, 1965 without designating said receivable as one due from an affiliate.

INTEREST OF MANAGEMENT AND OTHERS IN CERTAIN TRANSACTIONS

Licht and Bianco dominated and controlled registrant at all times material to this proceeding; they also organized and controlled Candlewood and Oneida. Notwithstanding the common control of these entities, such control and numerous transactions involving them were not disclosed in registrant's 1965 or 1966 annual reports. In particular, there was no disclosure of circumstances, summarized below, surrounding the purchases by Licht and Bianco through two nominees of shares of stock of North Atlantic Life Insurance Company ("NALIC"), of which Licht and Bianco were also controlling persons, and the arrangements entered into between Licht, Bianco and their nominees, Candlewood, Oneida and other affiliates of registrant in connection with the purchase of such stock and its disposition.

Licht and Bianco commenced purchasing shares of NALIC stock through nominees in December 1964, and they continued into 1966. They have claimed that it was their understanding that registrant was obligated to buy all NALIC shares so purchased, at cost plus interest on funds obtained to make such purchases, although they have stated that it was not their intention to attempt to enforce such obligation by legal proceedings. Prior to August 1965 Licht and Bianco had purchased 31,200 shares of NALIC stock through nominees, which the nominees transferred at the direction of Bianco and Licht to Candlewood at the nominees' cost plus interest. Some of these shares had been purchased with the proceeds of a check for $75,000 issued by registrant. Candlewood had also purchased additional shares of NALIC in its own name at Licht's and Bianco's direction. On August 2, 1965 Candlewood held 42,556 shares so acquired and granted registrant an option to purchase them at $17.50 per share.

Additional shares of NALIC were purchased by Licht and Bianco and their nominees during the period when registrant's shares were being offered to the public pursuant to the registration statement which was the subject of the stop-order proceeding. One source of funds utilized in making such purchases was Great Atlantic Realty Company ("Great Atlantic"), a wholly-owned subsidiary of registrant to which registrant had loaned $50,000 in 1965 and had transferred realty that was then mortgaged for about $75,000. Another source of funds was the proceeds of sales of Great Northern's stock which were effected through Oneida. As previously noted, approximately 150,000 shares of Great Northern stock had been sold through Oneida at $3 per share. During 1965 and 1966 approximately $387,000 derived directly or indirectly from such sales proceeds was used by one of the nominees to purchase NALIC stock.

Most of the NALIC shares purchased with these funds were pledged with various banks as collateral for loans of Licht and Bianco. On March 3, 1966 Licht obtained a bank loan of $420,000 the proceeds of which were paid to Oneida, and Oneida in turn paid $414,130 to Great Northern in payment of amounts received by Oneida in the sales through it of Great Northern stock. At the time Licht obtained the $420,000 bank loan it was understood by him, Bianco and the bank that Great Northern would assume the loan in the future.

By August 1966 Licht and Bianco were heavily indebted to various New York banks. The loans representing their indebtedness were for the most part secured by NALIC shares. In order to meet demands by the banks for payment of the loans, Licht and Bianco in August and September 1966 caused Great Northern to borrow, without prior authorization of its board of directors, an aggregate of $1,400,679 from three banks. Of the $1,400,679 thus obtained by Great Northern, $1,065,670 was used at the direction of Licht and Bianco to discharge their personal indebtedness to two of the banks as well as to reduce an indebtedness of Candlewood which was guaranteed by Licht and Bianco and others. Licht and Bianco stated that in return for such payments they intended that Great Northern would receive a large portion of the NALIC shares purchased by their nominees, and some of the shares of NALIC held by Candlewood, many of which had been pledged as collateral for the indebtedness.

In September of 1966 Licht and Bianco asked Great Northern's board of directors to ratify the above transactions which the board refused to do during 1966. Thereafter, by instruments dated December 31, 1966 Licht and Bianco transferred 35,599 shares of NALIC stock, theretofore purchased by them through their nominees, to Candlewood. Sometime in 1967, certain documents dated April 6, 1967, copies of which were attached as exhibits to registrant's annual report for 1966, were prepared. These documents consisted of an agreement between Candlewood and Great Northern providing, among other things, for the extension for five years of an existing obligation of Candlewood to registrant in the amount of $1,065,670 and the granting to registrant of a five year option to purchase from Candlewood up to 40,000 shares of NALIC stock at a minimum option price of $15 per share; a note in the amount of $1,065,670 issued by Candlewood to registrant which stated in part that it was issued by Candlewood to consolidate, extend and acknowledge previous borrowings by Candlewood from Great Northern in August and September 1966; and a guaranty of that note executed by Bianco, Licht and others.[2]

Thus the 1966 annual report as originally filed gave the impression simply that registrant had made a series of loans to Candlewood in August and September 1966 and that the April 6, 1967 documents were executed for the purpose of consolidating such loans. Nowhere were the roles of Licht and Bianco disclosed. An entirely different picture is afforded from the correcting amendment to that report filed as part of the settlement of this proceeding. While the original report reflected an aggregate of $1,065,670 as due from Candlewood, the amendment shows as loans to officers an amount of $690,000, which had in fact been used to pay off Licht's and Bianco's personal bank indebtedness, and with respect to the remaining $375,670 due from Candlewood, discloses that Candlewood and Great Northern were both under the control of Licht and Bianco. Thus, what were originally presented as purported arm's length transactions between Great Northern and Candlewood are revealed to have been advances by Great Northern to its officers.

THE CURRENT REPORT FOR OCTOBER 1967

In its current report on Form 8–K for October 1967 registrant stated among other things that Great Northern had obtained a loan from North Western National Life Insurance Company ("NWN") in the amount of $3,150,000 secured by a

[2] Minutes of meetings in April 1967 of registrant's board of directors reflect that the board then also ratified the actions whereby registrant had borrowed the $1,400,679 from three banks in August and September 1966.

pledge of 445,568 shares of NALIC stock owned by registrant. The report also stated that Great Northern had obtained 132,000 shares of NALIC stock from Candlewood at $17 per share of which Candlewood had obtained 55,000 shares from Licht and Bianco at $17 per share, and that Great Northern's option to purchase NALIC shares from Candlewood was cancelled.

None of the common control relationships between Licht, Bianco, Candlewood and Great Northern as previously noted in this opinion were disclosed in connection with these transactions. Nor was the fact that the cost basis to Licht and Bianco for a major portion of the 55,000 NALIC shares which they sold to Candlewood was $3.50 per share.

CONCLUSION

The reports filed with us by Great Northern which are the subject of this proceeding contained numerous serious deficiencies. In particular they failed to disclose many transactions between Great Northern, its officers and directors, principally Licht and Bianco, and other companies controlled by them, which involved material amounts. As noted above, however, correcting amendments to such reports have been filed pursuant to the offer of settlement, and accordingly no further action is necessary at this time.

By the Commission (Chairman BUDGE and Commissioners OWENS, SMITH and NEEDHAM), Commissioner HERLONG not participating.

IN THE MATTER OF

INTERCONTINENTAL INDUSTRIES, INC.

File No. 1-5566. Promulgated April 3, 1970

Securities Exchange Act of 1934—Section 12(d)

STRIKING OF SECURITY FROM LISTING AND REGISTRATION

Failure to Comply with Listing Agreement

Where issuer, in contravention of disclosure requirements included in its listing agreement with securities exchange, disseminated or permitted dissemination of inaccurate or misleading information concerning, among other things, the extent of orders for product of company which issuer had contracted to acquire and such company's projected sales and earnings, and issuer failed to take prompt action to correct and clarify such information, application by exchange, based on its delisting rules, to strike common stock of issuer from listing and registration, *granted.*

APPEARANCES:

Bernard H. Masas, Vice-President, for American Stock Exchange.

Bernard A. Feuerstein and *Irwin P. Underweiser*, of Feuerstein & Underweiser, for Intercontinental Industries, Inc.

FINDINGS, OPINION AND ORDER

The American Stock Exchange has filed an application, pursuant to Section 12(d) of the Securities Exchange Act of 1934 ("Act") and Rule 12d2-2(c) thereunder, to strike from listing and registration on the Exchange the common stock, $1 per value, of Intercontinental Industries, Inc. ("INI").[1] The stock has not been traded on the Exchange since June 19, 1969, when the Exchange halted trading. INI filed a memorandum in opposition to the application, the Exchange filed a reply and

[1] Section 12(d) of the Act and Rule 12d2-2(c) provide in pertinent part upon application by a national securities exchange, a security registered with such exchange may be delisted in accordance with the rules of the exchange upon such terms as we may deem necessary to impose for the protection of investors.

INI submitted a rebuttal memorandum and subsequently a letter presenting further argument.

The application is based on the Exchange's determination that INI disseminated or permitted the dissemination of inaccurate or misleading information concerning corporate developments. The Exchange's policy respecting delisting states that the Exchange will consider removing a security from listing when, in its opinion, "any . . . event shall occur or any condition shall exist which makes further dealings on the Exchange in the security unwarranted,"[2] and guidelines, adopted to assist in the application of the Exchange's policies, specify among other things that securities of a company which fails to comply with its listing agreement with the Exchange in any material respect "are subject to suspension from dealings and, unless prompt corrective action is taken, removal from listing," and that delisting will be considered if a company or its management engage in operations which, in the opinion of the Exchange, are contrary to the public interest.[3]

The application states that INI and its management disseminated or permitted the dissemination of inaccurate, incomplete or misleading information concerning material developments in its affairs and operations. In so doing, it is alleged, they failed to comply with a provision of the listing agreement with the Exchange requiring prompt public disclosure by a listed company of any material development in its affairs and operations which might significantly affect the market for its securities or influence investment decisions. The application further states that the activities of INI and its management in these respects were contrary to the public interest and violated the Exchange's requirements for continued listing.

There is no substantial dispute as to the nature of the information which was disseminated or as to the fact that such information was misleading in material respects. As recited in the Exchange's application, on April 11, 1969 INI preliminarily agreed to purchase 81 percent of the outstanding stock of Prebuilt Homes, Inc. ("Prebuilt"), a company that had been organized in March 1969 to produce and sell factory-built modular homes, from Prebuilt's three stockholders; on the same day INI announced that it proposed to acquire 81 percent of the stock of a modular home builder, which it did not then name, that had orders of about $130 million on hand; and in an announcement a few days later INI identified Prebuilt and

[2] American Stock Exchange Company Guide, § 1002.

[3] *Id.*, § 1003.

stated that Prebuilt had orders to build more than 9,800 homes, including 800 pre-finished modular homes for the Metropolitan Detroit Citizens Development Authority ("MDCDA"). On May 20, 1969, INI reported the execution of a definitive contract of purchase of the Prebuilt stock.

Following the above announcements written material prepared by Prebuilt was distributed to persons in the securities industry and others which indicated that as of April 1, 1969 Prebuilt had orders and proposals on hand for 9,039 housing units, amounting to a sales volume of over $116 million. The material projected annual sales of about $141 million and net earnings of about $10 million by 1973 and cumulative sales and earnings for the five-year period 1969–1973 of approximately $392 million and $29 million, respectively. The Wall Street Journal of June 3, 1969 reported a securities analyst's statement that an INI official had predicted Prebuilt's earnings would "jump" from an anticipated $100,000 in the fiscal year ending July 31, 1970 to $9 million three years later and sales would rise from $5.5 million to $97 million in the same period, and there would be a "meteoric" rise in INI's consolidated earnings from an estimated $425,000 in the current fiscal year to $10 million in the year ending July 31, 1973. The Exchange's application states that the analyst subsequently advised the Exchange that these projections had been received from a named vice-president and director of INI.

The application recites that when the above information was disseminated, certain material facts, including the following, were not disclosed: At the time of the April announcements, Prebuilt had only nominal tangible assets, had not commercially produced any modular homes, had no plant in operation in which modular homes could be manufactured [4] and had no previous history of operations or earnings. Prebuilt had no signed contracts to build modular home units and few, if any, firm commitments for the purchase of such units. Although it had received an award from MDCDA to build 800 units, no contract had yet been entered into.[5]· The remainder of the purported orders for 9,800 homes consisted of letters of intent or proposals in various stages of planning which were not legally binding.[6] These included a proposed project of 4,500

[4] During April Prebuilt was engaged in negotiating a lease for a 120,000-square foot building and on May 1, 1969 it took possession under a five-year lease.

[5] The application states that at a hearing before an Exchange committee on August 6, 1969, officials of INI and Prebuilt indicated that this contract was still being negotiated and that no other contracts had yet been executed.

[6] INI advised its shareholders in July 1969 that several of the original proposals covering a substantial number of the 9,800 housing units were subsequently withdrawn or terminated.

homes to be built by a joint venture in which the three stockholders of Prebuilt would be participants. The success of this project was contingent on the availability of land, financing and resaleability of the homes. The reference to $130 million of orders was based primarily on a letter of commitment from Lester Taubman, Prebuilt's president, in which he agreed to purchase 9,039 units from Prebuilt prior to June 1972, less such units as might be sold to MDCDA or any other organization or as might be erected by Prebuilt in connection with its own land development programs. While Taubman's commitment could exceed $100 million, his net worth was such that his ability to purchase units pursuant to the commitment was dependent on his ability to resell the units.

In connection with the earnings projections for Prebuilt, it was not disclosed that under employment contracts between Prebuilt and its three principals, the latter would receive as supplemental compensation an amount equal to 81 percent of Prebuilt's net income in excess of $5,225,000 for the five-year period ending July 31, 1974. This amount was to be paid annually, beginning in September 1974, out of 40 percent of pre-tax net profits for the fiscal year ending July 31, 1974 and subsequent fiscal years until paid in full.

On June 13, 1969, INI announced that it had joined with Capital Bancshares, Inc. (which is controlled by INI's president) to purchase 4.3 percent of the oustanding stock of Central Foundry Company from Central's president for $1 million and that INI and Bancshares intended to propose uniting the two companies with Central. The announcement included *pro-forma* figures for the three companies combined. Press accounts quoted INI's president as stating that he understood the management of Central was sympathetic to a proposal for combining the three companies. However, according to a letter sent by INI to its shareholders on July 18, 1969, following the halt in trading, the *pro forma* figures, especially for net income, were substantially overstated; INI had submitted no proposal for merger or unification of the three companies to Central's directors; and INI had received no formal commitment, written or oral, from any director of Central indicating that he favored such action.

The application states that the information disseminated regarding Prebuilt and INI had a significant effect on the market for INI stock between April 11, 1969, when the first announcement was made, and June 19, 1969, when Exchange trading was stopped, with both volume and price rising sharply during that period.[7] On June 26, we suspended all trading in INI stock. We then brought an injunction action against INI, Prebuilt and certain of their officers and directors, alleging that they violated antifraud provisions of the securities acts in the dissemination of false or misleading information concerning Prebuilt, and a consent decree was entered on July 15, enjoining statements of the nature described in the complaint. Following INI's information letter to its shareholders of July 18 regarding the matters discussed above and other matters, we terminated our suspension order, thereby permitting resumption of over-the-counter trading in INI stock.[8]

INI urges that we should deny the application and permit resumption of Exchange trading in its stock. It argues that the delisting guidelines relied on by the Exchange permit removal from listing only if following a suspension of trading prompt corrective action is not taken, and it points to instances of suspensions based on misrepresentations where the Exchange permitted resumption of trading after corrective action had been taken. It asserts that it took corrective action, in the form of the July 18 shareholder letter, as soon as it could legally do so following the suspension. It further argues that the Exchange's rules should be construed to permit delisting only where there has been a continuous pattern of misrepresentations amounting to willful fraud, which it asserts was not the case here. It also stresses that unlike the situation in other delisting cases, it meets all criteria for listing.

In our opinion, INI's arguments do not present a basis for disturbing the Exchange's determination that the company's stock should be delisted. One of the stated purposes of the Act is to "insure the maintenance of fair and honest markets in [securities] transactions." [9] It is essential to the maintenance of such markets that companies whose securities are held by the public refrain from publishing inaccurate and misleading information of a material nature.[10] It seems clear, moreover, that an exchange has an obligation, in the exercise of its self-regulatory responsibilities, to assure, as far as is possible, that the issuers of securities traded on it make prompt and accu-

[7] During the last three weeks of March and the first week of April, average weekly volume was about 7,000 shares and the price ranged from $11^1/_8$ to 13. On April 11, 18,600 shares were traded and the stock closed at $15^1/_2$, up $1^1/_2$. In the ensuing weeks, weekly volume ranged from 15,400 to 233,300, and the price from $14^1/_4$ to $31^1/_4$, the closing price prior to the halt in trading being $26^1/_2$.

[8] In the first week of such over-the-counter trading the bid quotations for INI stock ranged from $5^5/_8$ to $7^1/_2$ and the ask quotations from $6^1/_2$ to $9^1/_2$.

[9] Section 2.

[10] See *S.E.C.* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 858 (C.A. 2, 1968), *cert. den.* 394 U.S. 976 (1969).

rate disclosure of material corporate developments.[11] Pursuant to this obligation the Exchange has among other things adopted a policy requiring the prompt public disclosure of material corporate developments, which by its very nature embodies a requirement that such disclosure be accurate, and has incorporated such policy into its listing agreements. The listing agreement further specifies that,

> "It is expected that [corporate news releases] will be factual and that judgment and restraint will be used in not publicizing information which may be construed as overoptimistic, slanted or promotional—such as estimates and forecasts not warranted by existing circumstances, premature statements of mergers or acquisitions or descriptions of new products still in the experimental stage, the commercial feasibility of which is problematical, etc."

While as stated INI questions the appropriateness of delisting as a remedy for misleading corporate publicity where standards for continued listing are otherwise met, it seems clear that an exchange should be permitted to cleanse itself of the securities of issuers which act in clear disregard of its disclosure requirements. Although delisting may have adverse effects on present investors, in our opinion the Exchange may reasonably consider such effects to be outweighed by the interests of possible future investors where the issuer has evidenced an unreliability with respect to important disclosures. Of course the Exchange's action must conform to its rules. The Exchange contends, and we agree, that INI did not take such "prompt corrective action" as would preclude delisting under its rules. It is apparent that INI did not make full disclosure of the facts until forced into doing so by the Exchange and this Commission. As noted, in mid-April 1969, INI made a series of announcements concerning Prebuilt which contained misstatements and omissions of a most serious nature. During a period of more than two months thereafter, until trading was halted by the Exchange, no attempt was made to correct or clarify these announcements despite a marked increase in the price of, and volume of trading in, INI stock and inquiries by the Exchange as to the cause of such

[11] Under Section 6(d) of the Act, an exchange, in order to obtain registration, must have rules which are "adequate to insure fair dealing and to protect investors." Section 19(a)(1) of the Act authorizes us to suspend or withdraw the registration of an exchange which has failed to enforce, as far as is within its power, compliance with the provisions of the Act or the rules thereunder by an issuer of a security registered thereon.

increase.[12] And, as noted, further misleading statements were made in connection with the Central Foundry transaction. We cannot find unreasonable the Exchange's interpretation of its rules as requiring that the issuer take corrective action promptly after its non-compliance with the disclosure requirements, and not merely, as contended by INI, promptly after the Exchange has had to resort to a suspension of trading.

INI refers to evidence it presented at a hearing held before a committee of the Exchange in August 1969 which it claims showed that its press releases were issued in reliance on documents it believed to be accurate, including a proposed offering circular prepared by Prebuilt's attorneys. However, it seems clear, particularly in view of the extravagant nature of the claims being made for Prebuilt, a newly organized company, that a diligent investigation should have been made to ascertain the true facts before disseminating information to the public. The information in question was by its nature readily subject to verification. Moreover, instead of correcting the information released in April, further misleading information was disseminated by Prebuilt and by a vice-president of INI.[13]

It is not a basis for denying the application that, as asserted by INI, no question had been raised concerning press releases issued by it prior to those under consideration or that, despite the price rise, none of its officers and directors sold INI stock subsequent to April 11, when the first announcement concerning Prebuilt was made. Nor do we consider that the Exchange

[12] The Exchange states, and INI does not dispute, that during this period Exchange representatives contacted INI officials on a number of occasions to determine whether there were any developments which might account for the increased activity, but nothing was disclosed by INI suggesting that the announcements concerning Prebuilt may have been inaccurate or misleading. The Exchange further states that on June 4, 1969, INI's president and vice-president were cautioned by Exchange officials with respect to their responsibilities to insure fair and accurate disclosure in view of the optimistic projections and estimates being published about INI and Prebuilt.

[13] INI asserts that there is no evidence that any of the Prebuilt releases were distributed by persons authorized to do so by INI, that the statements attributed to the INI vice-president are based on hearsay and that the Exchange has not offered evidence as to whether he was actually interviewed by the securities analyst mentioned in the Wall Street Journal article of June 3 and, if so, whether he was accurately quoted. However, we agree with the Exchange that INI, having publicized the agreement to purchase a majority interest in Prebuilt, had a duty to assure the accuracy of material information thereafter disseminated by that company, which would necessarily affect the market for INI stock; at the least it had a duty to correct promptly any inaccuracies. INI has not denied that its vice-president made the statements attributed to him. INI points out that in the same Wall Street Journal article a statement is attributed to its president that "these estimates" (apparently referring to the earnings estimates for Prebuilt) were not coming from INI's management, or from him. But, according to the article, when asked how he could permit the management of a subsidiary to make earnings projections that might encourage invester activity, he responded that he was "not going to tell Prebuilt not to be enthusiastic. We're pleased with their enthusiasm,"; that it was a "remote possibility" that the projections could be met; and that the figures "should not be disseminated until we have a longer experience factor." Thus, the article demonstrates at the least an awareness in June 1969 by INI's management of the nature of the information being disseminated by Prebuilt.

was precluded from taking delisting action here because in other cases it has permitted trading to resume when, following a suspension of trading because of misrepresentation, corrective action had been taken. INI points in particular to action by the Exchange in December 1969 permitting the resumption of trading in a named security following clarification of certain public statements. However, no two cases are the same, and we think the Exchange must be accorded a reasonable discretion in determining the nature of the action which is appropriate in a particular case.[14]

INI further contends that the Exchange failed to accord it a full and fair hearing and thereby denied it due process. Its principal argument in this respect is that it was not provided with proper notice of the charges against it in advance of the hearing before the Exchange committee in August 1969 and was therefore unable to prepare a defense. The record before us shows, however, that INI had ample notice of such charges. Following the halt of trading on June 19, Exchange officials had numerous meetings with INI in which the company's noncompliance with disclosure requirements was explored. The essential facts subsequently recited in the delisting application were alleged in our injunctive complaint of July 11. INI's shareholder letter of July 18 referred to the information which had been disseminated by INI and Prebuilt and corrected and clarified such information. By letter of July 25, 1969, the Exchange advised INI that the question of continued listing of its stock was under consideration. The letter referred to the pertinent delisting policy and guidelines and to the dissemination by officers and directors of INI and Prebuilt of statements concerning Prebuilt's sales and orders and projected sales and earnings, INI's acquisition of an interest in Central Foundry and the possibility of its uniting with that company and Capital Bancshares, and *pro forma* figures for the three companies combined. It stated that in the absence of a satisfactory explanation for the misleading and inaccurate information disseminated, consideration had to be given to the question of continued listing and that INI would be given an opportunity for a hearing before the Committee on Securities before the matter was presented to the Board of Governors. At the hearing before the committee, representatives of INI, Prebuilt and other interested organizations made a presentation, following which the committee concluded, and the Ex-

[14] *Cf. Fotochrome, Inc.*, 43 S.E.C. 151 (1966), Securities Exchange Act Release No 8013 (December 29, 1966).

change's Board of Governors concurred, that delisting should be sought.

INI's other procedural arguments are equally without merit. There is no reason why INI should have been permitted to examine officials of the Exchange at the hearing. Its claim that the Exchange did not permit a transcript of the hearing to be made is denied by the Exchange which states that INI's counsel declined an offer by the Exchange to provide a reporter; in any event, INI has not shown that it was prejudiced by the absence of a transcript. There is also no basis for the contentions that the Exchange should have introduced evidence in support of its charges and that the committee which conducted the hearing and which is composed of members of the Board of Governors was not an impartial factfinder.

We conclude that it is appropriate to grant the Exchange's application. We are also of the view that no useful purpose would be served by the presentation of oral argument to us, as requested by INI.

Accordingly, IT IS ORDERED that the application of the American Stock Exchange to strike from listing and registration the common stock of Intercontinental Industries, Inc., be, and it hereby is, granted, effective at the opening of trading on April 7, 1970.

By the Commission (Chairman BUDGE and Commissioners OWENS, SMITH, NEEDHAM and HERLONG).

IN THE MATTER OF

EASTERN GAS AND FUEL ASSOCIATES

File No. 3-390. Promulgated April 13, 1970

Public Utility Holding Company Act of 1935—Section 10

MEMORANDUM OPINION AND ORDER

On November 3, 1967, we issued our Findings and Opinion and Order, which among other things approved, pursuant to the Public Utility Holding Company Act of 1935, a proposal by Eastern Gas and Fuel Associates, an exempt public utility holding company, to acquire additional shares of stock of Brockton Taunton Gas Company, a non-associate gas utility company, by means of a cash tender offer.[1] After we denied Brockton's petition for rehearing and reconsideration, Brockton filed a petition for review with the United States Court of Appeals for the First Circuit, which on June 28, 1968 affirmed our order.[2] Eastern states that it chose not to make a tender offer while reversal of that order was a possibility. Eastern further states that since September 26, 1968, the date as of which that possibility expired by failure of Brockton to apply to the United States Supreme Court for a writ of certiorari prior to that date, Eastern has made no tender offer for valid reasons, and it has moved that we extend the time within which it is authorized to make a tender offer to Brockton's shareholders. Brockton, on the other hand, has filed a motion for an order rescinding or vacating our order of November 3, 1967 and dismissing this proceeding on the ground that Eastern has failed to comply with the terms and conditions of Rule 24 incorporated in that order.[3] Briefs in support of and in opposition to these contrary motions have been filed by Eastern and Brockton, and our Division of Corporate Regulation has filed a reply opposing Eastern's motion.

[1] 43 S.E.C. 524

[2] *Brockton Taunton Gas Company* v. *S.E.C.*, 396 F.2d 717.

[3] Rule 24 under the Holding Company Act provides in part that an order granting an application under that Act shall be subject to the condition that absent other provisions the proposed transaction shall be carried out within sixty days.

The order approving Eastern's application specified among other conditions that Eastern's cash offer shall remain open for sixty days following its effective date. While the order did not fix a time period within which such offer must be made, it was clearly intended not to make applicable the provision in Rule 24 that the transaction proposed shall be carried out within sixty days after the application is granted. Nevertheless, it was not contemplated that the approval of a cash tender offer by Eastern should remain open for a period of more than two years without action by Eastern to implement such offer.

Eastern does not present a specific proposal as to when it will make a cash tender offer to Brockton shareholders. While it asserts that it still intends to make such a tender offer under certain circumstances, it states that in view of further acquisitions of Brockton shares since July 1968 by officers and directors of Brockton and their close associates there is clearly cause to be concerned whether a tender offer at this time would succeed in giving Eastern effective control of Brockton, and it admits that it is unlikely to commence the offer unless that situation can be changed. Eastern has urged, however, that we make an investigation of the methods by which the Brockton insiders have increased their holdings of Brockton stock and also as to whether the management group (Tenney Group) which controls Brockton and certain other utilities constitutes a holding company under the Act. Eastern believes that such an investigation would change the situation once it was commenced and ultimately bring about a fundamental change so as to make a tender offer practicable. It states that it may well decide to make an offer after such investigation has been commenced without awaiting its results. It argues that we should extend the time for commencing its proposed tender offer until June 30, 1970, and should grant further extensions if sought by it until the matter of the requested investigation is decided.

We find no warrant for keeping these proceedings open until some indefinite time in the future when Eastern may or may not decide to proceed with a tender offer. Eastern concedes that if and when it does undertake to go ahead with its tender offer, further hearings will be necessary with respect to the cash tender price and on any other areas in which the record made in these proceedings prior to November 1967 may appear to be stale.

Moreover, whether or not an investigation should be undertaken is a matter within our discretion. Even assuming it were to be undertaken, its possible effects on Eastern's efforts to acquire control of Brockton are conjectural and uncertain and cannot be accepted as a basis for what would of necessity be a further and undoubtedly lengthy delay in carrying out a proposal approved in November 1967. Such a result would be contrary to the policy of Rule 24, which contemplates, particularly in a situation such as this one, involving complex questions of fact based on forecasts and estimates, that the proposed action approved by us be consummated reasonably soon after the approval. While recognizing the factors in this case which have contributed to the delay, we conclude that an allowance of further time to consummate Eastern's proposed cash tender offer would be inconsistent with that policy and sound administration of the Act.

The motion by Eastern for additional time will be denied. We shall, however, reserve jurisdiction with respect to retention of the 16,101 Drockton shares acquired by Eastern from the Brocktaun Trust. The acquisition of such shares was approved in the context of, and on the assumption that there would be, a cash tender offer by Eastern to acquire sufficient additional shares of Brockton as would enable Eastern to control Brockton and operate it as a single system with Eastern's wholly-owned gas utility subsidiary, Boston Gas Company.

Accordingly, IT IS ORDERED that the proceedings with respect to the application for permission for Eastern Gas and Fuel Associates to acquire, pursuant to a cash tender offer, shares of stock of Brockton Taunton Gas Company, be, and they hereby are, terminated and the jurisdiction heretofore reserved with respect thereto be released, provided, however, that jurisdiction is reserved with respect to the acquisition by Eastern of 16,101 shares of Brockton stock from the Brocktaun Trust.

By the Commission (Chairman BUDGE, who appended a further statement, and Commissioners OWENS, SMITH, NEEDHAM and HERLONG).

Additional statement by Chairman BUDGE:

In joining in the foregoing opinion and action of the Commission, I do not depart from the views expressed in my dissenting opinion in connection with the prior decision in this case, (43 S.E.C. 524, 546–48).

In the Matters of

JAFFEE & COMPANY*

File No. 3–570. Promulgated April 20, 1970

Securities Exchange Act of 1934—Sections 15(b), 15A and 19(a)(3)

BROKER-DEALER PROCEEDINGS

Bids and purchases During Distribution

Failure to Deliver Prospectuses

Where registered broker-dealer through its trader purchased from underwriter, with a view to distribution, registered securities offered from time to time by selling stockholders, and trader on behalf of his firm (with knowledge of underwriter) and a selling stockholder who is controlling partner of another broker-dealer firm bid for and purchased such securities during distribution, in willful violation of anti-manipulation provisions of Rule 10b–6 under Section 10(b) of Securities Exchange Act of 1934, and where trader failed to have prospectuses sent to purchasers of registered securities in willful violation of Section 5(b)(2) of Securities Act of 1933, *held,* in public interest to suspend trader and partner from association with any broker-dealer, to suspend broker-dealer registration of firm controlled by partner, and to censure trader's firm and underwriter.

*Wilton L. Jaffee, Jr.; Greene & Company; Irving A Greene; Robert Topal; Bernard Horn; M. L. Lee & Co., Inc.; Martin L. Levy.

APPEARANCES:

Donald N. Malawsky, William H. Joseph, Gerald Gordon, Robert G. Willner, and *Michael Gettelman,* of the New York Regional Office of the Commission, for the Division of Trading and Markets.

Jerome J. Londin, of Carro, Spanbock & Londin, for Jaffee & Company and Wilton L. Jaffee, Jr.

Ira M. Millstein, Donald J. Williamson, and *Peter D. Standish,* of Weil, Gotshal & Manges, and *Melvin Katz,* for Greene & Company, Irving A. Greene, and Robert Topol.

Raphael P. Koenig, of Koenig and Ratner, for Bernard Horn.

Eric M. Javits, David A. Goldstein, William J. Quinlan, and *John C. Moore III,* of Javits & Javits, for M. L. Lee & Co., Inc.

FINDINGS AND OPINION OF THE COMMISSION

Following hearings in these private proceedings pursuant to Sections 15(b), 15A and 19(a)(3) of the Securities Exchange Act of 1934 ("Exchange Act"), the hearing examiner filed an initial decision in which he concluded, among other things, that the broker-dealer registrations of Greene & Company ("G Co.") and M. L. Lee & Co., Inc. ("Lee") should be suspended for five days, and that Wilton L. Jaffee, Jr., the principal partner in Jaffee & Company ("J Co."), a registered broker-dealer, should be suspended from association with a broker or dealer for 30 days, Irving A. Greene and Robert Topol, the partners of G Co., for 10 days, and Bernard Horn, who was a trader for G Co., for 20 days. The examiner further concluded that following Horn's suspension he should be restricted to employment in a non-supervisory capacity upon a showing of adequate supervision, and that the proceedings with respect to J Co. should be dismissed.[1] We granted petitions for review filed by all respondents except J Co. and by our Division of Trading and Markets ("Division"), and we ordered review of the examiner's decision with respect to all issues which were before him concerning respondents. Briefs were filed by respondents[2] and the Division and we heard oral argument.[3] Our findings are based upon an independent review of the record.

BIDS AND PURCHASES DURING DISTRIBUTION

The order for proceedings charges that, between June 1963 and March 1964, respondents willfully violated the anti-manipulation provisions of Rule 10b–6 under Section 10(b) of the Exchange Act in connection with a registered secondary offering of stock of Solitron Devices, Inc. ("Solitron"). Lee was properly appointed the "exclusive agent" for the offering,[4] effective October 11, 1962, of 107,700 shares of Solitron stock, representing about 28 percent of the shares outstanding, on behalf of 34 selling shareholders. Included among these share-

[1] The examiner also dismissed the proceedings with respect to Lee's president, Martin L. Levy, who died following the close of the hearings, and we shall enter an order of dismissal with respect to him. Levy is not included in the term "respondents" as used hereafter.

[2] In accordance with a specific request by Lee, we have also considered its proposed findings and brief filed with the hearing examiner.

[3] The request of various respondents and the Division to make certain corrections in the transcript of the oral argument are granted.

[4] See *Hazel Bishop, Inc.*, 40 S.E.C. 718 (1961).

holders were Jaffee, who registered 27,500 shares (the largest block involved), and an officer, a director, and the wives of other officers of Solitron. The shares were to be offered for sale by the individual sellers from time to time "in the proximate future" at the prevailing market price as reflected in the over-the-counter market. The prospectus stated that the selling shareholders had advised Solitron that they intended to offer their respective holdings for sale but that there was no assurance that any of such sellers would sell any or all of the shares owned by them. Solitron obtained agreements from Lee and the selling stockholders that they would "comply with the provisions of Rule 10b–6." By May 15, 1963, shortly before the period at issue here, 16,300 shares of Solitron had been sold. By the end of March 1964, Lee on behalf of the selling stockholders had sold a total of 75,100 shares, including a block of 3,500 of Jaffee's shares sold in October 1963.

Rule 10b–6 provides, in pertinent part, that it is a manipulative or deceptive device for any person who is an underwriter in a particular distribution of securities, or one on whose behalf such a distribution is being made, or a broker–dealer or other person who has agreed to participate or is participating in such distribution, to bid for or purchase such securities until he has completed his participation in the distribution.

During the relevant period, G Co., which engages mainly in trading securities for its own account, purchased as principal through Horn over 25,000 shares of registered Solitron stock from Lee for resale. With every such purchase of stock and until such shares were resold, G Co., which received copies of the Solitron prospectus from Lee and thus was aware that a distribution of registered Solitron stock was in progress, became a participant in the distribution and subject to the prohibitions in Rule 10b–6.[5] Nevertheless, while participating in that distribution, G Co., through Horn, not only continuously inserted bids in the quotation sheets published by the National Quotation Bureau, Inc., but also effected purchases for its own account of Solitron stock that was not a part of the offering. Horn had also received a copy of the Solitron prospectus from Lee. Thereafter, before making purchases of Solitron

[5] Although G Co. does not meet the definition of "underwriter" in Rule 10b-6(c) (1)—which is narrower than that in Section 2(11) of the Securities Act— the prohibitions of the Rule are applicable to any "person who . . . is participating" in a particular distribution "directly or indirectly" (10b-6(a) (3)). A distribution of securities comprises "the entire process by which in the course of a public offering a block of securities is dispersed and ultimately comes to rest in the hands of the investing public." *Oklahoma-Texas Trust*, 2 S.E.C. 764, 769 (1937), *aff'd* 100 F.2d 888 (C.A. 10, 1939). See also Shearson, Hammill & Co., 42 S.E.C. 811, 819 (1965).

stock from that firm, he should have inquired into the status of the offering so as to determine whether to discontinue bids for the stock and purchases of stock not a part of the offering. Lee's president testified that he examined the sheets every day and knew that G Co. was entering bids as well as offers for Solitron stock throughout the relevant period. Yet Lee continued to sell registered Solitron stock to G Co., and therefore, contrary to the examiner's finding, knew or should have known that G Co. was participating in the distribution. By such sales Lee aided and abetted G Co.'s violations of Rule 10b–6.

Jaffee, although he was one of the selling stockholders under the registration statement, made purchases of Solitron stock for his own account during the relevant period, and admitted that prior to that period but during the course of the Solitron offering he had asked Horn to "go into" the sheets. Thereafter, Horn as indicated above entered bids for the stock.[6]

Jaffee and Lee state that the Solitron registration constituted a "shelf registration" or "delayed offering" and argue that such an offering does not constitute a distribution within the meaning of Rule 10b–6. Jaffee further contends that the one sale of only 3,500 shares of registered Solitron stock on his behalf during the relevant period was not a distribution. G Co. and Horn claim that they simply engaged in normal trading activities, and Jaffee, G Co., and Lee assert that the record shows none of the usual indicia of a manipulation nor any manipulative intent on their part.

There is no merit in these contentions. An offering of stock pursuant to a registration statement by its very nature constitutes a distribution within the meaning of Rule 10b–6.[7] For purposes of the Rule, such distribution must here be deemed to have commenced at least upon commencement of the offering by the exclusive agent following the effective date of the registration statement. Jaffee, having agreed to participate in

[6] The only evidence of Jaffee's arrangement with Horn is contained in a transcript of Jaffee's prior investigative testimony portions of which were received in evidence only against Jaffee and therefore cannot be used against Horn.

[7] See Whitney, *Rule 10b–6: The Special Study's Rediscovered Rule*, 62 Mich. L. Rev. 567, 575 (1964): "There is no question that a 'distribution' [within the meaning of Rule 10b-6] is contemplated in an underwritten offering to the public of previously unregistered securities pursuant to registration under the 1933 Act . . .". The test used in *Bruns, Nordeman & Company* (40 S.E.C. 652, 660 (1961)) in finding there was a "distribution" under the Rule of securities which were neither registered nor subject to registration (*i.e.*, the magnitude of the offering and selling effort), merely extended the application of that term. See *Comment, The SEC's Rule 10b–6: Preserving A Competitive Market During Distributions*, 1967 Duke L. J. 809, 820. in *J. H. Goddard & Co., Inc.*, 42 S.E.C. 638, 640 (1965), we found sales by an underwriter of control shares subject to registration under the Securities Act to be a Rule 10b–6 distribution without regard to the *Bruns, Nordeman* test, whereas we applied that test to sales of blocks of stock which were neither registered nor subject to registration.

such an offering, became a participant in the distribution irrespective of any sales of his own registered shares, and his participation continued for so long as any of such shares remained unsold or until they were withdrawn from registration. Otherwise, the Rule's prophylactic purpose could be circumvented since each selling stockholder in turn could refrain from selling his shares for a certain period while engaging in buying and bidding activities serving to raise the price of the stock, and thereby benefit the other selling stockholders as well as himself when sales were effected at the higher price. Similarly, the Rule could be circumvented by Lee were it permitted, merely if it refrained from making bids or purchases, to sell the stock to other broker-dealers engaged in such activities. Whatever the type of offering involved in this case may be called—a time-to-time offering, or a shelf registration or delayed offering—it is clear that Rule 10b–6 is applicable.[8] The fact that the shareholders could control the timing of their sales in no way obviated the need for the protections of the Rule or gave rise to any exemption from it. G Co. and Horn should have been aware that their purchases for resale of stock that they knew was part of a registered offering did not constitute normal trading activity. Persons, like G Co., engaging in market-making activities in a security which at the same time is being offered in a registered distribution must not participate in such distribution unless they have terminated their bidding and purchasing in the open market as provided in Rule 10b–6. Finally, Rule 10b–6 defines certain conduct as manipulative *per se;* no further showing of manipulative practices or manipulative intent is required in order to establish violations of the Rule.[9]

Lee asserts that it had the right to assume that G Co. was buying registered Solitron stock for investment purposes and thus not participating in a distribution. Jaffee, Lee, and G Co. argue that they did not employ the mails or interstate facilities required for finding violations by them during the relevant period, and Jaffee and Lee assert that any violations by them were not willful. We disagree. Lee had no basis for assuming that a dealer who was placing offers for Solitron stock in the sheets every day was buying the stock for investment. G Co.'s insertion of bids in the sheets, which are dissemi-

[8] See *Hazel Bishop, Inc., supra,* 40 S.E.C. at 735–6; *Lum's Inc.,* 43 S.E.C. 223, 230 (1966); Securities Act Release No. 4936, pp. 5–6 (December 9, 1968).

[9] See *Lum's, Inc., supra.* Respondents' reliance upon cases involving manipulative practices in addition to those found herein is misplaced. The manipulation violations at issue in those cases were based on antifraud provisions including Rule 10b–5, or both Rules 10b–5 and 10b–6.

nated in interstate commerce, is a sufficient jurisdictional basis to support the findings against it and against Jaffee who arranged for such insertion.[10] Lee mailed confirmations of Solitron purchases and prospectuses to G Co., and in addition there were telephone conversations relating to Solitron between the two firms.[11] It is well established that a finding of willfulness under Section 15(b) of the Exchange Act does not require an intent to violate the law; it is sufficient that the person charged with the duty knows what he is doing.[12] Moreover, Jaffee and Lee were on notice of the applicability of Rule 10b–6 as shown by their agreements with Solitron in which they undertook to abide by the provisions of that Rule.

We conclude that G Co., which, as has been noted, knew that it was purchasing and selling shares that were part of a registered offering, willfully aided and abetted by Horn and Lee, and Jaffee willfully violated Section 10(b) of the Exchange Act and Rule 10b–6 thereunder.[12a]

With respect to J Co., it was not in existence during the relevant period and, as a basis for findings against it, the order for proceedings was amended to add charges of violations by its predecessor firm, Jaffee and Leverton ("J&L"). In view of our disposition of these proceedings with regard to J Co., as set forth below, we deem it unnecessary to determine on the record before us whether J&L, as a result of its transactions in registered Solitron stock, became a participant in the distribution and violated Rule 10b–6, and whether J Co. would be chargeable with any such violation.

As to Greene and Topol, there is no evidence that they were or should have been aware of the registered offering of Solitron stock. Accordingly, we find no violations of Rule 10b–6 by

[10] See *F. S. Johns & Company, Inc.*, 43 S.E.C. 124, 138n.–16 (1966), *aff'd sub nom. Dlugash* v. *S.E.C.*, 373 F.2d 107 (C.A. 2, 1967) and *Winkler* v. *S.E.C.*, 377 F.2d 517 (C.A. 2, 1967).

[11] See *Myzel* v. *Fields*, 386 F.2d 718, 727–8 (C.A. 8, 1967), *cert. denied* 390 U.S. 951.

[12] *Gearhart & Otis, Inc.* v. *S.E.C.*, 348 F.2d 798, 802–3 (C.A. D.C. 1965); *Tager* v. *S.E.C.*, 344 F.2d 5, 8 (C.A. 2, 1965). See also *Dlugash* v. *S.E.C.*, 373 F.2d 107, 109 (C.A. 2, 1967), which held that where the circumstances were such as to put respondents on notice that "something was wrong. . . . they were under a duty to investigate, and their violation of that duty brings them within the term 'willful' in the Exchange Act."

[12a] We cannot agree with the suggestion in the dissent to this portion of our opinion that to hold G Co. in violation of Rule 10b–6 could result "in a form of discrimination" as between the market maker in the over-the-counter market and the specialist registered with an exchange. A specialist, no less than an over-the-counter market maker, is subject to the prohibitions of the Rule if he is a participant in a distribution other than one covered by a plan filed by the exchange as provided under Rule 10b–6*(a)* (10). It is not material to consider whether or not a question would arise in the situation posed by the dissent of a purchase by the specialist of a very small number of shares subject to registration. His obligation, as a specialist, is to maintain a "fair and orderly market" in the particular security, and dealings for his own account are restricted so far as practical to those reasonably necessary to permit him to maintain such market. (Section 11(b) of the Exchange Act; see *Re, Re & Sagarese*, 41 S.E.C. 230, 231 (1962)). A market maker such as G Co. is not under the same obligation to maintain a market, and, in any event, the number of shares purchased by G Co., as previously noted, was substantial.

them, and they were not charged with a failure to supervise Horn with a view to preventing such violations.

FAILURE TO DELIVER PROSPECTUSES

Section 5(b)(2) of the Securities Act of 1933 makes it unlawful to cause to be carried through the mails or in interstate commerce any security, with respect to which a registration statement has been filed, "for the purpose of sale or for delivery after sale" unless accompanied or preceded by a prospectus. We find that, during September and October 1963, G Co. and Horn willfully violated that Section.

The record shows that during that two-month period G Co. caused its clearing agent to deliver 6,100 shares of registered Solitron stock through the mails to 18 broker-dealers but sent no prospectus to them. Horn was the only trader dealing in the stock at G Co. at that time. Contrary to the examiner's finding, it was Horn's responsibility, under the firm's system then in effect, to make a notation on the order ticket when he sold registered stock which would alert the back office to send a prospectus in connection with delivery of the shares. No such notation was made on any of G Co.'s Solitron order tickets, nor does any appear on sale confirmations, as would have been the case if any prospectuses had been sent to customers who purchased registered Solitron stock. In fact, the back office at G Co. received no special instructions concerning transactions in Solitron.

Since there is no evidence that Greene or Topol knew or should have known of Horn's failure to carry out his responsibility to see that prospectuses were delivered, we find no violations by them of Section 5(b)(2), and they are not charged with any failure of supervision. Nor does the record support findings of violations of that Section by Jaffee. For the reason previously indicated, we do not reach the question of J&L's liability in this respect.

G Co. argues that it was not acting as an underwriter with respect to Solitron stock and therefore, under Section 4(1) of the Securities Act, the prospectus-delivery requirements were not applicable to it;[13] that the Division had the burden of proving that the broker-dealers to whom G Co. sold registered shares had not already obtained a prospectus from some other source; that, in fact, these broker-dealers had previously purchased stock from Lee which sent a prospectus to every

[13] Section 4(1) provides that the registration and prospectus requirements of Section 5 shall not apply to transaction by any person other than an issuer, underwriter or dealer.

purchaser and, in any event, were sophisticated dealers who did not need the information in the prospectus; that a negative inference must be drawn from the staff's failure to call G Co.'s cashier instead of its assistant cashier as a witness because the latter "was not in a position to have knowledge of the facts at issue"; and that any violations by it were not willful.

We reject these contentions. It has been judicially established that the Section 4(1) exemption does "not in terms or by fair implication" protect those who, like G Co., "are engaged in steps necessary to the distribution of security issues".[14] G Co., as principal, purchased shares of registered Solitron stock from Lee and resold those shares to other broker-dealers. These purchases made G Co. a participant in the distribution and brought it within the definition of "underwriter" in Section 2(11) of the Securities Act.[15] G Co. does not fall within the exception from the definition of "underwriter" in Section 2(11) for persons whose interest is limited to receipt, from an underwriter or dealer, of usual and customary distributors' or sellers' commissions. It has not shown, in accordance with Rule 141 under the Securities Act, that its "commission" or margin of profit on resales was not in excess of the spread that is usual and customary in such transactions. Since G Co. was an "underwriter" within the meaning of Section 2(11), its transactions in Solitron securities were not exempted from Section 5 of the Act by Section 4(1), which is limited to a person other than an issuer, underwriter or dealer, or by Section 4(3), which is limited to a dealer "no longer acting as an underwriter."[16]

The record does not show that any of the broker-dealer customers who did not receive a prospectus from G Co. had previously purchased registered Solitron stock from Lee or received a prospectus from Lee or any other source. It was G Co.'s burden, not the staff's, to prove that a particular purchaser had already obtained a prospectus elsewhere.[17] The fact that the purchasers may have been "sophisticated" broker-dealers did not relieve G Co. of its statutory obligation.[18] While

[14] *S.E.C.* v. *Chinese Consolidated Benevolent Association*, 120 F.2d 738, 741 (C.A. 2, 1941), cert. denied 314 U.S. 618. See *S.E.C.* v. *Guild Films Company, Inc.*, 279 F.2d 485, 489 (C.A. 2, 1960); *Sutro Bros & Co.*, 41 S.E.C. 470, 477–78 (1963). See also *S.E.C.* v. *Culpepper*, 270 F.2d 241, 246–47 (C.A. 2, 1959), which held that a broker-dealer who purchased, for resale to the public, unregistered shares from other brokers who had acquired such shares from a control group of the issuer, was not entitled to a Section 4(1) exemption since he has "engaged in steps necessary to the consummation of the public distribution."

[15] *S.E.C.* v. *Culpepper*, *supra*, at p. 247.

[16] Even if we view G Co. as having acted solely as a dealer, the exemption provided in Section 4(3) would not be available for its transactions. The registered securities sold by Lee to G Co. were in the nature of "an unsold allotment to or subscription by [a] dealer as a participant in the distribution of such securities . . . by or through an underwriter" within the meaning of Section 4(3) (C).

[17] 1 *Loss, Securities Regulation* 250 (2d ed. 1961).

[18] *Cf. Pennaluna & Company, Inc.*, 43 S.E.C. 298, 307 (1967), and cases there cited.

the then assistant cashier, who is presently the cashier of G Co., testified that he was not familiar at the time with "all aspects of the trading activity being conducted", he had been employed by G Co. in "different phases" of its back office work since 1955 and had served as its assistant cashier since about 1960. Under the circumstances, we consider that he was fully competent to testify with respect to the matters concerning which he was questioned, and, since G Co. was free to call its former cashier as a witness if it considered his testimony superior, there is no basis for assuming that the former cashier would have testified to any different effect. Moreover, G Co. concedes that the "system in effect" required that trading slips be marked "prospectus enclosed" by each trader "to assure that the back office would send out prospectuses". Finally, G Co. and Horn caused registered Solitron stock to be sent through the mails for delivery after sale without sending customers prospectuses, and accordingly, on the basis of our discussion of willfulness in the context of Rule 10b–6, their violations of Section 5(b)(2) of the Securities Act were willful.

OTHER MATTERS

Jaffee attacks various rulings of the examiner. During cross-examination of a staff investigator who had prepared various charts showing trading in Solitron stock,[19] the examiner denied Jaffee's request for production of reports of staff interviews with and statements obtained from customers of J&L whose names appeared on such charts as purchasers of Solitron stock. Neither the Jencks Act[20] nor the case of *Brady* v. *Maryland*[21] cited by Jaffee entitled him to obtain the confidential investigative material sought. The Jencks Act, which in substance is incorporated into our Rules of Practice,[22] provides that prior statements of Government witnesses shall not be the subject of inspection until such witnesses have testified on direct examination, and is obviously inapplicable to Jaffee's request. The *Brady* case held that suppression by the prosecution of material evidence favorable to an accused who has requested it is a denial of due process. It does not authorize a

[19] Jaffee, G Co. and Lee object to the admission of these charts into evidence, and Jaffee, to the admission of a notebook kept by Lee detailing its sales of Solitron stock. Since none of our findings is based on these documents, we deem it unnecessary to consider those objections.

[20] 18 U.S.C. 3500 (1957).

[21] 373 U.S. 83 (1963).

[22] See Rule 11.1

"fishing expedition" into investigative material.[23] In any event, we have made no findings with respect to sales of Solitron stock by J&L.

There is similarly no basis for Jaffee's claim of prejudice resulting from his inability to inspect certain confidential Commission files relating to the Solitron registration statement. At the hearings, the attorney who prepared that statement was called as a witness by Lee and testified to various discussions with our staff concerning the mechanics of the offering. Apparently in an effort to satisfy the examiner's doubts concerning this witness' credibility, Lee requested that the staff produce "anything" in the Commission's Solitron files "reflecting on these conversations that the witness has testified about." Not only did Jaffee fail to join in Lee's request, which the examiner denied, but he has made no showing of the relevance of the evidence sought nor of any adverse effect upon him resulting from its absence.

PUBLIC INTEREST

Jaffee, Horn, and Lee argue that the public interest does not require the imposition of any sanctions upon them, and G Co. contends that any sanction other than censure would be unwarranted.[24]

Jaffee asserts, among other things, that his record is otherwise good, that he cooperated with our staff, and that his violations, if any, were technical in nature. We do not consider that Jaffee's violations of Rule 10b–6 were merely technical. Bids and purchases in the course of a distribution at market price have a manipulative effect on such price to the detriment of investors. We conclude that under all the circumstances it is appropriate in the public interest to suspend Jaffee from association with a broker or dealer for 20 days.

Horn asserts that his only function was as a trader. However, Horn was responsible for all of the violations which occurred at G Co. In view of his violations of Rule 10b–6, as well as of Section 5(b) (2) of which he was exonerated by the examiner, we conclude that the public interest requires that he be suspended for 30 days.

G Co. no longer employs Horn, and its partners, with respect to whom we have found no violations, point to lengthy unblemished records in the securities business. Lee asserts, among

[23] See *Harris Clare & Co. Inc.*, 43 S.E.C. 198, 201 (1966).

[24] Since we have found no violations on the part of Greene or Topol, the proceedings will be dismissed as to them.

other things, that no purchaser suffered a market loss. It points to the recent death of its president and 95 percent stockholder, who was in active control of its business during the relevant period, and states that it is presently in the process of liquidation.[25] Under these circumstances, we conclude that censure of the two firms will adequately serve the public interest.

With respect to J Co., a sanction may be imposed upon it pursuant to Section 15(b) (5) of the Exchange Act upon the basis of willful violations committed by an associated person, including a partner or controlling person, prior to becoming so associated if in the public interest.[26] The record shows that at the time these proceedings were instituted and during the hearings, Jaffee's partnership interest in J Co., which has two partners, exceeded 90 percent. The hearing examiner dismissed the proceedings against J Co. on the ground that the order for proceedings was not notice to that firm that Jaffee's association with it provided a basis for a sanction.

In our opinion, however, the order for proceedings constituted sufficient notice to J Co. that it would be subject to a sanction if findings of violations were made against Jaffee. J Co. was named a respondent and was served with a copy of that order. The order alleged violations of the securities acts by Jaffee, identified him as a partner of J Co., and recited that "in view of the allegations made . . ., the Commission deems it necessary that private proceedings be instituted to determine . . . what, if any, remedial action is appropriate in the public interest pursuant to Section 15(b) . . . of the Exchange Act." Accordingly, we reverse the examiner's order dismissing the proceedings against J Co.[27] And since Jaffee is the controlling partner of J Co., we conclude that the firm's broker-dealer registration should be suspended for 20 days, the same period as Jaffee's suspension.[28]

J Co., Jaffee, G Co., and Horn have filed motions requesting further oral argument before us and stays of any sanctions imposed pending determination of petitions for review to be filed by them in the Court of Appeals.[29] The Division filed a

[25] Dissolution of the respondent broken-dealer firm is no bar to the imposition of a sanction in the public interest. See *W.T. Anderson Company, Inc.*, 39 S.E.C. 630, 633 (1960).

[26] See *Richard N. Cea*, 44 S.E.C. (1969), and cases there cited. *Cf. Securities National Corporation*, 35 S.E.C. 163 (1953).

[27] See *Advanced Research Associates, Inc.* 41 S.E.C. 579, 613, n. 77 (1963).

[28] The exceptions to the initial decision of the hearing examiner are overruled or sustained to the extent they are inconsistent or in accord with our decision.

[29] Greene and Topol also joined in the motions, but since the proceedings will be dismissed as to them, their requests are moot.

memorandum in opposition. No basis for further oral arguement has been shown, and that request is denied. With respect to the request for stays, the specified effective date of the sanctions in our order will provide movants with time to file petitions for review before the sanctions go into effect. The sanction with respect to any respondent who files such a petition prior to the effective date shall be stayed pending final determination of the petition.

An appropriate order will issue.

By the Commission (Chairman BUDGE and Commissioner OWENS), Commissioner SMITH concurring in part and dissenting in part, and Commissioners NEEDHAM and HERLONG not participating.

Commissioner SMITH, concurring in part and dissenting in part:

I concur with the majority in all aspects of the case except its findings of violations of Rule 10b–6 by G Co., its trader Horn, and Lee. I do not believe the test used, that the registration of an offering *per se* makes that Rule applicable, comports with the intended coverage of the Rule, and, using a stricter test, I do not believe the evidence supports findings of violations. Consequently, I would reduce the sanction against Horn to censure and would dismiss as to Lee.

The majority reasons first that G Co. was an "underwriter" in a "distribution" within the meaning of those terms in Section 2(11) of the 1933 Act and thereby is required by Section 5 of that Act to deliver prospectuses. With that reasoning I agree. From that the majority deduces that a "particular distribution" was also occurring and G Co. was, if not an "underwriter," at least "participating" in that distribution within the meaning of those terms as used in Rule 10b–6 under the 1934 Act, thereby prohibiting any bids or purchases by G Co. in the course of market-making. While the symmetry is appealing, I do not think the result necessarily follows. I cannot agree with the majority's premise that a public offering of securities requiring registration under the 1933 Act "by its very nature" constitutes a distribution for purposes of Rule 10b–6 under the 1934 Act.[1] Nor can I agree with the asserted

[1] The majority cites former Commissioner Whitney's excellent article for this proposition, Whitney, *Rule 10b–6: The Special Study's Rediscovered Rule*, 62 Mich. L. Rev. 567, 573 (1964). I do not read the article to say that. The sentence quoted by the majority appears to me to contemplate the usual "underwritten offering" through a syndicate of securities firms, at which the group of 10b–6, 10b–7 and 10–8 rules simultaneously adopted in 1955 were mainly aimed. See Foshay, *Market Activities of*

consequence, that a person who is a statutory underwriter for purposes of the 1933 Act is automatically a participant in a distribution subject to Rule 10b–6. The term "distribution" is defined in neither the 1933 Act nor the 1934 Act, and its meaning and applicability to particular persons in each context should be strictly derived from the differing purposes for which it is used.

The purpose of the 1933 Act is to provide adequate disclosure about the issuer and the offering to the ultimate purchaser, and so one participating in the distribution of the new issue is required to see to it that a prospectus reaches the ultimate purchaser. With that purpose in mind, it behooves us to bring within the distribution process someone purchasing for resale who is in a position to effectuate prospectus deliveries (such as a professional like G Co.) and who cannot avail himself of any of the specific statutory exemptions. This we did.

On the other hand, the purpose of Section 10(b) of the 1934 Act is to prevent manipulation in the trading markets. Here we are called on by Rule 10b–6 to keep someone who chooses to be on the sell side of the market out of the market on the buy side where the particular distribution by that person is of such a nature as to raise a sufficient temptation to manipulate (because the financial rewards are high enough) to cause a threat to the integrity of the market processes. Thus, selling shareholders—such as Jaffee—are prohibitied by Rule 10b–6 from buying when they are selling or poised to sell, and Lee, the exclusive agent for the selling shareholders, is similarly prohibited. Jaffee, who purchased with shares unsold, violated 10b–6 [2] and in my view Lee, who made no purchases, did not. G Co., a market-maker, and Horn, its trader, stand on a different footing.

It is not difficult to conceive that in certain situations where 1933 Act registration serves a purpose, to apply Rule 10b–6 would serve no purpose because the dangers of manipulation at which the Rule is aimed do not exist.[3] For example, if an

Participants in Securities Distributions, 45 Univ. of Va. L. Rev. 407 (1959). In his article Mr. Whitney said (footnote 3), "the prudent 'rule of thumb' assumes that a registered 1933 Act 'distribution' normally will be subject to Rule 10b–6." That phrasing is a long way from a *per se* application. Moreover, when he defines distribution for 10b–6 purposes, he does so (footnotes 31 and 37) in terms of the *Bruns, Nordeman* test I describe below, and indicates (footnotes 3 and 26) that the term is used for different purposes in the two statutes so that interpretations of one do not necessarily control the other.

[2] It is material to me in finding violation of Rule 10b–6 by Jaffee that he held unsold registered shares when he purchased in the market and had taken no steps to deregister or otherwise disassociate himself from the selling group.

[3] There are, of course, situations where the converse is true: distributions that do not require registration under the 1933 Act but should be subject to Rule 10b–6 or comparable antimanipulative requirements, e.g. "unregistered secondaries" or sales of substantial blocks acquired privately and held for the requisite investment periods. See Whitney, *supra* note 1 at 579 and 581.

individual acquires a small number of shares, say 200, directly from a listed issuer in an actively traded stock and promptly sells them on the floor of the exchange, it is clear he would be a statutory underwriter for purposes of Section 2(11) of the Securities Act of 1933, and Section 5 would require him to register those shares. However, there would be no warrant in applying the prohibitions of Rule 10b–6 to a specialist who purchases those shares in the course of his functioning as a specialist, even though he obviously purchases them for resale. Sales of these shares would be simply normal trading transactions to which, I submit, Rule 10b–6 is not intended to apply. The specialist would not be required to exert any special efforts to sell these shares, since the amount involved does not approach a quantity the market is unable to absorb through normal action and no countervailing sales effort is therefore needed to stimulate demand. Rule 10b–6 has never been applied to this situation, probably because it is recognized that to require the specialist to give up the book and withdraw his bid until he sold out his position in the registered stock would unduly and unnecessarily disrupt the operation of the exchange market. Yet Rule 153 under the 1933 Act recognizes the applicability of the prospectus delivery requirement for such exchange transactions.

Unnecessary disruption of trading markets is as undesirable over-the-counter as on the exchanges. Nevertheless, the majority here would *per se* require any market-maker who buys shares covered by a registration statement to withdraw from the sheets. Such an automatic application of 10b–6 to a market-maker who is independent of the seller can result in a form of discrimination between the over-the-counter and exchange markets. There has not been persuasive demonstration in this case that the market-maker participated in the kind of activity which would raise the spectre of manipulative dangers at which Rule 10b–6 is aimed.

The Commission has had occasion to determine the circumstances which constitute a distribution for purposes of 10b–6 in several prior cases. In *Gob Shopes*[4] the Commission, while not finding a Rule 10b–6 violation, indicated that a distribution for 10b–6 purposes hinges on the presence of a major selling effort by the broker-dealer. Later, in *Bruns, Nordeman*,[5] a case based on the same facts as *Gob Shops*, the Commission found a Rule

[4] 39 S.E.C. 92, 103 at fn. 25 (1959).

[5] 40 S.E.C. 652, (1961).

10b–6 violation by the broker-dealer and enunciated the test which must be met to reach that conclusion:

> "Rule 10b–6 is applicable to all distributions whether or not subject to registration under the Securities Act and whether or not the conventional procedure of utilizing an underwriter or selling group is employed. The term 'distribution' as used in Rule 10b–6 is to be interpreted in the light of the rule'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. For these purposes a distribution is to be distinguished from ordinary trading transactions and other normal conduct of a securities business upon the basis of the magnitude of the offering and particularly upon the basis of the selling efforts and selling methods utilized." [6]

In subsequent cases the Commission reaffirmed its position that a concerted selling effort of an unusually large amount of securities constitutes the hallmark of a distribution for 10b–6 purposes.[7] None of the cases cited by the majority, save possibly one, reflects a departure from the *Bruns, Nordeman* test.

In *Hazel Bishop*,[8] for instance, the Commission issued a stop order for false and misleading statements in a pending registration statement covering a large secondary distribution at the market. The Commission there warned that any broker or person "acting for" any selling stockholder would be subject to the provisions of Rule 10b–6. There is no indication in *Hazel Bishop* that mere awareness or knowledge of a 1933 Act distribution, without more, is sufficient to make a market-maker purchasing and selling that stock for his own account a participant violating Rule 10b–6. There is no proof in this case that Horn or G Co. was "acting for" Lee or any of the selling stockholders.

In *Lum's*[9] the issue before the Commission was whether or not a temporary suspension of the Regulation A exemption from 1933 Act registration should be made permanent. The Regulation A offering included shares which a broker-dealer (Aetna, which was also a market-maker in Lum's stock) had acquired privately and certain shares owned by two principal officers of the company. After it had sold all its shares as principal, Aetna reentered the sheets with bid and asked quotations, while selling stock for and purchasing from the two

[6] *Id.*, at 660.

[7] See *Sutro Bros. & Co.*, 41 S.E.C. 470 (1963); *Batten & Co., Inc.*, 41 S.E.C. 538 (1963); *A.T. Brod & Co.*, 41 S.E.C. 643 (1963); *Woods & Company, Inc.*, 41 S.E.C. 725 (1963).

[8] 40 S.E.C. 718, 736 (1961).

[9] 43 S.E.C. 223 (1966).

officers, first as agent and later as principal. Aetna distributed all the selling stockholders' shares; 82 percent of the total shares it purchased during the relevant period were from the selling stockholders. The Commission determined in that case, correctly I believe, that Aetna was participating in a distribution for or on behalf of the two officers and Rule 10b–6 was applicable to its market activities. In the instant case, however, there is insufficient proof that G Co. was intimately involved with the selling stockholders or their exclusive agent, or was in any way acting for them, or was behaving other than as an independent market-maker.

The decision of the Commission in *Goddard*[10] need not compel a different result. In that case the broker-dealer/maker dominated and controlled the market in the unregistered stock being distributed, and its market activities in that stock would not be found to be ordinary trading transactions. The Commission pinpointed two particular such distributions of control stock to which it said Rule 10b–6 was applicable, as well as two particular distributions of non-control stock specifically meeting the *Bruns, Nordeman* test. The cases relied upon[11] to support the statement in *Goddard* that public sales of control stock subject to 1933 Act registration fall within the meaning of the term "distribution" in Rule 10b–6, all involved aggressive sales effort, as in *Goddard,* to induce purchases of the respective securities. There is no evidence that G Co. engaged in that type of conduct in this case.[12]

Having discussed policy and precedent, I turn to proof in this case. A review of G Co.'s trading activities over the whole of the relevant period, from June 1963 to March 1964, does not reveal anything unusual. It purchased a total of 25,610 shares from Lee, less than 24 percent of the total shares registered. Its purchases were from time to time and not in large units disproportionate to the units it sold in trading. Its total purchases from Lee amounted to only about 26 percent of its

[10] 42 S.E.C. 638 (1965).

[11] Cases cited in note 7 *supra.*

[12] The majority also cited, mistakenly I believe, *Oklahoma-Texas Trust,* 2 S.E.C. 764 (1937), and *Shearson, Hammill & Co.,* 42 S.E.C. 811 (1965), as authority for finding G Co. and Horn participants in a distribution for purposes of Rule 10b–6 (majority opinion at footnote 5). The portions of the decisions cited relate only to determinations that a 1933 Act public offering had not ceased, one for the purpose of deciding whether a stop order should issue, the other for the purpose of deciding whether the Regulation A $300,000 limitation had been exceeded. Application of Section 10(b) of the 1934 Act was not involved in any way in *Oklahoma-Texas.* It is true that in another portion of the *Shearson, Hammill* decision, a Rule 10b–6 violation was found. It was determined in that case, however, that partners and employees of the broker-dealer made extensive solitations of subscribers for the issue and purchased and resold shares of the issue as individuals, all at the time the firm was entering bids in the sheets and was the principal market-maker.

total purchases from all sources. G Co. was neither high nor even tied for high on over 65 percent of the days it submitted bids in the sheets. A total of 25 other firms were in the sheets, at least two for more than one-half the total trading days. G Co.'s largest long position was only 1,239 shares, while its largest short position totalled 6,632 shares. It engaged in no retail sales or in any retail sales effort, and there is no indication that its activities in the wholesale market were in any way out of the ordinary. Its trading mark-ups did not appear to be unreasonable and as the hearing examiner stated, "no pattern of manipulation by raising prices was found in the sales transactions." [13]

A closer examination of the record indicates that in one month, September 1963, G Co. purchased 20,160 shares from Lee, or 71 percent of its total purchases from Lee during the entire period. Those purchases represented about 48 percent of the shares sold by the selling stockholders during the entire period. In that month this represented 52 percent of G Co.'s total purchases from all broker-dealers. Of the 20,160 shares, 6,600 were purchased from Lee in three trades on September 12 and 9,500 were purchased in eight trades on September 18. G Co. was high bidder in the sheets on two days, by $^{1}/_{8}$ on September 11 and by $^{1}/_{4}$ on September 18, and tied for high on ten days out of the total of 20 trading days that month. Another firm was high bidder for five days in the month, and on six of the ten days when G Co. was tied for high, there were as many as three or more firms tied. The high bids that month moved between $9^{5}/_{8}$ and $13^{3}/_{4}$, beginning the month at $9^{5}/_{8}$ and ending at $12^{1}/_{2}$. There is no persuasive evidence on which to find that G Co. was even the principal market-maker that month or that it dominated the market in volume or price. G Co.'s sales about equalled its purchases in September and its inventory position remained throughout relatively low.

Even though this activity in September 1963 indicates a number of the registered shares were being traded by G Co., I can find no basis for finding that the stock was being absorbed by anything other than normal market action or that G Co. was acting in any way other than as an independent market maker responding to supply and demand in an unmanipulated market.[14] Certainly there is no evidence that a sales effort was

[13] Initial Decision, at p. 22.

[14] As the majority points out, the only evidence in the case of a possible arrangement between Horn and Jaffee relating to trading in Solitron stock, was admitted only as against Jaffee, and cannot be used against Horn or G Co. The existance of a direct wire between G Co. and J Co. is not sufficiently probative.

undertaken or participated in by G Co. to convey these shares to purchasers. Thus, on this record, I am unable to conclude that a sufficient showing has been made that G Co. and Horn engaged in the kind of activity which would support a finding they were participants in a distribution for purposes of Rule 10b–6. Since that proof is insufficient, I cannot find violations of Rule 10b–6 in this case by Lee.

IN THE MATTER OF

JACKPOT EXPLORATION CORP.

File No. 3-1947. Promulgated April 22, 1970

Securities Act of 1933—Section 3(b) and Regulation A

EXEMPTION FROM REGISTRATION

Grounds for Suspension of Exemption

Opportunity to Correct Deficiencies

Where notification and offering circular, filed pursuant to Regulation A for purpose of obtaining exemption from registration requirements of Securities Act of 1933, were materially deficient in that, among other things, offering circular failed to disclose adequately and accurately history of prior exploration of issuer's mining property and negative results of issuer's drilling, and notification omitted or misstated required information regarding jurisdictions in which offering was to be made and prior issuance of unregistered stock, *held*, since offering circular raised serious questions as to its adequacy it was in the public interest in first instance to suspend exemption temporarily without issuance by staff of deficiency letter, and in view of deficiencies and lack of care to present adequate and accurate filing, exemption should be permanently suspended notwithstanding issuer's willingness to file correcting amendments.

APPEARANCES:

Jack H. Bookey and *Walter F. Pitts* of the Seattle Regional Office of the Commission, for the Division of Corporation Finance.

Robert D. McGoldrick, for Jackpot Exploration Corp.

FINDINGS AND OPINION OF THE COMMISSION

Jackpot Exploration Corp., a Washington corporation organized in July 1968 which has been conducting explorations for gold on certain mining claims in Idaho, filed with us on February 19, 1969, a notification on Form 1-A and an offering circular for the purpose of obtaining an exemption from the registration requirements of the Securities Act of 1933, pursuant to Section 3(b) thereof and Regulation A thereunder, with respect to a proposed public offering of 300,000 shares of its no-par value common stock at $1.00 per share.

On April 17, 1969, we entered an order pursuant to Rule 261 of Regulation A temporarily suspending the exemption. The temporary suspension order stated there was reasonable cause to believe that the notification and offering circular contained materially misleading statements concerning, among other things, the extent and results of exploratory work by the issuer and the issuer's predecessor, the economic feasibility of the production of gold, if discovered, and the proposed uses of the proceeds of the offering; and that the issuer had failed to disclose required information regarding the jurisdictions in which the offering was to be made and the issuance of securities within one year of the filing.

At the issuer's request a hearing was held to determine whether to vacate that order or to enter an order permanently suspending the exemption. The hearing examiner submitted an initial decision in which he found that the notification and offering circular were deficient as alleged in the temporary suspension order, and concluded that a permanent suspension order should issue. We granted a petition filed by the issuer for review of the initial decision, and briefs were submitted by the issuer and by our Division of Corporation Finance. On the basis of our independent review of the record, we make the following findings.

Deficiencies

The Mining Properties

The issuer holds a lessee's interest in four unpatented mining claims ("Jackpot claims") on the Salmon River in the Camp Howard Mining District Near White Bird, Idaho, an extremely rugged mountainous area in which the lessor's late husband, Robert C. Old, had intermittently prospected for gold from about 1932 to about 1962.

The offering circular stated that in 1934 Old began dredging work in the river; he found some gold and in 1954 he examined the bottom of the river for the source of the gold and found "a ledge of gold-bearing rock in place and according to his wife quite a bit of gold was taken out, although there are no shipping records"; in 1955 he began drilling on the Jackpot claims near the river's edge in an effort to determine the direction of what was thought to be a fissure type vein; he expended over $10,000 in the drilling which continued until 1962; of the three holes which he drilled, two were completed and the third had approximately 50 feet to go "to cut the vein"; one of the completed holes located two "ore horizons" and the other, one ore horizon; and the sole surface expression of "the deposit" was a few seams of quartz in the rock.

It further stated that when the issuer acquired the lease interest in 1968, it drilled an additional three holes to determine "the nature and attitude of the mineralized structure"; the drill cores obtained by the issuer in this drilling were not analyzed and will not be until enough work is done to understand the origin and nature of "the deposition of the mineral"; at that time the drill cores "will be completely studied petrologically, mineralogically, and analytically"; gold is "the only metal of economic interest in the deposit"; further drilling will be necessary "to delineate the deposit at depth and laterally"; and the proposed public offering is intended to raise funds to continue drilling and related activities.

The principal question in this proceeding is whether the issuer's offering circular accurately states and properly qualifies the known material facts concerning the history of the mining claims, as required by Item 8A(e) of Schedule I of Form 1–A.[1] That requirement is designed to give the prospective investor an accurate basis for evaluating the risks involved in the proposed venture. We find that the offering circular does not meet that standard.

The descriptions in the offering circular of Old's prospecting activity, and particularly the references to "deposit," "vein," "ore horizons," and "mineralized structure," were materially misleading. Among other things, no disclosure was made that such descriptions were based solely on records and maps left by Old, supplemented by the recollections of his wife, and that Old was not a geologist or engineer. In describing the drilling by the issuer, which was intended to test the accuracy of the information derived from Old's records and maps, the offering circular failed to disclose that the three holes drilled by issuer intersected no ore horizons and found no mineral structures, or that one of the holes so drilled was about one foot from one in which Old was reported to have found two "ore horizons." And in stating that the drill cores would not be analyzed until further work was done, the offering circular omitted to disclose, as Adam Miller, issuer's president, testified, that no "free" gold or gold worthy of assay was found in the drill cores from these holes and that it would have been a waste of time and money to assay them.

[1] Item 8A(e) directs that: "If the properties are known to have been previously explored, developed or mined by anyone and that fact or the results of such work is material, furnish information as to such work insofar as it is know and material."

The use of the term "deposit" carried an implication not justified by the lack of success experienced by Old over many years and the negative results of the issuer's own drilling. We have held that the term "ore" is applied properly only to mineralized material which may be mined at a profit,[2] and while the term in other contexts may include materials without regard to commercial extraction possibilities, we agree with the hearing examiner that in the context of an offering circular intended to offer stock for public sale, the use of the term ore without qualification implies ore of commercial value. Moreover, the statement that "quite a bit of gold was taken out" was misleading in view of the omission to state that Old had obtained no income from material taken from the Jackpot claims and that he recovered only small amounts of gold from the river which he traded for groceries.

The misleading nature of the statements with respect to the extent and results of the exploratory work done by Old and by the issuer in relation to the economic feasibility of the production of gold and to the proposed use of the proceeds of the offering is not dissipated by the fact that elsewhere, on the face of the offering circular and in an introductory section, there were included statements that the securities were offered as a "speculation," that the project for which funds were sought was entirely exploratory in nature, and that no assurance could be given that gold would be discovered and produced in commercial quantities on the issuer's properties. While cautionary statements were appropriate, such statements in one part of an offering circular cannot be deemed to cure the misleading impression conveyed by the other statements we have discussed and a failure to disclose vital facts cannot be offset by a general disclaimer.[3]

OTHER MATTERS

Under Item 8 of the notification, calling for information with respect to the jurisdictions in which the securities were to be offered, the issuer stated only that it was not subject to Rule 253(b), which sets forth certain requirements for an issuer organized or conducting business in Canada, and failed to list the jurisdictions in which it did propose to offer securities. Under Item 9 of the notification, which called for information

[2] *National Boston Montana Mines Corporation*, 2 S.E.C. 226, 258 (1937); *Marquette Mines, Inc.*, 8 S.E.C. 172, 179 (1940); *National Lithium Corporation*, 40 S.E.C. 746, 752 (1961).

[3] See, for example, *Continental Distillers & Importers Corp.* 1, S.E.C. 54, 80-81 (1935); *Mining & Development Corporation*, 1 S.E.C. 786, 798-799 (1936); *Income Estates of America, Inc.*, 2 S.E.C. 434, 442 (1937); *Queensboro Gold Mines, Ltd.*, 2 S.E.C. 860, 862 (1937); *National Lithium Corporation*, 40 S.E.C. 746, 761 (1961).

with respect to unregistered securities issued or sold within one year of the filing, the issuer stated "none," although it appears that 770,000 shares of stock were so issued.

It is clear that the notification was deficient with respect to these two items.[4] The issuer asserts that it had not yet decided in which jurisdictions it was going to make its offering and points out that the offering circular stated that the securities proposed to be offered had been registered in the State of Washington.[5] The issuer further contends that it misunderstood the question in Item 9 as referring only to sales of unregistered securities to the public, and that there was no intent to mislead. In this connection it points out that the offering circular shows that 770,000 shares had been issued to 14 persons who were incorporators or persons to whom stock had been issued in exchange for leases or services, and that all these shares were held in escrow in compliance with Rule 253(c). However, disclosures in an offering circular cannot be considered to cure defects in the notification. In order to insure a complete presentation of all required information, it is necessary that the answer to each item be complete and accurate in itself through a full statement of the relevant facts, or at least by appropriate cross-reference to another part of the filing in which the facts are stated.[6]

CONCLUSIONS

The issuer asserts that there have been no sales of stock to the public, that no use has been made of the offering circular except to file it with us for review, that any deficiencies in the filing were unintentional, that it was not furnished with a letter of comments by our staff or given an opportunity to correct the deficiencies before the temporary suspension order was issued, and that it was not given an opportunity to amend the filing thereafter, which it is willing to do. The issuer contends that under the circumstances it was premature to issue the temporary suspension and that it would be unfair to make it permanent. We cannot agree.

[4] The hearing examiner also found that the filing was misleading in including the names of two broker-dealer firms as underwriters. This deficiency was not included in the original allegations in the suspension order nor was it specifically added by amendment. (See Rule 6(d) of our Rules of Practice.) Moreover, one of the named firms had executed a consent to being named as an underwriter in the filing, although it had not participated in the preparation of the notification or the offering circular. No agreement or consent had been obtained from the second firm, which was named as an underwriter in the offering circular but not in the notification. We are inclined to accept the issuer's statement that this firm's name was left in the offering circular by mistake. While this appears as another instance of a careless preparation of the filing, under all the circumstances, we do not base our decision herein on the listing of the underwriters.

[5] It should be noted that Miller testified that he intended to offer the stock in Washington and Idaho.

[6] *Cf. Ypres Cadillac Mines Limited*, 3 S.E.C. 41, 49 (1938); *Comico Corporation*, 39 S.E.C. 62, 73 (1959).

Contrary to issuer's suggestion, the issuer was not entitled to a deficiency letter as a matter of right. While it is stated in Section 202.3 of the Code of Federal Regulations (17 CFR 202.3) that "the usual practice is to bring the deficiency to the attention" of the issuer, that Section further provides that "this informal procedure is not generally employed where the deficiencies appear to stem from careless disregard of the statutes and rules or a deliberate attempt to conceal or mislead or where the Commission deems formal proceedings necessary in the public interest." The public interest warranted issuance of the temporary suspension order without or staff first sending a deficiency letter in view of the serious questions as to the adequacy of the offering circular.[7]

It is equally clear that the issuer does not have an absolute right to amend its filing as an alternative to or substitute for a permanent suspension. The exemption afforded by Regulation A is a conditional one based on compliance with express provisions and standards, and Rule 261 specifically provides that we may suspend an exemption in the event of noncompliance. The opportunity to amend or withdraw a deficient filing cannot be permitted to impair the required standards of careful and honest filings or to encourage a practice of irresponsible or deliberate submission of inadequate material to be followed by withdrawal or correction when deficiencies are found by our staff.[8]

In this case there were a number of serious deficiencies, primarily the failure to disclose material facts with respect to the prior exploration of the mining claims and the negative results of the issuer's drilling, as well as a number of deficiencies which at the least demonstrate a lack of care in the preparation of the filing. Under all the circumstances we cannot find that this filing demonstrates such a diligent and careful effort to present an accurate and adequate filing as to lead us in the exercise of our discretion to vacate the suspension.

We conclude, as did the hearing examiner, that it is appropriate in the public interest to make the suspension permanent.

[7] *Mutual Employees Trademart, Inc.*, 40 S.E.C. 1092, 1097-98 (1962); *Capitol Leasing Corporation*, 42 S.E.C. 232, 235 (1964).

[8] *Inspiration Lead Company, Inc.*, 39 S.E.C. 108, 114 (1959); *Edsco Manufacturing Co., Inc.*, 40 S.E.C. 865, 869 (1961); *General Aeromation, Inc.*, 41 S.E.C. 219, 227-228 (1962); *Del Consolidated Industries, Inc.*, 42 S.E.C. 682, 686 (1965).

We have also noted that our policy of considering amendments to a Regulation A filing after the issuance of a temporary suspension order would be more limited than in the case of a registration statement in view of the simplified requirements under Regularion A. See *Illowata Oil Company*, 38 S.E.C. 720, 723-24 (1958); *Hart Oil Corporation*, 39 S.E.C. 427, 432 (1959).

The suspension of the privilege of selling securities under Regulation A will leave the issuer free to offer its securities to the public if it complies with the registration provisions of the Act by filing a registration statement, from which a public investor may make an informed judgment as to whether the issuer's business venture involves risks which he is willing to assume.[9]

We have considered the initial decision of the hearing examiner and the exceptions thereto, and to whatever extent such exceptions involve issues which are relevant and material to the decision of this case, we have by our Findings and Opinion herein ruled upon them. We hereby expressly sustain such exceptions to the extent that they are in accord with the views set forth herein, and we expressly overrule them to the extent that they are inconsistent with such views.

Accordingly, IT IS ORDERED, pursuant to Rule 261 of Regulation A under the Securities Act of 1933, that the exemption from registration with respect to the proposed public offering by Jackpot Exploration Corp. be, and it hereby is, permanently suspended.

By the Commission (Chairman BUDGE and Commissioners OWENS, SMITH, NEEDHAM and HERLONG).

[9] *Gold Crown Mining Corporation*, 39 S.E.C. 619, 622 (1960); *Aluminum Top Shingle Corporation*, 40 S.E.C. 941, 946-947 (1961); *U.S. Systems Inc.*, 42 S.E.C. 461, 463 (1964). Moreover, while under Rule 252(c) a suspension order will bar the use of Regulation A by the issuer for five years, it may file an application for relief from such bar upon a proper showing made pursuant to Rule 252(f). *Nevada Consolidated Mines, Inc.*, 42 S.E.C. 271 (1964).

In the Matter of

DOCTOR DOLITTLE ANIMAL FAIRS, INC.

File No. 3-2138. Promulgated April 24, 1970

Securities Act of 1933—Section 8(d)

STOP ORDER PROCEEDINGS:

Misleading Statements and Omissions

Discontinuance of Proceedings

Where registration statement filed by newly organized franchise corporation, whose initial success was stated to depend largely on the efforts of its officers and marketing staff, was materially deficient in describing the experience and background of its president who was the only full time executive employee and the only officer represented to have any franchise experience, but among other factors it appeared that none of the securities had yet been sold to the public, that registrant had admitted the deficiencies and filed an amendment curing them, and such amendment and publication of Commission's findings would serve to inform potential investors of deficiencies in original filing and of severance of president's connection with registrant, *held*, appropriate in public interest to discontinue stop-order proceedings subject to condition that corrected prospectus and Commission's findings be furnished to all persons who received copies of deficient preliminary prospectus.

APPEARANCES:

Ralph H. Tracy, *John S. Bernas* and *Richard B. Nesson*, for the Division of Corporation Finance of the Commission.

Sheldon P. Darr, of Fleischman & Barr, for Doctor Dolittle Animal Fairs, Inc.

FINDINGS, OPINION AND ORDER

This is a proceeding instituted under Section 8(d) of the Securities Act of 1933 to determine whether a stop order should issue suspending the effectiveness of a registration statement filed by Doctor Dolittle Animal Fairs, Inc. on May 28, 1969. The registration statement, which has not become effective, relates to a proposed offering to the public of 300,000 shares of registrant's $.10 par value common stock at $2.00 per share, and of an offering to the underwriter at $.01 per warrant, of 30,000 warrants to purchase 30,000 shares of common stock at $4 per share and of the 30,000 shares so purchasable.

After appropriate notice, a public hearing was held, at which registrant admitted the allegations in the Statement of Matters of the Division of Corporation Finance but urged that it was not necessary to issue a stop order. An initial decision by the hearing examiner was waived, registrant and the Division filed briefs, and we heard oral argument. Our findings set forth below are based on an independent review of the record.

THE DEFICIENCIES

The prospectus filed as part of the registration statement stated that registrant was incorporated in February 1969 to franchise "Doctor Dolittle Animal Fairs", under a licensing agreement permitting the use of the name and certain properties from the movie Doctor Dolittle, which are intended to employ publicity and merchandising techniques to sell at retail a variety of pets, with emphasis on puppies and kittens, and related pet items. It further stated that registrant's initial success will depend largely upon the efforts of its officers and marketing staff only one of whom has had franchise experience. The prospectus listed Arnold Filner, president and franchise sales director, as its only full-time executive employee, and listed various associations of Filner in the pet and franchise business during the period August 1962 through February 1969, beginning with an employment from August 1962 through September 1966 as assistant to the president of Puppy Land, Inc., a chain of retail puppy stores.[1]

Contrary to the representation in the registration statement, however, Filner was not employed as assistant to the president of Puppy Land, Inc. during the period from August 1962 through September 1966, but only for about three months, from September to November 1967. During the period from August 1962 through September 1966 he was not associated with any pet or franchising business.[2] The registration statement, as registrant concedes, was materially deficient with respect to Filner's business background and experience in this respect. Registrant, however, notes that it has filed an amend-

[1] The prospectus further listed Filner's associations after September 1966, the correctness of which is not questioned, as follows: from November 1966 through November 1967 Filner was Franchise Sales Director of Docktor Pet Centers, Inc., a pet store franchisor; from December 1967 through July 1968 Franchise Sales Manager of Puppy Palace Enterprises, Inc., a franchisor of pet stores specializing in the sales of puppies; and from October 1968 through February 1969 Regional Marketing Director of A to Z Rental Inc., a franchisor of rental centers.

[2] During this period Filner served six months on a conviction of a charge of possession of marijuana.

ment which corrects the deficiency and it argues that no purpose will be served by issuing a stop order.

Whether or not an amendment curing deficiencies in a registration statement filed after the institution of stop order proceedings should be considered is a matter for the exercise of our discretion on the basis of an examination of all the circumstances bearing on the public interest and the protection of investors and the requirements of an orderly procedure.[3] In this connection we have noted that a stop order not only suspends the effectiveness of a registration statement but it also is generally the most effective means of warning the investing public that unreliable statements have been filed and counteracting the misleading information publicized by the filing.[4]

Whether the filing of an amendment curing deficiencies eliminates the justification or necessity for a stop order depends on the particular facts of each case. In general, we have refused to forego issuance of a stop order where there was a large number of serious deficiencies which indicated that the issuer had been grossly negligent and had not made a reasonable effort to comply with the standards of full, fair and honest disclosure; where a large number of securities have been sold to the public; and where it is believed that appropriate measures otherwise to publicize the deficiencies have not or cannot be taken.[5]

In the instant case, the registration statement has not become effective and none of the securities covered thereby have been sold to the public. It also appears that when the staff raised questions about Filner's background, registrant obtained from Filner a corrected resume of his background and furnished it to the staff, accepted Filner's resignation as an officer and director and later discharged him as an employee, and registrant thereafter filed its corrective amendment which describes the institution of this proceeding. We note on the other hand that the charged deficiencies relate to an important matter, namely the qualifications of the individual who was to be the sole experienced executive of a new enterprise,

[3] See *Automation Shares, Inc.*, 37 S.E.C. 771, 775 (1957) and cases cited. See also *Columbia General Investment Corporation*, 38 S.E.C. 202, 210 (1958), *aff'd* 265 F.2d 559 (C.A. 5, 1959); *Texas Glass Manufacturing Corp.*, 38 S.E.C. 630, 637 (1958); *Hazel Bishop, Inc.*, 40 S.E.C. 718, 733 (1961); *Doman Helicopters, Inc.*, 41 S.E.C. 431, 441 (1963).

[4] *Faradyne Electronics Corp.* 40 S.E.C. 1053, 1062-63 (1962); *Franchard Corporation*, 42 S.E.C. 163, 185 (1964); *Clinton Engines Corporation*, 42 S.E.C. 353, 360-61 (1964).

[5] See, for example, *American Republic Investors, Inc.*, 37 S.E.C. 287, 295 (1956); *Ultrasonic Corporation*, 37 S.E.C. 497, 506 (1957); *American Investors Corporation*, 37 S.E.C. 675, 680 (1957); *Doman Helicopters, Inc.*, 41 S.E.C. 431, 441, (1963).

and are not to be excused. Persons who sign a registration statement have an obligation to make a reasonably diligent investigation affording them reasonable grounds for believing that the registration statement is true and accurate. They cannot be permitted to make filings which, whether through lack of concern or by design, contain deficiencies in material areas with an intent to correct them after the deficiencies are discovered. Here the deficiencies do not appear to be of such a nature as to suggest a fraudulent intent on the part of the issuer's management. The filing of the correcting amendment and the publication of our findings and opinion would serve to alert potential investors to the deficiencies in the original filing and inform them of the correct facts concerning Filner and that he is no longer associated with registrant.

We conclude that under all the circumstances the issuance of a stop order is not necessary in the public interest and for the protection of investors if the registration statement is amended to describe this proceeding and its disposition and the final corrected prospectus and a copy of these findings and opinion are furnished to persons who received the preliminary prospectus.[6]

Accordingly, IT IS ORDERED that this proceeding be, and it hereby is, discontinued, provided, however, that the registration statement filed by Doctor Dolittle Animal Fairs, Inc. shall not become effective until after a further amendment is filed describing this proceeding and making such other changes as may now be required, and provided further, that a copy of the final corrected prospectus and a copy of these findings and opinion be furnished to all persons who received copies of the deficient preliminary prospectus.

By the Commission (Chairman BUDGE, Commissioners OWENS, SMITH, NEEDHAM and HERLONG).

[6] *Cf. Automation Shares, Inc.*, 37 S.E.C. 771, 775 (1957); *Surinam Corporation*, 39 S.E.C. 657, 662 (1960; *Miami Window Corporation*, 41 S.E.C. 68, 84 (1962); *Londontown Manufacturing Company*, 41 S.E.C. 676, 687-88 (1963); *Franchard Corporation*, 42 S.E.C. 163, 185 (1964); *The Wolf Corporation*, 42 S.E.C. 1042, 1052 (1966).

In the Matter of

GRAY LINE CORPORATION

File No. 3-1917. Promulgated May 14, 1970

Investment Company Act of 1940—Section 3(b)(2)

DEFINITION OF INVESTMENT COMPANY

Exemptions

Application under Investment Company Act by unregistered company for declaration that it is not an investment company, *denied*, where company owns and holds investment securities and record does not sustain contention that company is primarily engaged in a business other than that of investing, reinvesting, owning, holding or trading in securities.

APPEARANCES:

Robert J. Nye, of Nye and Nye, for Gray Line Corporation.

Nicholas H. Politan, of Krieger, Chodash & Politan, for Gray Line Corporation in connection with an agreement to sell certain securities.

Philip N. Smith, for the Division of Corporate Regulation of the Commission.

Leon Silverman and *Sheldon Raab*, of Strasser, Speigelberg, Fried & Frank, for the Trustee-Receiver of Fifth Avenue Coach Lines, Inc.

FINDINGS, OPINION AND ORDER

Gray Line Corporation ("Gray Line"), which is not registered under the Investment Company Act of 1940 ("Act"), has filed an application for exemption from registration pursuant to Section 3(b)(2) of the Act. After appropriate notice,[1] a hearing was held before a hearing examiner at which counsel for the Trustee-Receiver ("Trustee") of Fifth Avenue Coach Lines, Inc. ("Fifth Avenue"), of whose common stock Gray Line owns 212,803 shares, participated. An initial decision by the hearing examiner has been waived, and our Division of Corporate Regulation has filed proposed findings and a brief in opposition

[1] *Gray Line Corporation*, Investment Company Act Release No. 5684 (May 20, 1969).

to the application, with which the Trustee has associated himself. Our decision is based upon an independent review of the record.

Gray Line, known prior to 1962 as Gray Line Motor Tours, is a New York corporation with its office in Chicago, Illinois, and has about 2,000 shareholders. Its assets, in addition to the Fifth Avenue shares, consist of 26,080 shares of capital stock of Gateway National Bank ("Gateway"),[2] and a small amount of cash. The Fifth Avenue shares constitute approximately 24 percent of all outstanding Fifth Avenue stock and the Gateway stock constitutes approximately 66 percent of all outstanding Gateway shares.

Of the Fifth Avenue shares owned by Gray Line, 181,102 shares are pledged with Fifth Avenue, as security for an indebtedness of Gray Line to Fifth Avenue in the principal amount of $1,792,341. The Gateway stock was purchased in 1967 from Fifth Avenue at a price of $27.50 per share and all of it is pledged with Fifth Avenue as security for payment of the $650,800 principal amount still due on the purchase price. According to testimony of Phillip C. Goldstick, president and a director of Gray Line and the only witness at the hearing, he had been informed of recent quotations of about $13 per share for the Gateway stock and about $12 per share for Fifth Avenue stock. On the basis of those quotations, Gray Line's holdings would have a value of about $2,900,000 of which the Fifth Avenue shares would represent about 88 percent and the Gateway shares about 12 percent.

In its application Gray Line in effect contends that it is not an investment company under Section 3(a)(3) of the Act, and that in any event it is entitled to an order of exemption under Section 3(b)(2) on the ground that through its majority-owned subsidiary, Gateway, it is primarily engaged in the banking business.

Insofar as relevant here, Section 3(a)(3) of the Act defines an investment company as including any issuer which is "engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis." For purposes of this section investment securities are defined not to include, among other things,

[2] The number of Gateway shares owned by Gray Line is referred to variously as 26,080 and 26,280. The difference is not material.

"securities issued by majority-owned subsidiaries of the owner which are not investment companies."

It is clear that at a minimum Gray Line can be considered, as conceded by its president at the hearing, to be engaged in the business of owning and holding securities. The disjunctive wording of Section 3(a)(3) shows that the relatively inactive business of owning or holding securities was intended as an independent criterion as to what constitutes an investment company.[3] It further appears that Gray Line meets the second element of the test of an investment company set up by Section 3(a)(3), i.e., the value of its "investment securities" exceeds 40 percent of the value of its total assets. The Fifth Avenue shares owned by Gray Line, which are clearly investment securities as defined in the Act, represent more than 40 per cent of the value of Gray Line's total assets.

In its application Gray Line "suggests" that Fifth Avenue may be exempt from the Act, in which event Gray Line itself could also be exempt under Section 3(c)(8) on the ground that all of its investment securities, consisting of the shares of Fifth Avenue, are represented by securities of a single issuer which is exempted from the Act.[4] However, not only is there no evidence in the record to support this suggestion, but on July 26, 1968, the United States District Court for the Southern District of New York found that Fifth Avenue had been and was an investment company which should be registered under the Act,[5] and in August 1968 that Court appointed the Trustees for Fifth Avenue and ordered him to register Fifth Avenue as an investment company.[6] That has been done, and Fifth Avenue is now registered under the Act as a closed-end non-diversified management investment company.

Gray Line further claims that it is "primarily" engaged in a non-investment company business and therefore under the

[3] *The Atlantic Coast Line Company*, 11 S.E.C. 661, 663 (1942). In view of the independent tests of owning and holding securities, we find no merit in the contention made by Gray Line at the hearing that it cannot be an investment company because various legal proceedings have so tied up Gray Line's securities that it cannot invest or trade in securities.

[4] Section 3(c) (8) of the Act provides that an issuer is not an investment company under the Act if 90 percent or more of the value of its investment securities are represented by securities of a single issuer of a class exempt under certain other sections of the Act, including among others, issuers in the banking or insurance business.

[5] *S.E.C.* v. *Fifth Avenue Coach Lines, Inc.*, 289 F. Supp. 3.

[6] The District Court on February 17, 1970 authorized the Trustee to call a shareholders meeting for May 20, 1970 for the election of directors of Fifth Avenue and ordered that Gray Line's Fifth Avenue holdings not be voted at such meeting. *S.E.C.* v. *Fifth Avenue Coach Lines, Inc.*, S.D.N.Y., 67 Civ. 4182.

provisions of Section 3(b)(2) is not an investment company.[7] The record before us falls short of sustaining that claim.[8] To be entitled to a Section 3(b)(2) order an applicant must come forward with affirmative evidence in order to provide a basis for a finding that it is "primarily" engaged in a non-investment company business through a majority-owned subsidiary.[9] Gray Line has not satisfied this burden by showing merely that it owns about 66 percent of the stock of Gateway, and that its sole income in the last fiscal year was from dividends on such stock.

The critical issue as to the primary business engagement of a company is one which must be resolved with reference to the particular facts of each case. We have previously stated that the principal relevant considerations to a determination of this factual issue are the company's historical development; its public representations of policy; the activities of its officers and directors; the nature of its present assets; and the source of its present income.[10] Gray Line introduced no evidence concerning its historical development or public representations of policy. There is little evidence concerning the activities of Gray Line's officers and directors, and that evidence indicates that their almost exclusive recent activity in connection with Gray Line involves attempts to sell Gray Line's Fifth Avenue and Gateway holdings. Indeed, except for their attendance at some board meetings, there is no evidence to indicate that they have engaged in other activities respecting Gray Line.[11]

In a number of cases, we have recognized as an important factor in determining the primary business engagement of a

[7] Section 3(b) (2) of the Act provides that notwithstanding the definition of an investment company under Section 3(a), a company is not an investment company within the meaning of the Act if we find and declare by order that it is primarily engaged either directly, or through majority-owned subsidiaries, or through controlled companies conducting similar types of businesses, in a business or businesses other than that of investing, reinvesting, owning, holding or trading in securities. Section 3(b) (2) also provides that the filing of an application by an issuer other than a registered investment company shall exempt the applicant for a period of sixty days from all provisions of the Act applicable to investment companies, and that we may extend such period by order for cause shown. In its application filed February 24, 1969, Gray Line requested an extension of the 60 day period of exemption until determination of its application. No such extension has been granted, however, and the statutory 60 days expired April 25, 1969. We see no basis for finding, as urged by the Division, that Gray Line's application was not filed in good faith and that therefore Gray Line was not entitled to the 60 day exemption.

[8] Gray Line's application, filed under Section 3(b) (2), in support thereof refers to Section 3(c) (7) of the Act which insofar as here relevant exempts any company primarily engaged in the banking business through a majority-owned subsidiary. Thus the issue of primary business engagement is the same under Section 3(b) (2) and Section 3(c) (7).

[9] *The Atlantic Coast Line Company*, 11 S.E.C. 661, 666 (1942). *Cf. S.E.C.* v. *Ralston Purina Co.*, 346 U.S. 119, 126 (1953); *S.E.C.* v. *Midland Basic, Inc.*, 283 F. Supp. 609, 615 (S.D., 1968).

[10] *Tonopah Mining Company of Nevada*, 26 S.E.C. 426, 427 (1947); *Newmont Mining Corporation*, 36 S.E.C. 429, 431 (1955).

[11] There is no indication in the record that Gray Line has any full time officers.

company, the fact that officers and directors of that company were actively engaged as representatives of the company in the operation and management of a non-investment company subsidiary.[12] In the instant case there is no testimony as to the active involvement of Gray Line's officers and directors in the management and operation of Gateway.[13] Moreover, Gray Line's holdings of Gateway stock represent a relatively small part of Gray Line's assets in comparison to its holdings of Fifth Avenue shares. While recently its only source of income has been dividends declared on the Gateway stock, such income (less than $16,000 in the first nine months of 1969) is so small as to leave Gray Line in financial straits generally and particularly in the light of its substantial indebtedness to Fifth Avenue against which both the Gateway and the Fifth Avenue shares are pledged as security.

Under all the circumstances we are unable on the basis of the record before us to find and declare that Gray Line is primarily engaged in a business other than owning or holding securities, and accordingly its application for such an order must be denied.

We reject the request that has been made that we not rule on the application pending Court action on approval of an agreement for the sale of the company's Fifth Avenue shares to one Newton Glekel or of alternative dispositions of the shares.[14] Subsequent to that request the Court, in commenting on the argument that Gray Line is an investment company and cannot legally sell the stock without first registering under the Act, expressly noted that that question could not be determined on the record before it, and it was appropriate to await our action on Gray Line's application for exemption

[12] *Northeast Capital Corporation*, 37 S.E.C. 715, 719 (1957); *Great American Life Underwriters, Inc.*, 41 S.E.C. 1, 20 (1960). *Cf. The Atlantic Coast Line Company*, 11 S.E.C. 661, 666 (1942); *Interbanc Investors, Inc.*, 16 S.E.C. 119, 122 (1944); *Atlas Corporation*, 41 S.E.C. 144, 149 (1962). We have also recognized, however, that control and operation of a business does not necessarily preclude a finding that a company's activities are those of a special-situation type of investment company. *United Stores Corporation*, 10 S.E.C. 1145, 1150 (1942); *Bankers Securities Corporation*, 15 S.E.C. 695 (1944), *aff'd* 146 F.2d 88 (C.A. 3, 1944).

[13] The record contains copies of minutes of meetings of Gray Line's board of directors. The minutes of a special meeting held October 4, 1969, among other things, recite that the board commended Goldstick for his work as Chairman of the Board of Gateway during the first nine months of 1968, attributed to him increases in the bank's loan portfolio and operating earnings during that period, and credited him with having acted for a time during the third quarter in the capacity of operating management when an unanticipated management problem arose. There is no testimony supporting or explaining these statements, nor any evidence that Goldstick, who testified that he practices law, performed any management services for Gateway since the third quarter of 1968, or that any other officer or director of Gray Line was or is active in any way in the management or operation of Gateway.

[14] The defferal request was made by the attorney who represented Gray Line in connection with the Glekel agreement, which was signed by its directors other than Goldstick who apparently opposes it.

before considering the proposed disposition of the shares.[15] Under the circumstances it is not inappropriate for us to proceed to issue our determination with respect to such application.

Accordingly, IT IS ORDERED that the application for exemption under Section 3(b)(2) of the Investment Company Act of 1940 filed by Gray Line Corporation be, and it hereby is, denied.

By the Commission (Chairman BUDGE, Commissioners OWENS, SMITH, NEEDHAM and HERLONG).

[15] Opinion of the United States District Court, S.D.N.Y., 67 Civ. 4182, January 19, 1970. The Court had previously authorized the Trustee to take steps to forclose the pledge on the Fifth Avenue shares held as security for Grey Line's indebtedness to Fifth Avenue.

IN THE MATTERS OF

D. H. BLAIR & CO. ET AL.*

File Nos. 3-329, 8-8239. Promulgated May 21, 1970

Securities Exchange Act of 1934—Sections 15(b) and 19(a)(3)

BROKER-DEALER PROCEEDINGS

Grounds for Remedial Action

Sale of Unregistered Securities

Manipulation

Improper Extension of Credit

Inadequate Supervision

Where salesman knew or should have known that sales of unregistered securities through account handled by him were being made for controlling person of issuer, and was instrumental in arrangements through which customers engaged in manipulative scheme involving transactions in and quotations of such securities at advancing prices by salesman's employer as well as by other, ostensibly independent, dealers, *held*, willful violations of registration and antifraud and antimanipulative provisions of securities acts, and in public interest to bar salesman from association with broker-dealer.

Where registered broker-dealer, by virtue of employees' acts, violated registration, antifraud and anti-manipulative provisions; its senior partners failed reasonably to supervise with view to preventing violations; and its trader participated in manipulative activities; where clearing broker-dealer failed reasonably to supervise with a view to preventing violations of registration provisions and unlawfully extended credit; and where another broker-dealer failed to exercise sufficiently comprehensive supervision over its trader who aided and abetted manipulation, *held*, in public interest to impose sanctions on respondents pursuant to offers of settlement.

* Robert W. Miller; Charles J. Miller; Ralph J. Trapani; Ronald Neumark; Seymour Katz; Loeb, Rhoades & Co., formerly Carl M. Loeb Rhoades & Co.; Goodbody & Co.; Richard V. Miller; Troster, Singer & Co.; Sidney Woolich.

APPEARANCES:

Joseph C. Daley, *Roberta S. Karmel*, *Robert Berson*, *Howard Bernstein* and *William Nortman*, for the Division of Trading and Markets of the Commission.

George Rosier and *Victor Brudney,* of Hellerstein, Rosier & Brudney, for D. H. Blair & Co. and Charles J. Miller.

Milton V. Freeman, Harry Huge and *Werner J. Kronstein,* of Arnold & Porter, for Robert W. Miller.

Bernard D. Cahn, for Ralph J. Trapani.

Mortimer Goodman and *Joseph Cosgrove,* of Grandefeld & Goodman, for Ronald Neumark.

Arthur Lawler, Peter Landau, Richard B. Rodman and *David H. Carlin,* of Lawler, Sterling & Kent, for Seymour Katz.

Alvin K. Hellerstein and *Richard Savitt,* of Stroock & Stroock & Lavan, and *Sam Harris* and *Arthur Fleischer, Jr.,* of Strasser, Spiegelberg, Fried & Frank, for Loeb, Rhoades & Co.

William F. Clare, Leonard B. Boehner and *Henry Poole,* of Clare & Whitehead, for Goodbody & Co. and Richard V. Miller.

George Adams and *J. F. Dwyer,* of Satterlee, Warfield & Stephens, for Troster, Singer & Co.

George A. Dean, Jr. and *Joseph A. Tracy,* for Sidney Woolwich.

FINDINGS AND OPINION OF THE COMMISSION

These were private proceedings pursuant to Sections 15(b), 15A and 19(a)(3) of the Securities Exchange Act of 1934 ("Exchange Act") with respect to D. H. Blair & Co., a registered broker-dealer, certain other registered broker-dealers, and various persons associated or formerly associated with them. Following extensive hearings, offers of settlement were submitted by Blair; Charles J. Miller, a partner of Blair; Robert W. Miller, who was a Blair partner during the period encompassed by the order for proceedings; Ralph J. Trapani, Blair's trader during that period; and Loeb, Rhoades & Co. ("Loeb") and Goodbody & Co., both registered broker-dealers.[1] They waived post-hearing procedures and, solely for the purpose of these proceedings, consented to our making certain findings and suspending Blair from the National Association of Securities Dealers, Inc. ("NASD") for up to 30 days, suspending Robert Miller and Trapani from association with a broker or dealer for a like period and censuring the other respondents.

The hearing examiner filed an initial decision with respect to the remaining respondents, in which he concluded that Seymour Katz, a salesman for Blair during the relevant period, should be barred from association with any broker or dealer;

[1] Blair, Loeb and Goodbody are also members of the New York Stock Exchange and other exchanges and of the National Association of Securities Dealers, Inc.

that Ronald Neumark, a salesman for and later partner of Blair, and Richard V. Miller and Sidney Woolwich, traders for Goodbody and Troster, Singer & Co. ("Troster"), respectively, should be suspended from such association for periods of 20, 10 and 5 business days, respectively; and that Troster should be censured. We granted a petition for review filed by Katz, and he and our Division of Trading and Markets filed briefs. Since neither the other respondents dealt with in the initial decision nor our Division of Trading and Markets sought review and we did not order review on our own initiative, the initial decision became final as to those respondents. However, we determined not to make that decision public at that time, and to defer the effective date of the sanctions ordered as to those respondents, until issuance of our decision as to the remaining respondents.

On the basis of an independent review of the record and the offers of settlement, which for reasons stated below we have determined to accept, and for the reasons set forth herein and in the initial decision, we make the following findings.

The issues in these proceedings relate to transactions in the common stock of American States Oil Company ("ASO") in an account maintained at Blair for one Larry Gulihur during the period between November 1960 and about July 1961. As further appears below, this account was used by Gulihur and his father-in-law, J. Tom Grimmett, in connection with distributions of unregistered ASO stock and a manipulation of the market in such stock.

ASO had been incorporated in 1952 to deal in real property and to develop and deal in oil, gas and minerals. ASO's operations were negligible. For the three fiscal years ended April 30, 1962, its total income was $3,147 and its taxable losses totalled $151,601. At the end of that period it had an earned surplus deficit of more than $1.2 million. Grimmett was president of the company from its inception until 1954, and again from 1959 until his death in 1964. In 1959, at a time when approximately 300,000 shares of ASO stock were outstanding, ASO issued 650,000 shares to a bank as escrow agent and trustee for Grimmett and, between October 1959 and January 1960, it issued an additional 550,000 shares to Mid-State Drilling Company as Grimmett's nominee. None of ASO's shares were registered under the Securities Act of 1933. Mid-State was a shell corporation which Grimmett had acquired from ASO in 1957 for $15,000 and which he employed as a vehicle for transactions in ASO stock. At the time he acquired Mid-State, Grimmett designated Gulihur as its president and gave him and his wife 8,000 shares and his own wife 8,000 shares, out of a total of 20,000 outstanding shares. Gulihur performed office work for Grimmett and was paid by ASO, receiving no income from Mid-State. It is thus clear that, as found by the examiner, Grimmett at all pertinent times was a person in control of ASO and Mid-State.

Sale of Unregistered Securities

Between November 10, 1960, when the Gulihur account was opened at Blair, and the end of April 1961, 93,567 shares of ASO stock were purchased for the account, at prices increasing from $1^1/_2$ to $5^3/_8$, and 60,805 shares were sold at prices ranging from $3^1/_8$ to 6. With the exception of 8 transactions in another security, these were the only transactions in the account. Of the ASO shares purchased, 21,500 were part of the 550,000 shares which had been issued by ASO to Mid-State. These shares were purchased in a single transaction in March 1961 from a broker-dealer which was in fact acting as agent for Grimmett and Mid-State, and they were resold out of the Gulihur account. The record further shows that between 1959 and 1961 Mid-State sold a total of 505,000 of the 550,000 shares as well as more than 100,000 shares bought in the open market.

We find that Blair and Katz, who was the salesman handling the Gulihur account, were "statutory underwriters" with respect to the sales of ASO stock for that account and willfully violated Sections 5(a) and 5(c) of the Securities Act of 1933. Section 2(11) of that Act defines an "underwriter" to include any person who offers or sells for an issuer in connection with the distribution of any security, or participates in any such undertaking. For purposes of Section 2(11), "issuer" is defined as including a person directly or indirectly controlling the issuer or under common control with the issuer. It is thus immaterial whether, as found by the examiner, Grimmett, Gulihur and Mid-State were in common control of ASO, or whether, as the record more clearly indicates, Grimmett controlled Gulihur as well as ASO and Mid-State. In either event, the sales of ASO stock were made for an "issuer." Nor is it material that part of the shares sold had been acquired in open-market purchases[2] or that Blair's sales were exclusively to other broker-dealers.[3]

[2] See *Gearhart & Otis, Inc.*, 42 S.E.C. 1, 27-28 (1964), *aff'd* 348 F.2d 798 (C.A. D.C., 1965).

[3] The record shows, however, that a substantial number of shares were subsequently resold to public investors.

Katz contends that the record does not show that he knew he was selling stock which should have been registered and that we cannot find that he willfully violated the registration provisions. He asserts that he was an "innocent pawn" of Grimmett and Gulihur, and that the only evidence to the effect that he was a "knowing participant" is Gulihur's testimony which, he argues, is unworthy of belief because Gulihur admitted giving false testimony and a false affidavit. The examiner considered that there was no basis for rejecting all of Gulihur's testimony, which attributed to Katz knowledge that the Gulihur account was merely a "front" for Grimmett and active collaboration in Grimmett's scheme, and he based certain of his findings on it. In our view, even if such testimony is disregarded to the extent it conflicts with Katz's testimony, the latter testimony and other evidence in the record amply support the examiner's findings that Katz knew or should have known that the ASO stock being sold for the Gulihur account was control stock and that he willfully violated the registration provisions.[4] Recently, in holding that violations of Section 5 of the Securities Act by certain salesmen were willful, we stated that "salesmen, no less than broker-dealers, should be aware of the requirements necessary to establish an exemption from the registration requirements of the Securities Act, and they should be reasonably certain such an exemption is available, particularly in circumstances where their activities depart from normal business practices . . ."[5] In the same case, we held that a salesman is required to make certain basic inquiries concerning the sellers and the source of their stock when he is asked by unknown persons to sell substantial amounts of little known securities; that the violations of a salesman who failed to make reasonable inquiry despite factors which should have alerted him to the need for such inquiry were willful; and that careless disregard of his responsibilities as a securities salesman constituted willfulness.[6] Here the record demonstrates that at the least Katz closed his eyes to circumstances which clearly indicated the ASO stock in question was control stock.

[4] Willfulness within the meaning of Section 15(b) of the Exchange Act requires only an intention to commit the act which constitutes the violation and not an actual awareness of the violation. See, *e.g.*, *Hughes* v. *S.E.C.*, 174 F.2d 969 (C.A. D.C., 1949); *Gilligan, Will & Co.* v. *S.E.C.*, 267 F.2d 461, 468 (C.A. 2), *cert. denied* 361 U.S. 896 (1959); *Tager v. S.E.C.*, 344 F.2d 5, 8 (C.A. 2 1965).

[5] *Strathmore Securities, Inc.*, 43 S.E.C. 575, 582 (1967), *aff'd* 407 F.2d 722 (C.A. D.C., 1969)

[6] *Id.*, at pp. 583-86 of release. We do not consider that a finding in Katz's favor in this case is required by virtue of our action in *Lloyd, Miller & Company*, 42 S.E.C. 73 (1964), cited by Katz, where we held that salesmen had not been shown to have committed willful violations of the registration provisions where it did not appear that they knew or had reason to know that registration was required.

While employed by another firm prior to joining Blair on November 1, 1960, Katz had serviced an account in Gulihur's name and admittedly had become aware that Gulihur was the son-in-law of Grimmett and that the latter was president of ASO. Shortly after Katz became employed by Blair, he opened accounts for a number of his old customers, including Gulihur. According to Katz, Gulihur asked him, shortly before that account was opened, if Blair would enter quotations for ASO stock in the daily sheets of the National Quotation Bureau, Inc. ("sheets") for him. Trapani, Blair's trader, at first refused, apparently because his income was based on the firm's own trading profits and he was using the full number of listings in the sheets for which he had subscribed. However, he was instructed by a Blair partner to insert such quotations and did so beginning with the sheets dated November 10.

After the account was opened, Katz had daily conversations with Gulihur, in which the latter gave orders for the purchase or sale of ASO stock at specified prices, on the basis of which Trapani inserted the quotations. Katz was given discretion to buy or sell ASO stock, within specified limits as to amounts, at the indicated prices. Katz admitted that he also spoke frequently with Grimmett concerning the account and that the latter placed orders with him for the account. In late November 1960, Loeb, which cleared Blair's accounts, received checks drawn on Grimmett's bank account in payment for ASO stock purchased for the Gulihur account. At Loeb's request, Katz had Grimmett furnish Loeb written authorization to receive his checks. Trading in the Gulihur account was suspended for several days in January 1961 after a Grimmett check had failed to clear and during this period, Katz, pursuant to Loeb's request, asked Gulihur to submit an affidavit to Loeb concerning his relationship to ASO. Gulihur submitted an affidavit which stated that he was not an officer or director of ASO, and that he was sole owner of his shares and was trading for his own benefit. Trading in the account was again suspended on March 14, 1961, when shares sold for the account had not been delivered, and meetings were held at Blair and at Loeb, in which Katz, Gulihur, Grimmett and certain of the Blair and Loeb personnel variously participated. At that time Gulihur and Grimmett disclaimed any interest in the account by the latter. Resumption of trading was thereafter permitted and activity in the account, involving mostly purchases, increased until the trading ended on April 28, 1961, at which time there was a debit balance of about $145,000.

Katz's admitted knowledge regarding the relationship between Gulihur and Grimmett, the latter's position with ASO and the payments made with checks drawn on Grimmett's bank account, and Katz's frequent contacts with Grimmett regarding transactions in the account, combined with the unusual manner in which the account was carried on, at the least placed Katz on notice that a searching inquiry was called for as to whether the shares being sold represented control stock which could not be sold without registration. Yet Katz made no meaningful investigation.[7] He admitted that he had no knowledge concerning Gulihur's financial position, or how much ASO stock Gulihur owned, and had no information about ASO.

Katz asserts that he relied on the determinations of partners and attorneys of Blair and Loeb who permitted continuation of the Gulihur account with knowledge of the facts known to him. While as discussed below, the record shows that the Millers and Loeb were also on notice of irregularities, unlike Katz they were not aware of the active role played by Grimmett in running the account. Moreover, any such reliance, while it may be a pertinent factor in determining the appropriate sanction, cannot relieve Katz of his own responsibility.[8]

The examiner concluded that Neumark also willfully violated Sections 5(a) and 5(c) of the Securities Act. He found that Neumark shared commissions with Katz on the latter's business until Neumark became a partner of Blair on January 1, 1961, was "intimately knowledgeable" concerning the transactions in the Gulihur account and, particularly after he became a partner, exercised some authority over that account.

We further find, pursuant to their offers of settlement, that Robert and Charles Miller, the senior partners of Blair, failed reasonably to supervise, and that Loeb failed reasonably to supervise its margin and bookkeeping departments, with a view to preventing the violations of Section 5. The testimony regarding the knowledge which the Millers had regarding the Gulihur account and activities related to it, and that concerning the extent to which Blair personnel relied on Loeb for information and decisions, and vice versa, is conflicting in

[7] A thorough investigation would have uncovered the facts that in 1956 Grimmett, on the basis of a complaint filed by this Commission, had been enjoined from further violations of Section 5 of the Securities Act in the sale of ASO stock, and we had issued an order temporarily suspending an exemption under Regulation A with respect to a proposed offering of ASO stock by Grimmett, on the grounds that, among other things, the notification which had been filed failed to disclose the sale by Grimmett of a substantial number of unregistered shares of ASO stock within the preceding year.

[8] *Mark E. O'Leary*, 43 S.E.C. 842, 848 (1968), *aff'd* 424 F.2d 908 (C.A. D.C., January 30, 1970).

many respects. And it may well be that the division of responsibility regarding Blair's accounts between Blair and Loeb contributed to the failure to terminate trading in the Gulihur account at an early stage. In our view, however, both the Millers and Loeb failed to carry out their responsibilities.

While the Millers denied having any awareness of the Gulihur account until mid-March 1961, just prior to the suspension of trading, there is considerable testimony which would indicate an earlier awareness.[9] Even accepting the Millers' testimony in this respect, however, it appears that there was a serious breakdown in supervision and that they should have been aware of the account almost from its inception. They testified that Neumark who had come to Blair with Katz from a common prior firm with the understanding that he would become a partner on January 1, 1961, and who, as noted, shared commissions with Katz on all their business up to that time, was given supervisory responsibilities over the salesmen, including Katz, as soon as he joined Blair on November 1, 1960.[10] It seems apparent that Neumark should not have been placed in a supervisory position over Katz with whom he shared commissions. Moreover, in view of his lack of prior supervisory experience, he should himself have been closely supervised by the senior partners. With proper supervision of the handling of customers' accounts, the unusual nature of the trading in the Gulihur account, involving a large turnover in a single obscure security and trades of substantial blocks with small firms, would have been noted and given rise to a careful inquiry. That both bid and ask quotations were being inserted in the sheets for the customer, in itself a highly unusual practice, was a further "red flag". However, Trapani was virtually unsupervised in his trading activities. By the middle of March, the Millers admittedly became aware of the account and at least Robert Miller was apprised of the relationship between Grimmett and Gulihur and the former's position with ASO. However, as noted, trading was permitted to resume after an interruption, without the thorough inquiry into the nature of the account which should have been made.

[9] For example, Katz testified that Charles Miller authorized the insertion of quotations for the Gulihur account in the sheets, and this testimony is to some extent corroborated by Trapani's testimony that he was directed to insert quotations by a partner of the firm. According to the testimony of a Loeb partner with back-office responsibility, he discussed the Gulihur account with Robert Miller in January 1961 in connection with the short suspension of trading at that time.

[10] The partner who had primary responsibility for supervision of the salesmen at that time was preparing to leave Blair to form a new firm.

Under the clearing arrangement between Blair and Loeb, the latter firm in essence handled all aspects of over-the-counter transactions by Blair's customers once they were executed, including the preparation and mailing of confirmations and monthly statements, the receipt and delivery of securities and money, and the maintenance of appropriate records. It also obtained any payment extensions necessary under Regulation T. In addition, Loeb's research facilities were available to Blair, which had only a one-man research department.

In a statement which it has submitted to us concerning the responsibilities of clearing firms, Loeb urges that we should not impose on a clearing firm the obligation to exercise a general responsibility over the operations of its "correspondent" firm. It states that in its view such action would result in inhibiting clearing relationships contrary to the public interest. We do not undertake in this opinion to impose such a general obligation on a clearing firm. Arrangements between clearing and correspondent firms are a matter of contract between them, so long as the public customers' interests are not jeopardized. But where, as here, the record shows that personnel of the clearing firm were aware of serious irregularities in an account, it seems to us both reasonable and in the public interest to impose on that firm an independent obligation to make appropriate inquiry and take prompt steps to terminate any participation in activity violative of the securities laws.

As previously noted, from the outset of the account checks received by Loeb in payment for purchases were drawn on Grimmett's bank account. In November or December 1960, a partner with back-office responsibility was informed by the margin department of Grimmett's checks and payment problems and a credit report was obtained on Gulihur in December 1960 which stated, among other things, that Gulihur was the son-in-law of and employed by Grimmett, the "owner" and president of ASO; that he was president of Mid-State, and his wife and mother-in-law the other officers; that his estimated monthly income was $950; and that he was slow or delinquent in payments to various creditors. Although the partner testified that he relayed this information to Blair (either to one of the Millers or Neumark) and was told that Gulihur was trading for his own account, under the circumstances, Loeb was clearly on notice that the account was in fact a "front" for Grimmett.

MANIPULATIVE ACTIVITIES

We find, as did the examiner, that Katz participated in a manipulative scheme with respect to ASO stock, thereby willfully violating or willfully aiding and abetting violations of Section 17(a) of the Securities Act, Sections 10(b) and 15(c)(1) of the Exchange Act and Rules 10b–5, 10b–6 and 15c1–2 thereunder. As previously stated, from the time the Gulihur account was opened on November 10, 1960, Trapani inserted quotations for ASO in the sheets pursuant to the orders which he received from Katz who in turn received them from Gulihur or Grimmett. Between November 10 and January 17, 1961, when Goodbody first inserted quotations for ASO, Blair's bids, which were generally the highest or equal to the highest in the sheets, increased from 1$^3/_4$ to 3$^1/_2$ and then declined to 3. During this period, ASO stock was purchased for the account at prices rising from 1$^1/_2$ to 3$^1/_2$ before going down to 3, and sales were effected at prices between 3 and 3$^3/_4$. As found by the examiner, these prices and the quotations based on them were arbitrarily determined and dictated by Gulihur and Grimmett.

According to Katz's testimony, Gulihur had asked him to try to get other dealers into the sheets; he discussed the matter with Trapani; the latter subsequently advised him that Goodbody and Troster would go into the sheets if they would receive $^1/_8$ of a point on each transaction; and Gulihur agreed to this arrangement. Goodbody and Troster began quoting ASO in the sheets on January 17 and February 8, 1961, respectively. The examiner found that Trapani had agreements or at least understandings with Richard Miller, a Goodbody trader, and Woolwich, a Troster trader, pursuant to which quotations for ASO would be inserted on behalf of Goodbody and Troster, respectively, and those firms would receive $^1/_8$ of a point profit on their transactions in ASO stock with Blair. While the three traders denied the existence of any agreement, the examiner took into consideration among other things the fact that Trapani had discussed ASO with the other two before they entered quotations and had told them he had orders in that stock, the similarity of the increasing quotations of the three firms which were generally the highest or equal to the highest in the sheets, and the facts that most of the transactions in ASO effected by Goodbody and Troster were with Blair and that they received a profit of $^1/_8$ on nearly all transactions with Blair.

Katz asserts that he had little experience in over-the-counter trading and did not know he was participating in a manipulation. He states that he relied on Trapani with respect to the propriety of getting other dealers into the sheets, and on the stature of the two other firms involved; and that, since the period was one of generally rising prices and Gulihur had advised him that the price of ASO had been depressed because of year-end tax selling, he had no reason to question the propriety of the increase in the prices given him by Gulihur. We cannot accept these claims. The record, including particularly Katz's own testimony and admissions, demonstrates that at the least he was clearly on notice that Gulihur and Grimmett were engaged in improper market activities and that he was their willing instrument. He admits that he regarded "the whole thing" as suspicious "right from the beginning", and was of the opinion that Gulihur and Grimmett were trying to move the price of the stock up.[11] Moreover, he must or at least should have been aware that the arrangements with Goodbody and Troster which he was instrumental in establishing would have the effect of creating a false appearance of activity in ASO stock and thereby facilitate the manipulation.[12]

We further find that Trapani also willfully violated or willfully aided and abetted violations of the antifraud provisions referred to above. While the record shows that he was directed to enter quotations for ASO in the sheets for the Gulihur account, this does not absolve him from responsibility for his actions. He was aware that it was an unusual practice to enter quotations in the sheets dictated by a customer and that the prices given to him showed a steady rise. Moreover, as noted above he was instrumental in making the arrangements with the Goodbody and Troster traders which he should have known would create the appearance of independent trading interest by those firms and would contribute to a distortion of the market.

The examiner also found that Neumark willfully violated or willfully aided and abetted violations of the antifraud provisions referred to above.

On the basis of the willful violations of its employees, we also

[11] It is no defense to a manipulative program that it was undertaken in the *bona fide* belief that the security should be selling at a higher price. See *Gob Shops of America, Inc.*, 39 S.E.C. 92, 102 (1959).

[12] As we pointed out in *M. S. Wien & Co.*, 24 S.E.C. 4, 13–14 (1946), "it is improper for a dealer who is furnishing advancing quotations of his own to employ an ostensibly independent dealer to publish advancing quotation at the same time so as to raise prices and create an appearance of trading in order to induce purchases or sales of securities. The nature of such conduct is that it creates a false and misleading appearance of active trading . . ." (Footnotes omitted.)

find that Blair willfully violated the antifraud provisions designated above. And, for reasons previously stated, we find that Robert and Charles Miller failed reasonably to supervise with a view to preventing such violations.

The examiner also found that by their trading activities pursuant to the agreement or understanding with Trapani, Richard Miller and Woolwich willfully violated or willfully aided and abetted violations of the antifraud provisions referred to above.

Pursuant to Goodbody's offer of settlement, we find that it failed to exercise sufficiently comprehensive supervision over its trader Miller and that such failure permitted Miller to aid and abet violations of the antifraud provisions resulting from the illegal manipulation and distribution of ASO stock. The record shows that supervision of traders at Goodbody during the period in question was very limited and directed primarily to protection of the firm's capital. The manager of the trading department, who was required to give his approval before a security could be traded for the first time, generally gave such approval if there appeared to be sufficient activity in the stock and if other firms he considered reputable were also trading the stock. If a trading market already existed, there was no requirement to research the issuer or otherwise investigate the stock, and no such research or investigation was undertaken with respect to ASO. Following the commencement of trading, the traders had discretion as to quotations to be inserted. The manager reviewed trading transactions on a daily basis, but admittedly was concerned primarily with profits made and the extent of the firm's position. The partner in charge of the trading division daily reviewed the firm's position in each stock traded and periodically spot-checked particular transactions.

We have repeatedly stressed the duty of a broker-dealer to maintain and enforce adequate standards of supervision and have stated that this duty extends to every aspect of operations, including the trading of securities.[13] We find that here proper supervision would have alerted the firm to the unusual nature of the trading activity in ASO, including the concentration of transactions with Blair at an almost constant profit of $^1/_8$, and caused it to undertake a diligent inquiry. In a brief filed by Goodbody prior to submission of its offer of settlement,

[13] See *F.S. Johns & Company, Inc.*, 43 S.E.C. 124 (1966), *aff'd sub nom. Dlugash v. S.E.C.*, 373 F.2d 107 (C.A. 2, 1967) and *Winkler v. S.E.C.*, 377 F.2d. 517 (C.A. 2, 1967).

it argued, among other things, that "numbers" trading, i.e., trading on the basis of supply and demand and without investigation of the issuer, was during the period in question and still is accepted industry practice, and that it serves a genuine economic function. We do not here express a view on those matters which are beside the point where as here the trading was not independent. At the least, when trading is conducted by the numbers and no basis exists for determining whether price movements have any relation to the investment value of the security, a particularly close supervision must be maintained with a view to detecting any sign of possible manipulation or other irregularity.

The examiner found that Troster failed adequately to supervise its trader Woolwich with a view to preventing the latter's violations in substantially the same manner as discussed above with respect to Goodbody.

Violations of Credit Extension Provisions

The examiner found that there were extensive violations of Section 7(c)(2) of the Exchange Act and Regulation T adopted thereunder by the Board of Governors of the Federal Reserve System, in that credit was extended to Gulihur in contravention of those provisions. In his discussion in this regard, he found that in a number of instances payment for purchases was received after the 7-day period specified by Section 4(c)(2) of Regulation T and extensions of such payment period granted by the New York Stock Exchange, when, under that Section, the transactions should have been promptly cancelled or otherwise liquidated. He further found that on a number of occasions, ASO stock purchased in the account was sold before it was paid for, thus restricting the account, under Section 4(c)(8) of Regulation T, for 90 days to purchases covered by funds already in the account, but that purchases not so covered were effected. Finally, he concluded that in view of the violations of Sections 4(c)(2) and 4(c)(8), the large number of extensions obtained and other factors, the transactions in the Gulihur account, at least from January 1961 on, were not *bona fide* cash transactions, as required by Section 4(c)(1), and were therefore disqualified from inclusion in a special cash account.[14]

[14] A special cash account permits a broker or dealer to effect bona fide cash transactions involving the purchase of a security by a customer in such account which does not have sufficient funds for the purpose only if he does so in reliance on an agreement accepted by him in good faith that the customer will promptly make full cash payment and does not contemplate selling the security prior to making such payment.

Our review of the record leads us to conclude that the examiner's findings are in substance supported by the record, and we find, as provided in Loeb's offer of settlement, that it willfully violated Section 7(c)(2) of the Exchange Act and Section 4(c) of Regulation T. The examiner's finding that Katz aided and abetted these violations is predicated primarily on Katz's involvement with the Gulihur account and the facts that requests for payment were communicated by Loeb to Gulihur through Katz and that the latter furnished Loeb with reasons for payment extension requests. We are not persuaded that the evidence establishes that Katz was aware or should have known that the credit provisions were actually violated. The pertinent facts relating to the receipt of funds and securities in the account appear to have been primarily in the domain of Loeb as the clearing firm performing the back office functions.[15]

OTHER MATTERS

Katz contends that the lapse of more than 4 years between the activities in question and the institution of these proceedings in October 1965 prejudiced him in presenting his defense and deprived him of a fair hearing. He argues that the case against him is based primarily on the testimony of Gulihur, and particularly on the latter's testimony regarding statements made by Grimmett, who because of his death in 1964 was not subject to cross-examination. However, our findings as to Katz's violations do not rely on Gulihur's testimony regarding statements made by Grimmett and, indeed, are not based on such testimony in any respects in which it was inconsistent with Katz's own testimony. Under the circumstances, even aside from the question whether the time interval was unreasonable in light of the complexity of the transactions and the number of firms and individuals involved,[16] it does not appear that it was prejudicial.[17]

PUBLIC INTEREST

Katz urges that a bar, which the examiner recommended as to him, would represent an excessive and discriminatory sanction. He asserts that other respondents who are to receive lesser sanctions had the same information regarding the Gulihur account and had more authority. Katz argues that pre-

[15] The evidence relating to violations of Regulation T was not offered against Trapani, and the allegation that he aided and abetted such violations is therefore dismissed.

[16] *Cf. Deering Milliken, Inc.* v. *Johnston*, 295 F.2d 856, 867 (C.A. 4, 1961).

[17] See *Costello* v. *United States*, 365 U.S. 265, 281–284 (1961).

sumably the examiner relied on disciplinary actions taken against him by the New York Stock Exchange on four occasions between 1962 and 1967, and that such action was based on relatively minor misconduct and was taken in nonjudicial proceedings in which he was not represented by counsel.

The remedial action which is appropriate in the public interest with respect to a particular respondent depends on the facts and circumstances applicable to him and cannot be measured precisely on the basis of action taken against other respondents.[18] The lesser sanction imposed by the examiner on Neumark, to which Katz points, is not before us[19] and as to the other respondents dealt with in this opinion we have deemed it appropriate to accept offers of settlement.[20] In any event, we consider that Katz's culpability is greater than that of the other respondents. He was the primary instrument through which Gulihur and Grimmett were enabled to carry out their illegal activities, and at least until March 1961 was the only one of the respondents who was familiar with and involved in every facet of the transactions centering about the Gulihur account other than the back office matters. Moreover, the various disciplinary actions taken against him by the New York Stock Exchange may properly be taken into consideration in determining an appropriate sanction.[21] Such actions include a six-month suspension in 1967 for failure to conform to Exchange rules relating to required diligence as to customers' accounts and to the opening of accounts for an employee of another member without his employer's consent, and for making misstatements to his own employer on new account cards.[22] Under all the circumstances, we conclude that it is in the public interest to bar Katz from association with any broker or dealer.[23] This does not mean that he may not at some future time be permitted to return to the securities business upon an appropriate showing.

With respect to the offers of settlement, we have, as noted above, determined to accept them, and we have further concluded that in each case the sanction should be the maximum

[18] *Cortlandt Investing Corporation*, 44 S.E.C. 45, 54, (1969).

[19] See *Irving Friedman*, 43 S.E.C. 314, 323, (1967).

[20] See *Cortlandt Investing Corporation*, *supra*, at p. 54.

[21] *Cf. e.g.*, *Reynolds & Co.*, 39 S.E.C. 902, 918, n. 31 (1960).

[22] In the other instances Katz was "severely" censured for failing to obtain sufficient information regarding and closely watch the Gulihur account, was admonished "very strongly" for failing to follow his employer's instructions concerning acceptance of orders in an account, and was admonished for borrowing money from a factor.

[23] The exceptions to the initial decision of the hearing examiner are overruled or sustained to the extent they are inconsistent or in accord with our decision.

provided for in the offer, i.e., 30-day suspensions of Blair from the NASD and of Robert Miller and Trapani from association with a broker-dealer, and censure of Charles Miller, Loeb and Goodbody. In determining to accept the offers, we considered the affirmative recommendations of our staff as well as various mitigating circumstances. Thus, it appears that transactions in ASO stock, which were with other broker-dealers only, represented a very minor part of the overall business of Blair, Loeb and Goodbody during the period in question. These considerations are also pertinent with respect to Robert and Charles Miller. In addition, it appears that the three firms have taken steps to improve their internal procedures so as to prevent a re-occurrence of the type of misconduct involved here. Moreover, Blair has been reconstituted so that Charles Miller is the only individual respondent now associated with it.[24] With respect to Trapani, we have taken into consideration among other things the facts that he has not been the subject of any prior proceedings in his more than 30 years in the securities business, that to some extent he acted pursuant to the specific directions of his superiors, and that he derived no income from the transactions in ASO stock.

An appropriate order will issue.

By the Commission (Chairman BUDGE and Commissioners OWENS, NEEDHAM and HERLONG), Commissioner SMITH concurring in part and dissenting in part.

Commissioner SMITH, concurring in part and dissenting in part:

In my view, the 30 calendar-day suspensions imposed by the majority on Blair, Robert Miller and Trapani should be conformed with the 20 business-day suspension imposed by the hearing examiner on Neumark.

[24] It appears that the firm has 19 general partners in addition to Miller. On the basis of a stipulation between our staff and Blair, Charles Miller and D. H. Blair Securities Corporation, a wholely-owned subsidiary of Blair whose broker-dealer registration was permitted to become effective during the pendency of the proceedings, we will suspend that subsidiary from NASD membership for the same 30-day period as its parent.

In the Matter of

PENNALUNA & COMPANY, INC.

BENJAMIN A. HARRISON

HARRY F. MAGNUSON

File No. 8-11752. Promulgated May 27, 1970

Securities Exchange Act of 1934—Sections 15(b) and 19(a) (3)

OPINION AND ORDER

These proceedings have been remanded to us by the Court of Appeals for the Ninth Circuit[1] for a re-examination, in the light of the Court's reversal of certain of the Commission's findings, of the sanctions ordered with respect to Pennaluna & Company, Inc., a registered broker-dealer ("registrant"), Benjamin A. Harrison, its sole stockholder, and Harry F. Magnuson, formerly a principal stockholder and officer of registrant, and for clarification, if we so desired, of the Commission's opinion with respect to the determinations reversed by the Court.

The Commission's order had revoked registrant's registration, barred Harrison and Magnuson from association with any broker or dealer, and expelled Harrison from membership in the Spokane Stock Exchange.[2] The Commission had found that Harrison, Magnuson and Pennaluna & Company ("Pennaluna"), a partnership composed of Harrison and Magnuson which was registrant's predecessor, had willfully violated antifraud and registration provisions of the Securities Act of 1933 and Securities Exchange Act of 1934 and certain rules thereunder in connection with the sales of unregistered shares of common stock of Silver Buckle Mining Company and West Coast Engineering, Inc.

[1] *Pennaluna & Company, Inc.* v. *S.E.C.*, 410 F.2d 861 (1969), *cert. denied* 396 U.S. 1007 (1970).

[2] Securities Exchange Act Release No. 8063 (April 27, 1967). On May 1, 1967, the Commission stayed the effectiveness of its order pending determination of the petitition for review to be filed by respondents, and on July 6, 1967 it denied a petition for reconsideration of such order. Securities Exchange Act Release No. 8121.

With respect to the registration provisions of the Securities Act, the Court affirmed the Commission's findings of violations in the sale by Pennaluna of stock which it had purchased from Magnuson, a controlling person of Silver Buckle and West Coast, and by Magnuson of a large number of Silver Buckle shares through broker-dealers other than Pennaluna. However, the Court reversed the Commission's findings that the registration provisions were violated by Pennaluna's sales of two blocks of Silver Buckle stock. Magnuson had been instrumental in arrangements by which shares including those two blocks, which were or were in danger of becoming subject to the control of an individual hostile to Silver Buckle's management, had been acquired by persons friendly to that management or who were not likely to sell their shares and create the danger to the market presented by that individual's indicated intention to dump the shares on the market. The Commission found that Magnuson, as a controlling person in Silver Buckle, caused accounts over which he had control and the facilities of Pennaluna to be employed to buy and resell to the public large amounts of Silver Buckle stock, and that Pennaluna thus sold "for or on behalf of a controlling person of the issuer" and therefore became an "underwriter" within the meaning of Section 2(11) of the Securities Act.

The Court stated that it could not accept the conclusion that Pennaluna sold the shares "for or on behalf of" Magnuson. It pointed out that while the shares may have been acquired by Pennaluna at the behest of Magnuson, they were sold on its own behalf. As a consequence of its reversal in these respects, the Court also reversed *pro tanto* the Commission's findings that Pennaluna, Harrison and Magnuson had willfully violated Rule 10b–6 under the Securities Exchange Act as a result of Pennaluna's bids for and purchases of Silver Buckle stock during periods when it and Magnuson were engaged in distributions of such stock.

The Commission's findings that Pennaluna sold the blocks in question "for or on behalf" of Magnuson used that phrase in the sense of acting "for the benefit of" Magnuson rather than as referring to an agency relationship.[3] However, in the pres-

[3] *CF. S.E.C. v. Chinese Consolidated Benevolent Association, Inc.*, 120 F.2d 738, 740 (C.A. 2) *cert. denied* 314 U.S. 618 (1941).

Under another analysis of the transactions in question it could have been found that Pennaluna, which was under common control with Silver Buckle, the issuer, was itself an "issuer" as defined in Section 2(11) of the Securities Act; that other broker-dealers to whom it sold and who purchased with a view to distribution were "underwriters"; and that Pennaluna, Harrison and Magnuson were participants in sales by such underwriters.

ent posture of the case we make the re-examination of the sanctions which the Court directed on the basis only of those findings of violations affirmed by the Court.

In re-examining the sanction issue, we think it is clear that there has been no substantial diminution of the seriousness of respondents' misconduct as compared to that on which the Commission had based the original order. In addition to the findings with respect to the registration provisions that were affirmed by the Court, the Commission had found that Pennaluna, through Harrison, engaged in a manipulative scheme designed to raise the price of Silver Buckle stock; that Harrison made false and misleading statements to other broker-dealers; and that Magnuson was chargeable with knowledge of and was responsible for such misconduct. The Commission had further found that Magnuson, while a director and controlling person of West Coast, violated the antifraud provisions by selling large amounts of West Coast stock without disclosing that company's adverse financial condition. The Court affirmed those findings, and various other violations which the Commission had found were not contested on appeal.[4]

Respondents, in a memorandum submitted to us, argue that lesser sanctions should be imposed, contending among other things that the violations were of a "technical" nature and do not warrant "permanent" penalties; that those violations of the registration provisions which the Court sustained involved only a "modest" dollar amount; that the misrepresentations by Harrison were made to other sophisticated traders; and that the record-keeping deficiencies have been corrected. They state that since commencement of the proceedings registrant and Harrison have conducted themselves in exemplary fashion and again point to Harrison's long period of activity and reputation in the securities business and to registrant's assertedly vital role as a market-maker in silver mining securities in the area. However, we do not view respondents' violations as technical, but rather as of a serious nature and involving basic requirements or prohibitions of the securities laws. Although in terms of dollar amount, the unlawful sales of unregistered Silver Buckle stock may not have been very large, in view of the fact that respondents were put on notice by our staff that the stock might not be saleable without registration, we can-

[4] Among the other violations found were violations of credit extension and record-keeping provisions and failure to make required disclosures regarding the common control of Pennaluna and Silver Buckle and West Coast.

not countenance such wilful violations. Furthermore, a market manipulation and misrepresentatiions, whether made to customers or other broker-deralers, obviously must be viewed with the utmost seriousness.

Considered in their totality, the activities of respondents constitute serious violations of the securities laws which, notwithstanding the mitigating factors advanced, in our opinion makes it appropriate in the public interest that respondents not be permitted to continue to engage in the securities business, and our order herein shall so provide. The bars that are imposed by such order do not, however, necessarily mean that respondents are permanently excluded from the securities business; under the Exchange Act and applicable rules they are not precluded from applying for permission in the future to reenter that business upon an appropriate showing.

Accordingly, IT IS ORDERED that the registration of Pennaluna & Company, Inc. as a broker and dealer be, and it hereby is, revoked; that Benjamin A. Harrison and Harry F. Magnuson be, and they hereby are, barred from being associated with any broker or dealer; and that Benjamin A. Harrison be, and he hereby is, expelled from membership in the Spokane Stock Exchange.

By the Commission (Commissioners OWENS, SMITH, NEEDHAM and HERLONG), Chairman BUDGE not participating.

IN THE MATTER OF

OHIO POWER COMPANY

File No. 3-2287. Promulgated June 8, 1970.

Public Utility Holding Company Act of 1935—Sections 9(a) and 10

ACQUISITION OF UTILITY ASSETS FROM MUNICIPALITY

Application by electric utility subsidiary of registered holding company to acquire municipal electric utility properties which were inadequate to supply electric needs of City's customers without improvements requiring substantial funds and if performed by municipality imposition of substantially higher electric rates than if acquired by applicant, which was only bidder for properties, *granted*, where consideration to be paid is within the range of fairness and proposal otherwise satisfies applicable standards of Sections 9 and 10 of Public Utility Holding Company Act of 1935.

APPEARANCES:

James B. Henry and *Klaus Bergman*, for Ohio Power Company.

Karl W. Sommer, Jr., of Frazier & Sommer, and *Alan P. Buchmann*, of Squire, Sanders & Dempsey, for City of Martins Ferry, Ohio.

R. Moshe Simon, for the Division of Corporate Regulation of the Commission.

FINDINGS AND OPINION OF THE COMMISSION

We have entered an order[1] in these proceedings granting an application pursuant to Sections 9(a) and 10 of the Public Utility Holding Company Act of 1935 filed by Ohio Power Company, an electric utility subsidiary company of American Electric Power Company, Inc., a registered holding company, requesting authorization to acquire from the City of Martins Ferry, Ohio its municipal electric utility system for $4,825,000.

After appropriate notice,[2] public hearings had been held at which representatives of the City were present as *amicus curiae;* briefs were filed by Ohio Power, the City and our Division of Corporate Regulation; a statement of views was

[1] The order, dated June 5, 1970, is attached hereto.

[2] Holding Company Act Release No. 16566 (December 22, 1969).

submitted by a Citizens Committee of Martins Ferry; and we heard oral argument. We now issue our findings and opinion, which are based upon an independent review of the record.

THE SYSTEMS INVOLVED

Ohio Power, one of American Electric's seven principal operating subsidiaries,[3] is engaged in the generation, purchase, transmission and distribution of electric energy in over 550 communities in north-western, east-central, eastern and southern Ohio having an estimated population of 1,628,000 and 518,114 customers as of December 31, 1968. At that date it had generating capacity of approximately 4,400,000 kilowatts ("kw") and its total electric plant less depreciation was stated at $813,413,000. For the calender year 1968, it had electric operating revenues of $226,963,000.

The electric system of Martins Ferry, which has a population of approximately 12,000, provides service to about 4,800 customers and its total revenue during 1968 was $689,253. It has a total generating capacity of 8450 kw, consisting of three steam generators built in 1925, 1930 and 1942, having an aggregate generating capacity of 6500 kw, and three 650 kw diesel generators installed in 1964. It has six distribution circuits, five of which are served by the municipal generating plant, and one with power purchased at wholesale from Ohio Power. During 1968 the City purchased from Ohio Power approximately 20 percent of its total load. The City's electric system has not been providing adequate and reliable electric service to its customers, experiencing numerous outages of services and severe voltage fluctuations. The generating facilities because of their age are unreliable and uneconomic for use except for peaking purposes. The distribution system has been undermaintained and is not designed to meet present or projected requirements of its customers.

THE PROPOSED ACQUISITON

Pursuant to an ordinance of the City Council of Martins Ferry adopted on August 7, 1969, the City published invitations for competitive bids for the purchase of its electric utility properties. On October 14, 1969, Ohio Power submitted its bid of $4,825,000, the only bid received, and on December 18, 1969, the City Council unanimously accepted that bid.

[3] Amercian Electric has 23 subsidairy companies variously engaged in the generation, transmission and sale of electric energy or related businesses.

Upon acquisition of the City's system, Ohio Power proposes to immediately proceed to expand interconnections with Ohio Power's system at a cost of approximately $230,000, and to improve the City's distribution system to the extent necessary at an estimated cost of approximately $100,000. It plans to operate the generating plant on a base-load basis until the increased interconnection is completed, and thereafter to operate the generating facilities for peaking purposes.
It further proposes in about five years to convert the City's present 4-kv distribution system to 12-kv, at an estimated cost of $420,000. It agrees to furnish the City free street-lighting for three years.

STATUTORY STANDARDS

Section 9(a) of the Act prohibits Ohio Power, as a subsidiary of a registered holding company, from acquiring the Martins Ferry utility assets without our prior approval under Section 10.

Under Section 10(c)(2) of the Act, we may not approve the proposed acquisition unless we affirmatively find that "such acquisition will serve the public interest by tending towards the economical and efficient development of an integrated public-utility system." The record supports and we make such finding. Martins Ferry is situated in territory now generally served by Ohio Power and the facilities to be acquired, which as noted are already partly interconnected with Ohio Power, are to be fully integrated with existing and planned facilities of Ohio Power after acquisition. The record indicates that the quality and reliability of electric service in Martins Ferry will be substantially enhanced following the acquisition.

Under Section 10(b), we are required to approve the proposed acquisition unless we find that "(1) such acquisition will tend towards interlocking relations or the concentration of control of public utility companies, of a kind or to an extent detrimental to the public interest or the interest of investors or consumers" or (2) that the consideration "is not reasonable or does not bear a fair relation to the sums invested in or the earning capacity of the utility assets to be acquired." After a review and consideration of the extensive record made at the public hearings herein, we do not find that adverse findings are required under either of these provisions.

With respect to Section 10(b)(1), the Division, while contending that Ohio Power has embarked upon a campaign to acquire all municipally-owned electric systems within or adjacent to its service area and that such program contravenes the provisions of that Section as interpreted in the light of the public policy represented by the federal antitrust laws,[4] nevertheless is of the opinion that the proposed acquisition should be permitted provided the price to be paid meets the test of Section 10(b)(2). It considers that in view of the deteriorated condition of the municipal facilities and the need of the citizens of Martins Ferry for adequate and reliable service, which Ohio Power, the only prospective purchaser, is in a position to supply, the circumstances justify invocation of the "failing company" doctrine to permit the acquisition.[5]

Ohio Power asserts that the acquisition of the City system would not result in any anti-competitive effects which would outweigh the benefits to the public. It states that the City system does not compete and is not capable of competing in any meaningful way with Ohio Power for customers in the area adjacent to the City. It is also asserted that competition between sources of energy would be enhanced in the City's operating territory, which is presently served with gas by a subsidiary of a large natural gas utility system. And Ohio Power claims that because of the physical limitations of the City electric system, and the resulting limitations on the ability of customers to install high load electric appliances, the competition between gas and electric service will be increased upon consummation of the proposed transaction and completion of the system's upgrading and rehabilitation by Ohio Power. It also notes that the proposed acquisition of the Martins Ferry system would not significantly increase the size of Ohio Power. Based on 1968 statistics, such acquisition would increase the number of customers served by Ohio Power by 0.9 percent, and its electric operating revenues, generating capacity and utility plant by 0.3 percent, 0.2 percent and 0.6 percent, respectively.

Disclaiming the existence of any "campaign" to acquire municipal systems, Ohio Power asserts, as the City of Martins Ferry also urges, that the proposed acquisition is in the public interest as the only feasible means of assuring reliable and adequate electric service at reasonable rates to the Martins

[4] *Cf. Municipal Electric Association of Massachusetts* v. *S.E.C.*, 413 F.2d 1052 (C.A. D.C., 1969); *Northern Natural Gas Company* v. *F.P.C.*, 399 F.2d 953 (C.A. D.C., 1968).

[5] The "failing company" doctrine is a judicially created principle that an acquisition does not substantially lessen competition within the meaning of the antitrust laws where the resources of one company are so depleted and the prospect of rehabilitation is so remote that it faces the grave possibility of a business failure, and there is no other prospective purchaser. *Citizen Publishing Co.* v. *U.S.*, 394 U.S. 131, 136-139 (1969).

Ferry customers. It points out that a substantial increase (which it estimates at 10–20 percent) in Martins Ferry's residential electric rates would be necessary merely to continue present operations, and that substantial further rate increases would be required if the City itself were to seek to make improvements for adequately meeting projected peak loads. Ohio Power states that it will apply the rates governing service in its operating territory to service to Martins Ferry customers and estimates that such rates will result in an increase of about 2 percent in the cost of electric service to the average Martins Ferry residential customer.

We recognize that under Section 10(b)(1) of the Act we are required to consider the proposed acquisition in the light of federal antitrust polices,[6] and have examined the competitive factors in the light of the record developed at the hearings. We conclude that it is not necessary for us to determine in this case whether or not Ohio Power has embarked on a campaign of acquisitions as alleged by the Division and that upon consideration of all relevant factors, including particularly the conditions obtaining with respect to the Martins Ferry electric system, approval of the present application does not involve anticompetitive consequences of a kind or to an extent detrimental to the public interest or the interest of investors or consumers as to require disapproval under Section 10(b)(1).

We accordingly turn to the question of the fairness of the proposed consideration. In support of the proposed price of $4,825,000 Ohio Power submitted an analysis which projected estimated revenues for the Martins Ferry properties in the fourth full year of operations by Ohio Power; deducted estimated expense to arrive at estimated operating income; adjusted such income to reflect the value of the generating facilities to be utilized for peaking purposes and the estimated increased usage of electricity by Martins Ferry residential customers; and capitalized the resulting income at 12.5 percent. On such basis it arrived at a range of $4,500,000 to $5,100,000, which as a result of matters developed in the hearings it revised upward somewhat. It asserts that this is a reasonable range of investment to which the projected earnings capacity of the property to be acquired may appropriately be related.

The Division, accepting the formula used as a reasonable means of testing whether or not the proposed price meets the

[6] See, *e.g.*, *Hawaiian Electric Company, Inc;* 44 S.E.C.188 (1970).

standards of Section 10(b)(2) of the Act, raised questions with respect to three aspects of the analysis which in its view suggest a lower price would be necessary to satisfy the statutory requirements. One aspect is Ohio Power's inclusion in incremental operating income of an estimated $66,000 to $132,000 representing the value of the Martins Ferry generating plant for peaking purposes. The Division, citing the age and lack of reliability of the Martins Ferry generators, questioned that all such units would be available for peaking purposes, and in effect suggests that the two oldest steam generators be disregarded, thereby substantially reducing the projected income from peaking operations. Ohio Power points out that the range of values in its analysis was based on a projected use of the generating facilities of between 50 percent and 100 percent, and it argues that an assumed use factor of at least 50 percent for peaking purposes is not unreasonable and gives adequate recognition to the condition of the generators. The second of the questioned items is the inclusion by Ohio Power of a $100,000–$107,000 credit for the additional usage of electricity by residential customers of the municipal system. The Division points out that such credit is based on a projected increase of 75 percent or more in average residential usage of electric power in Martins Ferry and contends that an estimated increase of 50 percent would be a more reasonable and prudent expectation. Ohio Power stresses that its projected average residential usage in 1973 for Martins Ferry customers is about the same as the 1968 average residential usage for all Ohio Power customers, lower than the 1969 average in the Ohio Power Steubenville District in which Martins Ferry is located, and lower than the projected 1973 average u. ıges for any of the six areas in that District. The record indicates that average residential usage in Martins Ferry has been substantially lower than that in surrounding areas, a reflection of the distribution and generating limitations of the municipal system, which will not prevail after acquisition by Ohio Power.

The third aspect questioned by the Division concerns the expected expenditure by Ohio Power of approximately $750,000 during the five years following the acquisition, for expanding interconnections, upgrading the distribution system, and eventually converting it from 4-kv to 12-kv. The Division contends that such amount represents a capital expenditure necessary to assure the anticipated incremental income reflected in the economic valuation of the system, and that in arriving at a reasonable price it is therefore necessary to deduct this amount. The testimony in the record, however, appears to support Ohio Power's contention that at the most only the $330,000 expected to be spent to increase interconnection and improve the distribution facilities should be considered capital expenditure, and that the $420,000 to be spent in about five years to convert to a 12-kv system should be considered maintenance. It appears that Ohio Power in the regular course of maintenance is continually in the process of changing 4-kv equipment to 12-kv without requiring or seeking associated rate increases.

We have considered the evidence in the record and the various contentions respecting economic value, not in order to suggest what the actual income and usage will be for the Martins Ferry system under the operation of Ohio Power, but only to determine whether we are required under Section 10(b)(2) to find that the consideration proposed to be paid is not reasonable or does not bear a fair relation to the sums invested in or the earning capacity of the assets to be acquired. Having in mind that the price proposed here was arrived at arm's length after the City had indicated that no bids lower than $4,000,000 would be acceptable, and the inherent inability to attain precision in valuations based on future projections, we conclude that the proposed price is within a reasonable range of fairness and that the more conservative projections of the Division do not require an adverse finding.[7]

CONCLUSION

We find that the applicable standards of the Act are satisfied, that no adverse findings are necessary, and that it is appropriate in the public interest and in the interest of investors and consumers that the application be granted.

By the Commission (Chairman BUDGE and Commissioners OWENS, SMITH, NEEDHAM and HERLONG).

[7] Although the Citizens Committee stated that additional data might possibly show a fair price to be $6,000,000, there does not appear to be any basis for such a position.

IN THE MATTER OF

DARRELL G. HAFEN

doing business as

WESTERN SECURITIES COMPANY

File No. 3-1888. Promulgated June 12, 1970

Investment Advisers Act of 1940—Section 203(d)

INVESTMENT ADVISER PROCEEDINGS

Grounds for Denial of Registration

Where applicant for registration as investment adviser had used for own benefit funds obtained from customer for investment for minor children, issued in purported payment for securities, checks unsupported by adequate funds, and made false and misleading statements of material fact in registration application, *held*, in public interest to deny application.

APPEARANCES:

Joseph F. Krys and *John M. High*, of the Denver Regional Office and *Delano S. Findlay* of the Salt Lake City Branch Office of the Commission, for the Division of Trading and Markets.

Darrell G. Hafen, pro se.

FINDINGS, OPINION AND ORDER

In this proceeding pursuant to Section 203(d) of the Investment Advisers Act of 1940 ("Advisers Act") to determine what action should be taken on an application by Darrell G. Hafen for registration as an investment adviser,[1] the hearing examiner submitted an initial decision in which he found that applicant willfully violated antifraud provisions of the Securities Exchange Act of 1934 ("Exchange Act") and rules thereunder and willfully made false and misleading statements of

[1] Pursuant to Section 203(e) of the Adviser Act, our order instituting this proceeding postponed the effective date of the application for registration for 90 days. With applicant's consent, within the 90 days we entered an order further postponing the effective date of the application until final determination of whether or not such registration should be denied.

material fact and omitted to state .aterial facts required to be stated in his application for reg.stration. The hearing examiner concluded that in view of those findings it was in the public interest to deny applicant's application for registration as an investment adviser.

Applicant advised the hearing examiner that he was giving notice "of a petition for review" of the initial decision. Although this notice did not comply with our Rules of Practice,[2] we accepted it as a petition for review and gave applicant 30 days within which to file a brief in support of his petition. After more than 60 days had elapsed without the filing of any supporting brief by applicant, our Division of Trading and Markets filed and served a motion to adopt the initial decision of the hearing examiner as the final decision in this proceeding, contending that the applicant had abandoned his petition for review by failing to prosecute it.[3] In answer to that motion applicant filed a statement reciting that he has been out of the country for the "past 3 weeks of 5" and requesting "a hearing before the full Commission." This document did not specify any exceptions to the initial decision nor did it present any supporting argument. Nevertheless, in view of the fact that applicant has appeared in the proceeding without counsel, we have undertaken to review the initial decision.

After an independent review of the record, we agree with the findings and conclusions of the hearing examiner and we adopt the detailed findings set forth in his initial decision. As the examiner found, the evidence in the record shows that applicant willfully violated the antifraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. In 1963 applicant obtained $15,000 from an investor upon the representation that applicant would invest such funds in the common stock of the Syntex Corporation for the accounts of the investor's minor children. Instead applicant purchased such securities in the name of Green and Sand Hollow Springs Water Company, of which he was president, and thereafter sold such securities and applied a large portion of the proceeds to his own use and benefit.

In June 1968, applicant issued a check in the amount of

[2] Rule 17(b) of our Rules of Practice states that any person seeking Commission review of an initial decision shall serve and file a petition for Commission review containing exceptions to the initial decision and indicating specifically the findings and conclusions as to which exceptions are taken together with supporting reasons.

[3] Rule 17(b) of the Rules of Practice provides that any objections to an initial decision not saved by written exception filed pursuant to the Rule will be deemed to have been abandoned and may be disregarded.

$499,994.88 drawn on a bank in Mexico in purported payment of securities purchased by him. The check was not supported by funds and was dishonored, and the securities were not delivered to applicant. In September 1968, applicant issued checks drawn on a Swiss bank in the amounts of $4,200 and $840 to a broker-dealer in purported payment for the purchase of other securities. These checks were also dishonored but prior thereto applicant resold the securities to the broker-dealer and received the proceeds of such sale, which he retained.[4]

As the examiner further found, the record shows that applicant, in his application for registration as an investment adviser, willfully made false and misleading statements of material fact and omitted to state material facts required to be stated therein. Applicant answered in the negative the question in the application form as to whether he had been the subject of any desist and refrain or similar order, whereas, in fact, a Desist and Refrain Order had been issued against him (and others) by the Division of Corporations of the State of California on July 5, 1966. Applicant also omitted to show, as required by the application form, that he had been formerly employed as a registered representative by a broker-dealer firm. Applicant further stated his principal place of business to be at an address which he did not in fact occupy, his sublease of such office space having been terminated for nonpayment of rent before his application was filed.[5]

In view of the above findings, we conclude, as did the hearing examiner, that it is in the public interest to deny the application.[6]

Accordingly, IT IS ORDERED that the application of Darrell G. Hafen for registration as an investment adviser be, and it hereby is, denied.

By the Commission (Chairman BUDGE and Commissioners OWENS, SMITH, NEEDHAM and HERLONG).

[4] On March 8, 1970, the United States District Court for the District of Utah issued a preliminary injunction against applicant enjoining him pending trial on the merits from further violations of antifraud provisions of the Exchange Act by, among other things, knowingly issuing any insufficient fund check or draft in purported payment for any securities purchased. *S.E.C. v. Darrell G. Hafen*, U.S.D.C., D. Utah, Civilian Action File No. C8-70.

[5] Applicant's answer to the Division's motion to adopt the hearing examiner's decision stated that he was moving out of the country and that he would advise us of his foreign address.

[6] We have not construed applicant's answer to the Division's motion to adopt the initial decision as constituing a request for oral argument but rather a request that the Commission itself review the initial decision, which we have done. Assuming, however, that applicant's statement was a request for oral argument, it was not made within the time provided for filing his brief, as required by Rule 21(a) of our Rules of Practice. Under all the circumstances of this case, we conclude that oral argument would serve no useful purpose and that no reason exist why we should disregard this requirement of our Rules.

IN THE MATTER OF

BABCOCK & COMPANY

LOUIS W. BABCOCK

ROBERT T. STEAD

File No. 3–1512. Promulgated June 19, 1970

Securities Exchange Act of 1934—Section 15(b) and 15A

BROKER-DEALER PROCEEDINGS

Grounds for Remedial Sanctions

Offer, Sale and Delivery of Unregistered Securities
Failure to Disclose Participation in Distribution
Failure to Comply with Record-Keeping Requirements
Inaccurate Financial Report
Improper Extension of Credit

Where registered broker-dealer and associated person or persons offered, sold and delivered unregistered securities, failed to furnish purchasers with written notification of its participation in distribution of securities, failed to comply with record-keeping requirements, and filed inaccurate financial report, and where broker-dealer improperly extended credit to customers, in willful violation of Securities Act of 1933 and Securities Exchange Act of 1934, *held*, in public interest to revoke broker-dealer's registration and expel it from membership in registered securities association and to bar associated persons from association with any broker-dealer with provision for supervised association after specified periods upon appropriate showing.

APPEARANCES:

Joseph F. Krys and *G. Gail Weggeland*, for the Division of Trading and Markets of the Commission.

Alexander H. Walker, Jr., for Babcock & Co. and Louis W. Babcock.

Norman S. Johnson, of Gardiner & Johnson, for Robert T. Stead.

FINDINGS AND OPINION OF THE COMMISSION

Following hearings in these proceedings pursuant to Sections 15(b) and 15A of the Securities Exchange Act of 1934 ("Exchange Act"), the hearing examiner issued an initial decision in which he concluded that the registration as a broker and dealer of Babcock & Co. ("registrant"), a partnership, should be revoked and that it should be expelled from membership in the National Association of Securities Dealers, Inc. He further concluded that Louis W. Babcock, registrant's only active partner, and Robert T. Stead, a salesman and trader for registrant, should be barred from association with any broker or dealer, with the proviso that after six months each of them may become associated with a broker-dealer in a supervised capacity upon a showing that he will be adequately supervised. We granted the petitions of registrant, Babcock and Stead for review of the initial decision. Respondents and our Division of Trading and Markets ("Division") filed briefs, and we heard oral argument. Our findings are based upon an independent review of the record.

Registrant became registered with us in April 1964. Registrant's principal office was in Ogden, Utah, and Stead was employed in its only branch office, which was located in Salt Lake City and accounted for about 80 percent of registrant's business.

TRANSACTIONS IN UNREGISTERED SECURITIES

The record establishes that from about April 20 to June 1967, respondents willfully violated the registration provisions of Sections 5(a) and 5(c) of the Securities Act of 1933 in the offer, sale and delivery of the common stock of Triumph Corporation, and that during August and September 1967 registrant willfully violated those provisions in the offer, sale and delivery of the stock of Silver Shield Corporation.

Registrant offered and sold Triumph stock on behalf of the issuer when no registration statement under the Securities Act had been filed or was in effect as to such stock. Sales of the stock were effected by Babcock through an account in registrant's principal office in Triumph's name, and by Stead through an account in the branch office entitled "R & E Investment" which replaced the Triumph account and was opened on April 20, 1967.[1] Both accounts were opened by Hugo Emery who, as Babcock and Stead knew, was president of Triumph, and the only transactions in those accounts were sales of Triumph stock. The R & E account contained Triumph

[1] Babcock testified that the earlier account was mistakenly opened in the name of Triumph instead of R & E.

stock that was borrowed by the company and was to be sold to raise funds for its drilling program.[2] Registrant purchased for its trading account a total of 17,000 shares of Triumph stock from the Triumph account on March 22 and April 19, 1967, and thereafter sold a number of such shares, and, in addition, it sold around 70,000 shares of Triumph stock in the R & E account between April 20 and May 1, 1967.

Stead claims that he was not involved in the transactions in the R & E account that were effected prior to April 28 because he assertedly did not commence his employment with registrant until April 27.[3] While there is some uncertainty in the record as to the exact date of the beginning of Stead's employment, taken as a whole the evidence supports the examiner's finding that such date was around April 20. The first transaction in the R & E account with registrant which Stead handled as a salesman was effected on that date, and the record indicates that the account was opened by Stead. Moreover, on that date the last sale of Triumph stock was effected in a similar account maintained with Stead's previous employer which had also been opened by Emery for the purpose of selling such stock and was handled by Stead, and also on that date Stead effected the first transaction in his personal trading account with registrant. It further appears that Stead ceased trading in his personal account with his prior employer on April 21. Stead additionally participated in the distribution of Triumph stock in that from April 24 to May 1, 1967 he purchased 20,000 Triumph shares from the R & E account for his own trading account with registrant and resold virtually all of such shares during that period.

Respondents assert that reasonable inquiry concerning the status of Triumph stock had been made by Stead when he handled the R & E account for his previous employer. Stead testified that he had questioned Emery who stated that he did not own that stock, that it was not control stock, and that he was acting as agent for certain stockholders who did not want their identities disclosed. Stead also testified that he communicated with the transfer agent who stated the stock was freely tradeable. Stead further testified that he was not aware that the transfer agent was also an officer of Triumph. Registrant and Babcock also assert that 'a subsequent inquiry of the

[2] The Stockholders who loaned the shares to Triumph had the option of accepting a certain payment for or the return of such shares.

[3] Stead's answer originally recited that his employment began about April 15, and was amended at the hearing to state April 23.

transfer agent was made by Stead at the instance of registrant after Stead became employed by registrant, and that such inquiry confirmed the free trading status of the stock.

In our opinion, respondents could not properly rely on the statements made to Stead by Emery and the transfer agent regarding the status of the Triumph stock in the R & E account maintained with Stead's previous employer, particularly since Emery had refused to disclose the identity of the persons for whom he was purportedly acting as agent and had previously demonstrated to registrant and Stead his strong interest in selling Triumph shares.[4] That further investigation was necessary is evidenced by the transfer agent's testimony that had Stead asked her to identify the beneficiary of the R & E account, she would have named Triumph.[5] The subsequent inquiry by Stead while employed by registrant was made long after the sales in question and after our staff had inquired into the propriety of registrant's transactions in Triumph stock. We conclude that Babcock and Stead failed to make sufficient inquiry despite the various circumstances which should have alerted them to the need for such inquiry.[6]

Registrant effected transactions in Silver Shield stock in an account maintained in registrant's branch office in the name of "J. J. Minerich & Co.". The account was opened by William Campbell, Jr., who was president of Silver Shield as well as president of Minerich, for the purpose of selling Silver Shield stock as to which no registration statement under the Securities Act had been filed or was in effect. The only transactions in the account were sales of Silver Shield stock at Campbell's direction, and 125,000 shares were sold from August 21 to September 4, 1967. Those shares were subject to registration because Campbell controlled both the issuer and Minerich and the latter was therefore an "issuer" and registrant an underwriter within the meaning of Section 2(11) of the Securities Act. In addition, at least a portion of those shares had been

[4] Pursuant to an option granted by Emery in March 1967, registrant's purchases of 17,000 shares from the Triumph account on March 22 and April 19, 1967 were effected at 10 per share, when the market price was considerably higher as evidenced by substantially contemporaneous prices of 14¢ and 17½¢ at which registrant purchased or sold such shares. We find, as did the examiner, that this option was given to registrant as a special inducement to sell Triumph stock. We further note that, in the course of Stead's previous employment, Emery had offered compensation for inserting quotations for Triumph stock in the sheets, although such offer was declined by Stead.

[5] Stead refers to testimony of the transfer agent indicating that she had had a legal opinion that the Triumph stock "involved" was freely tradeable. However, that opinion, which apparently was oral, did not relate specifically to the stock in the R & E account.

[6] See *Strathmore Securities, Inc.*, 43 S.E.C. 575, 585—86 (1967), *aff'd* 407 F.2d 722 (C.A. D.C. 1969); *S.E.C.* v. *Culpepper*, 270 F.2d 241, 251 (C.A. 2, 1959); *S.E.C.* v. *Mono-Kearsarge Consolidated Mining Company*, 167 F. Supp 248, 259 (D. Utah, 1958).

acquired by Minerich from the issuer around the time of the sales and registration of such shares was required because Minerich and registrant were statutory underwriters. Checks for the proceeds of the sales, which were prepared by registrant's principal office, were sent to Minerich at the same address Campbell had as a customer of registrant and were endorsed by Campbell as its president.[7]

The salesman who handled the account testified that, pursuant to his inquiry in connection with opening the account, he was advised by Campbell that the stock was not insider or control stock. We agree with the examiner that the salesman failed to make adequate inquiry with respect to the tradeability of the stock. The salesman knew that Campbell was president of Silver Shield but did not inquire as to the nature of Campbell's relationship with Minerich, whose account was opened by Campbell, with a view to determining whether Minerich and Silver Shield were subject to his common control.

As further found by the examiner, registrant, while participating in the distribution of Triumph stock, effected transactions in the stock without giving to purchasers at or before the completion of each purchase written notification of the existence of its participation in the distribution in willful violation of Section 15(c)(1) of the Exchange Act and Rule 15c1–6 thereunder. We also find, as did the examiner, that Babcock and Stead willfully aided and abetted registrant's violations of those provisions.

FAILURE TO COMPLY WITH RECORD-KEEPING REQUIREMENTS

The record supports the examiner's finding that registrant, willfully aided and abetted by Babcock, willfully violated the record-keeping provisions of Section 17(a) of the Exchange Act and Rule 17a–3 thereunder, in failing to make and keep current and accurate certain required books and records.

An inspection by our staff in late September and early October 1967 disclosed that registrant failed to maintain a commission payable account and a record of monies borrowed and loaned and securities pledged, that the general ledger had not been posted since May 31, 1967, and that current trial balances had not been prepared for June, July or August 1967. Belated trial balances for those months prepared at the request of our staff were deficient in failing to indicate, among other things, securities pledged, monies borrowed, and sales

[7] The same salesman also opened and handled Campbell's personal account.

commission payable. And the brokers' and customers' accounts showed only net figures instead of separate aggregate debit and credit balances. In addition, registrant's stock position records were not current or accurate.

The condition of registrant's records was such that registrant's chief cashier had characterized them as being in a state of "turmoil" and registrant ceased doing business from October 6 to December 29, among other things, to reconstruct the books and records and install a new bookkeeping system.

We further find, as did the examiner, that Stead willfully aided and abetted registrant's bookkeeping violations to the extent that they involved deficiencies in his individual trading account with respect to matters that were subject to his control. Stead's account was rendered inaccurate by virtue of, among other things, the arrangements involving the delivery of his own securities to registrant for the purpose of future sale. As Babcock advised Stead, such securities were not entered in Stead's account. Babcock did not wish to have those securities reflected on registrant's books because of the additional work and expense that would be involved in connection with an impending audit of registrant's books and because he considered many of them to be of poor quality. Following the sale by Stead of such securities, Babcock in some instances entered them in the Stead account for the first time. In other instances no entry was made to reflect receipt of a security whose sale was recorded, thereby giving the misleading appearance of a short sale. A reconstructed account subsequently prepared by registrant's chief cashier also showed substantial differences in money balances and securities received, with the disparity in money balances amounting to $23,875 as of May 31, 1967.

Registrant and Babcock urge that any violations were not willful, and that the problems in this respect resulted from an increase in business and the difficulty of obtaining and retaining competent help and were similar to those experienced by other firms. It is well established, however, that a finding of willfulness does not require an intent to violate the law; it is sufficient that the person charged with the duty intentionally commits the act which constitutes the violation.[8] Although registrant and Babcock were warned by our staff in 1965 and 1966 of record-keeping deficiencies and registrant was unable

[8] See *Tager* v. *S.E.C.*, 344 F. 2d. 5, 8 (C.A. 2, 1965), and cases there cited.

to maintain its records on a current basis, Babcock engaged Stead in April 1967 to increase business volume, and following his employment, registrant's volume increased 60 percent. Although it appears that registrant contracted to purchase a bookkeeping machine prior to Stead's employment, there was a delay in its arrival and programming, and it kept breaking down.

Stead points out that, as found by the examiner, he was not employed in a managerial capacity, and argues that he is not responsible for registrant's record-keeping deficiencies with respect to his own account which was kept in the principal office and supervised by Babcock. As previously indicated, however, we have limited his culpability to the deficiencies found in his own account of which he knew or should have known because they involved matters subject to his control.

Inaccurate Financial Report

Registrant's report of financial condition as of May 31, 1967, which was signed and sworn to by Babcock and was filed with us in July 1967, contained materially inaccurate statements. That report showed a net worth of $53,880 and current liabilities of $185,099, including commissions payable of $3,024. Liabilities were understated by at least $9,152, representing commissions and other moneys payable to Stead.[9] In addition, the report referred to the existence of an "automatic" bank loan of up to $25,000 in the event of an overdraft position when, in fact, no such loan existed.

We agree with the examiner that in the above manner registrant, willfully aided and abetted by Babcock, willfully violated the reporting provisions of Section 17(a) of the Exchange Act and Rule 17a–5 thereunder. Although Babcock asserts that he signed the report in reliance upon the certified public accountant who prepared it, it is clear that he had the primary responsibility for the accuracy of the information to which he swore and that he cannot shift such responsibility to the accountant.[10]

[9] The figure of $9,152 is based on corrections made to the financial report submitted by registrant's auditors in January 1968. An earlier reconstructed version of Stead's account prepared in November 1967 by registrant's chashier showed an understatement of $23,875 in moneys payable to Stead, but it is not clear whether the auditors took the changes reflected in the cashier's version into account.

[10] See *Thompson & Sloan, Inc.*, 40 S.E.C. 451, 456 (1961); *Interstate Hosiery Mills, Inc.*, 4 S.E.C. 706, 721 (1939).

The examiner also found that Stead willfully aided and abetted registrant's violation of the reporting provisions. The record before us, however, does not contain sufficient evidence to support this finding.

IMPROPER EXTENSION OF CREDIT

Registrant and Babcock do not dispute the hearing examiner's conclusion, and we find, that between April 1967 and January 1968 registrant violated the credit provisions of Section 7(c) of the Exchange Act and Sections 4(c)(2) and 4(c)(8) of Regulation T promulgated thereunder by the Board of Governors of the Federal Reserve System. We further conclude, as did the examiner, that such violations were willful. As found by the examiner, registrant in a number of instances failed promptly to cancel or liquidate purchases by customers in cash accounts handled by a salesman in registrant's branch office in which full payment was not made within seven business days. Registrant also permitted customers to purchase securities in cash accounts which did not contain sufficient funds for such purchases prior to execution and in which during the preceding 90 days securities were purchased and, without full payment being made, were sold.[11]

These respondents assert that registrant was denied adequate time to prepare a defense by virtue of an amendment to the charge of Regulation T violations in the order for proceedings requested by the Division and granted by the hearing examiner in the course of the hearings. The amendment changed the allegation charging a violation of Section 4(c)(5), which requires payment within 35 days against delivery, to one charging a violation of Section 4(c)(2), which requires payment within seven business days. In our opinion no prejudice has been shown. Registrant had adequate time to prepare a defense to the amended charge, and additional time was not requested by it. In any event, the charge as amended was based upon registrant's own records, and not upon unexpected evidence.

OTHER MATTERS

Respondents assert that the hearing examiner's treatment of certain charges as to which he determined not to find a violation or, in one instance where he found a violation, not to consider it in imposing a sanction, prejudicially influenced his evaluation of the sanctions to be imposed,[12] and evidenced bias

[11] In our opinion the record does not support the hearing examiner's further finding that Babcock and Stead aided and abetted the violations of Regulation T. Moreover, Babcock was not charged with a failure of adequate supervision.

[12] The examiner held that the conduct involved in one of the charges did not constitute a violation of the designated statutory provisions; refused to sustain another charge on the ground that the conduct in question was not willful; held that a third charge was not sustained by a preponderance of the evidence; and determined not to base any sanctions upon a fourth charge, as to which he found a violation, because he was unable to find any precedent for such finding.

against them. There is no substance to this assertion. In our opinion, it was appropriate for the examiner, in considering the Division's contentions with respect to those charges, to discuss them fully and explain his reasons for rejecting them so that the Division could determine whether to seek review of his findings. We consider that the examiner who is legally trained and judicially oriented, would not be prejudicially influenced by those findings. Moreover, our determination of the question whether the sanctions ordered by the examiner should be set aside or reduced is based on our independent examination of the record with respect to the issues raised by respondents' petitions for review.

Public Interest

Registrant and Babcock contend that the sanctions imposed upon them by the examiner are unduly severe and not comparable to those imposed in analogous cases. They assert among other things that customers have suffered no losses, and that registrant "voluntarily" suspended business for almost three months to make its books and records current and accurate and has maintained proper records since, has closed its Ogden office and no longer employs Stead, has prohibited its traders from maintaining personal accounts with it, and has retained a new accounting firm and legal counsel to insure future compliance with applicable requirements. Finally, they state that our staff has lodged no complaints against them since the hearings which were held in May 1968, and that barring Babcock from all but supervised association (after six months) will remove him permanently from any meaningful participation in the securities business and is penal in nature.

In our opinion, the factors presented by registrant and Babcock and the fact that we have made no adverse finding against Babcock as to the Regulation T charge are not sufficient to warrant a reduction in the sanctions imposed upon them by the examiner. The violations we have found here demonstrate either an inability or unwillingness to operate registrant's business in conformity with applicable requirements, even after these respondents were alerted to certain of those requirements by our staff. It is mere speculation to affirm that no customer suffered a loss where securities are distributed without the safeguards provided by full disclosure of pertinent information, and where records are not properly kept. The suspension of registrant's operations to correct its records was pursuant to Babcock's understanding from conversations with our staff that otherwise steps would be taken to close the business. With respect to the asserted absence of any staff complaint against these respondents since the hearings, we note that in April 1969 (prior to their assertion), upon the recommendation of our staff, we instituted broker-dealer proceedings against them charging willful violation of the registration provisions of the Securities Act in 1968.[13]

The remedial action which is appropriate in the public interest with respect to any particular respondent depends on the applicable facts and circumstances and cannot be measured precisely on the basis of the action taken against other respondents.[14] The sanctions imposed are remedial, not penal, in nature and are designed to protect investors and the public interest by barring registrant from the securities business and deterring Babcock as well as others in the industry from committing violations of the securities laws. The requirement of supervised association in any future employment will not necessarily be permanent. A future employer would not be precluded from making a showing in favor of permitting Babcock to occupy a supervisory position.[15]

Stead urges that no sanction be imposed upon him. As we have seen, Stead's participation in the violations found, except for those relating to the distribution of Triumph stock, was more limited than Babcock's, and we have exonerated him from responsibility in connection with registrant's inaccurate financial report and Regulation T violations. He states that, unlike Babcock, he did not occupy a managerial position with registrant and had received no prior warnings of misconduct, that he has been in the securities business for 15 years without any other complaint, and that he is now the owner and principal of a broker-dealer firm employing about 20 persons and the sanction ordered by the examiner would close that business. We note, however, that Stead, as well as registrant and Babcock, was named as a respondent in the broker-dealer proceedings instituted in 1969, and that those proceedings are pending against him. Under all the circumstances, while Stead has not made a sufficient showing to warrant setting aside the

[13] Pursuant to an offer of settlement in those proceedings submitted by registrant and Babcock without admitting or denying the allegations, those respondents were found, among other things, to have willfully violated the registration provisions as alleged, registrant's broker-dealer registration was suspended for 30 days, and Babcock was suspended from association with any broker-dealer for a like period. Securities Exchange Act Release No. 8804 (January 21, 1970).

[14] See *Dlugash* v. *S.E.C.*, 373 F.2d 107, 110 (C.A. 2, 1967); *Century Securities Company*, 43 S.E.C. 371, 384 (1967), *affd sub nom. Nees* v. *S.E.C.*, 414 F.2d 211 (C.A. 9, 1969).

[15] See *Melvyn Hiller*, 43 S.E.C. 969, 974 (1968), *aff'd sub nom. Gross* v. *S.E.C.*, 418 F.2d 103 (C.A. 2, 1969).

sanction imposed by the examiner, we consider that it would be appropriate to reduce such sanction by changing the proviso to the bar order so that Stead may become employed in a supervised capacity after three months, upon a showing of adequate supervision.

An appropriate order will issue.[16]

By the Commission (Chairman BUDGE and Commissioners OWENS, SMITH and NEEDHAM), Commissioner HERLONG not participating.

[16] The exceptions to the initial decision of the hearing examiner are overruled or sustained to the extent they are inconsistent or in accord with our decision.

In the Matter of

MICHIGAN CONSOLIDATED GAS COMPANY

MICHIGAN CONSOLIDATED HOMES CORPORATION

File No. 3-2111. Promulgated June 22, 1970

Public Utility Holding Company Act of 1935—Sections 9(a) and 10

ACQUISITION BY PUBLIC UTILITY SUBSIDIARY COMPANY OF REGISTERED HOLDING COMPANY OF SECURITIES OF NON-UTILITY COMPANY

Application under Sections 9(a) and 10 of Public Utility Holding Company Act of 1935 for approval of proposed acquisition, by public-utility subsidiary company of registered holding company, of securities of non-utility subsidiary company which proposed to construct low and moderate income urban housing projects pursuant to National Housing Act, *denied*, as not meeting standards of Holding Company Act.

Acquisition by public utility subsidiary company of registered holding company of stock and notes of wholly owned subsidiary company formed to construct and operate housing projects under National Housing Act *may not be authorized* under "other business" clauses of Section 11(b)(1) of Public Utility Holding Company Act of 1935 in absence of showing of operating or functional relationship between such nonutility business and operations of integrated public utility system.

Acquisition of ownership and management of a housing corporation *does not meet* test for exemption under Section 9(c)(3) of Public Utility Holding Company Act of 1935 as being appropriate in ordinary course of business of public-utility subsidiary company of a registered holding company.

Appearances:

Arthur R. Seder, Jr., and *Sidley & Austin*, for Michigan Consolidated Gas Company and Michigan Consolidated Homes Corporation.

Solomon Freedman, *Aaron Levy* and *H. Kennedy Linge*, for the Division of Corporate Regulation of the Commission.

FINDINGS AND OPINION

On March 31, 1969, the Commission, by a divided vote, granted an application, filed pursuant to the Public Utility Holding Company Act of 1935 ("Act"), for authorization to Michigan Consolidated Gas Company ("Michigan Consolidated") to provide financing for a housing project in Detroit, Michigan, through investment in and loans to its wholly-owned subsidiary company, Michigan Consolidated Homes Corporation ("Homes Corporation"), a company which was organized to construct and operate low and moderate income housing projects as a "limited dividend" housing corporation under the National Housing Act.[1] That housing project has been virtually completed and two additional projects (Inkster and Elmwood) are presently under construction for which funds have been advanced on notes issued by Homes Corporation to Michigan Consolidated. These two companies have now filed another application relating to the financing of the two additional housing projects.

Public notice of the instant application was given affording any interested person an opportunity to request a hearing. No hearing has been requested or ordered. Pursuant to the notice and the agreement of applicants, we have considered the matter on the application, certain additional information supplied by applicants, and the briefs filed in the prior proceedings.

PROPRIETY OF ADVANCES AND NOTES

Michigan Consolidated is a gas utility subsidiary company of American Natural Gas Company, a registered holding company under the Act. As a subsidiary company of a registered holding company, Michigan Consolidated is prohibited by Section 9(a)(1) of the Act from acquiring any securities or any other interest in any business without our approval under Section 10. The prior Commission action authorized Michigan Consolidated, pursuant to its request, to acquire up to $500,000 in common stock and up to $3,000,000 of short term promissory notes of Homes Corporation, in connection with a proposal by Homes Corporation to construct a housing project of 130 units on 6.5 acres in the Detroit inner-city area at an estimated cost of $2,340,000. It was proposed that upon completion of the construction the outstanding notes would be retired with the proceeds of a mortgage loan which Homes Corporation ex-

[1] *Michigan Consolidated Gas Company*, 43 S.E.C. 1108. Commissioners Smith and Wheat held that the acquisition by Michigan Consolidated of stock and notes of Homes Corporation was permissible under the "other business" clauses of Section 11(b) (1) of the Act. Commissioner Owens, while concluding that such acquisitions could not be authorized under the standards of Section 11(b) (1), concurred in the authorization, finding that the transactions could qualify as exempted acquisitions in the ordinary course of Michigan Consolidated's business under Section 9(c) (3). Chairman Budge dissented holding that such acquisitions met neither the tests of Section 11(b) (1) nor those of Section 9(c) (3).

pected to obtain from the Federal National Mortgage Association.

Homes Corporation obtained a mortgage loan of $2,086,000 on the first project, and used $1,900,000 of the proceeds to retire a like amount of notes it had issued to Michigan Consolidated. It also appears that as of March 20, 1970, Michigan Consolidated had made advances of $1,855,000 and $410,000, respectively,[2] evidenced by notes issued to it by Homes Corporation, to finance construction of the two new housing projects, one of which is in Inkster, a suburb of Detroit.

The application now before us requests authorization for Michigan Consolidated to acquire and for Homes Corporation to issue an additional $500,000 in Homes Corporation stock to provide equity capital for the two projects now proposed and others, and up to $6,000,000 in short term Homes Corporation notes to provide for construction and other expenses for the Inkster and Elmwood projects.

The interim financing for the two new projects was not covered by the authorization of March 31, 1969. Any reading of the opinions of the Commissioners who joined in the prior authorization makes it clear that such authorization was limited to the specific housing project described in the application then before the Commission. Repeated references were made to a housing project in the Detroit inner city, to the conditions existing in that area and to the fact that such area was in Michigan Consolidated's primary service area. That Michigan Consolidated and Homes Corporation contemplated that they might undertake additional housing construction projects in other parts of the Detroit area is not a basis for any inference or finding that the authorization covering the first project would extend to subsequent projects. Certainly, the retirement of $1,900,000 in notes issued in connection with the financing of the first housing project for which authorization was granted did not authorize advances and notes in an equivalent amount for new and different projects.[3]

THE OTHER BUSINESS CLAUSES OF SECTION 11(b)(1)

We overrule the prior Commission determination and find that authorization for financing of housing projects of this

[2] As of May 15, 1970, six additional notes had been issued as follows: two on April 15, 1970, in the amounts of $70,000 and $15,000; two on May 13, 1970, in the amounts of $140,000 and $30,000; and two on May 15, 1970, in the amounts of $200,000 and $227,832.

[3] In view of the illegality of the transactions respecting the two projects, Michigan Consolidated must divest itself of the interests concerned. We of course do not hereby intend to and we do not undertake to withdraw or set aside the previous authorization.

nature by registered holding companies or subsidiary companies thereof under the Holding Company Act is not permissible under the standards and requirements of that Act.

Section 10(c)(1) directs that we shall not approve "an acquisition of securities . . . or of any other interest . . . which is detrimental to the carrying out of the provisions of Section 11." Section 11(b)(1) requires us to limit the operations of a registered holding company system to a single integrated public-utility system (or under certain conditions more than one) and to "such other businesses as are reasonably incidental, or economically necessary or appropriate to the operations" of an integrated public-utility system, including interests in any other business which we find "necessary or appropriate in the public interest or for the protection of investors or consumers and not detrimental to the proper functioning of such system." Section 11(b)(1) is a basic provision of the Act[4] designed to implement the legislative findings set forth in Section 1(b) of the Act wherein the Congress enumerated five separate conditions, each of which does or may, adversely affect "the national public interest, the interest of investors in the securities of holding companies and their subsidiary companies and affiliates, and the interest of consumers . . ." Paragraph (4) of Section 1(b) states that such interests are or may be adversely affected "when the growth and extension of holding companies bears no relation to economy of management and operation or the integration and coordination of related operating properties."

In order to give meaning to Section 1(c), which provides, inter alia, that all the provisions of the Act shall be interpreted "to meet the problems and eliminate the evils as enumerated in this section", Section 11(b)(1) must be construed in such a way as to effectuate Section 1(b)(4) and reflects a Congressional policy against acquisitions of interests in non-utility businesses that bear no functional relation to utility operations.

In connection with the adoption of Section 11(b)(1) Senator Wheeler, the manager of the bill in the Senate, emphasized "the principle that utility holding companies shall confine themselves to gas and electric service and not continue to mix into all manner of other businesses." 79 Cong. Rec. 10,847 (74th Cong., July 9, 1935). See also *United Gas Improvement Co.* v. *S.E.C.*, 138 F.2d 1010, 1019 (C.A. 3, 1943) where the court stated:

[4] As the Supreme Court noted, in sustaining the constitutionality of Section 11(b)(1) in *North American Co.* v. *S.E.C.*, 327 U.S. 686, 704, note 14 (1946), Section 11 is "the very heart of the title."

> "The obvious intention of Congress in enacting Section 11(b)(1) was to integrate public utility holding company systems and to compel holding companies subject to the Act to relinquish interests in unrelated utilities as well as unrelated non-utility companies. The myriad, promiscuous activities and investments of some of the holding company systems was a prime cause of investors' losses."

Following this legislative purpose and the policy guidelines set forth in Section 1(b)(4), the Commission has frequently held that the two "other business" clauses of Section 11(b)(1), read together permit the retention of a non-utility business only on "an affirmative showing of an *operating* or *functional* relationship between the operations of the retainable utility system and the non-utility business sought to be retained, and that retention would be in the public interest." [5] It is significant to note that this interpretation has been sustained by the Courts of Appeals of four circuits. *North American Co.* v. *S.E.C.*, 133 F.2d 148, 152–153 (C.A. 2, 1943), affirmed on certiorari limited to constitutional issues, 327 U.S. 686 (1946); *United Gas Improvement Co.* v. *S.E.C.*, 138 F.2d 1010, 1019–22 (C.A. 3, 1943); *Arkansas Natural Gas Corp.* v. *S.E.C.*, 154 F.2d 597 (C.A. 5, 1946), cert. den. 329 U.S. 738 (1946); *Philadelphia Co.* v. *S.E.C.*, 177 F.2d 720 (App. D.C. 1949).[6] Any property or interest whose disposition would be required under these tests may not be acquired.[7]

The business of Homes Corporation, which is non-utility in character, is related to the operations of the American Natural public-utility system only in that it may help to rehabilitate and preserve areas serviced by Michigan Consolidated and thereby promote its general gas utility business. The Commission has held that a customer relationship between a non-utility company and a public utility company is not the type of operating or functional relationship which Congress contemplated when it established the standards of the "other busi-

[5] *General Public Utilities Corporation*, 32 S.E.C. 807, 839–40 (1951) and cases therein cited; *United Light and Railways Company*, 35 S.E.C. 516, 519 (1954); *Philadelphia Company*, 28 S.E.C. 35, 74-6 (1948). *Cf.* the statement in *North American Co.* v. *S.E.C.*, 327 U.S. 686, 697 (1946), that "other holdings may be retained only if their retention is related to the *operations* of the retained utility properties." (emphasis supplied).

[6] In *Engineers Public Service Company*, 12 S.E.C. 41, 72–78, 90–93 (1942), the Commission required divestiture of certain non-utility properties for lack of the necessary functional relationship, but the Court of Appeals for the District of Columbia Circuit reversed, holding that such relationship was not equired. *Engineers Public Service Co.* v. *S.E.C.*, 138 F.2d 936, 946–948 (1943). The Supreme Court granted certiorari, 322 U.S. 723 (1944), but after a voluntary divestment of the properties by the company, the judgment below was vacated for mootness, 332 U.S. 788 (1947). Subsequently in *Philadelphia Co.* v. *S.E.C.*, *supra*, the Court of Appeals noted its prior opinion, and its reference to the Supreme Court's opinion in *North American* (noted in the text above) expressed its approval of the functional test.

[7] *Texas Utilities Co.*, 21 S.E.C. 827, 829 (1946).

ness" clauses.[8] A relationship based on use of the utility's services could be established with respect to almost any business, and if permitted to constitute a basis for retainability under the "other business" clauses it would enable a utility system to engage in almost any sort of activity contrary to the intent of Section 11(b)(1).[9] We accordingly conclude that there has been no showing of the appropriate relationship between the business of Homes Corporation and the gas utility business of Michigan Consolidated.

THE ORDINARY COURSE OF BUSINESS TEST IN SECTION 9(c)(3)

Nor does Section 9(c)(3) of the Holding Company Act, which has been advanced by the Division of Corporate Regulation as a basis for favorable action, provide authority to grant the instant application. That section provides that an exemption from the prohibitions of Section 9(a) may be granted for the acquisition of "such commercial paper and other securities . . . as the Commission may . . . prescribe as appropriate in the ordinary course of business of a . . . subsidiary company [of a registered holding company] and is not detrimental to the public interest or the interest of investors or consumers." This clearly indicates that the securities to be acquired must be in the "ordinary course" of the business of the acquiring company. The acquisition here proposed would enable Michigan Consolidated to become engaged, through a wholly controlled subsidiary company, in the businesses of constructing and operating a housing development. The "ordinary course of business" of Michigan Consolidated is the operation of a retail gas business and not a housing project, nor are the retail gas business and the housing business related businesses. Section 9(c)(3) cannot be employed to evade the proscription of Section 11(b)(1) prohibiting the acquisition by a gas utility company of an interest in a business unrelated to its business.[10]

Further, given the construction of the mandate of Section 1(c), noted above, we cannot find it is not detrimental to the

[8] *The North American Company*, 32 S.E.C. 169, 183 (1950); *Cities Service Power & Light Company*, 14 S.E.C. 28, 29 (1943).

[9] *Philadelphia Company*, 28 S.E.C. 35, 73 (1948); *Cities Service Power & Light Company*, 14 S.E.C. 28, 39 (1943) and cases cited.

[10] It is suggested that the provisions of Section 9(c) (3) permit departure from the standards of Section 11(b) (1) so as to allow as appropriate in the ordinary course of business an acquisition unrelated to the public utility functions of the acquiring company. This construction would permit the acquisition, contrary to the clear Congressional intent, of any security the Commission, in its discretion, stated was in the "ordinary course of business" of the acquiring company. This would permit the Commission to ignore the mandate of the statute and would nullify the carefully drawn provisions of Section 11(b) (1) which restrict registered holding company systems to the operation of public utility properties and other properties operationally related thereto.

public interest or the interest of investors or consumers to have a registered holding company grow and extend into areas which bear no relationship to the integration and coordination of that company's integrated gas utility system.[11]

This case differs in important respects from those relied upon by applicants where the Commission issued orders exempting from Section 9(a) acquisitions of small amounts of securities of industrial development or home construction companies, which involved only investments in, and have not involved ownership and control of, another business by the acquiring company.[12] As noted, Homes Corporation is wholly owned by and under the direction and control of Michigan Consolidated.

We are fully aware of the meritorious policy in the National Housing Act to assist private industry in providing programs to rehabilitate urban areas and the public interest sought to be served thereby. However, the Housing act does not authorize this Commission to ignore the express policy findings and prohibitions set forth in the Public Utility Holding Company Act.

In the circumstances, we believe the conclusion is inescapable that the ownership and management of a housing corporation, however otherwise desirable in the context of other statutes, does not meet either the "other business" test under Section 11 requiring an operating or functional relationship to the operations of the utility system, or the test under Section 9(c)(3) of being "appropriate in the ordinary course of business" of a subsidiary company of a registered holding company.

An appropriate order will issue.

By the Commission (Chairman BUDGE and Commissioners NEEDHAM and HERLONG), Commissioner OWENS concurring in part and dissenting in part, and Commissioner SMITH dissenting.

Commissioner OWENS, concurring in part and dissenting in part:

[11] This conclusion is confirmed by the fact that Michigan Consolidated contemplates undertaking similar projects of approximately 500 units per year. Such an undertaking necessarily requires the further acquisition of large tracts of land, and perhaps the construction of community and shopping or other commercial facilities as permitted under the National Housing Act.

[12] *Consolidated Gas Supply Corporation*, Holding Company Act Release No. 15877 (October 17, 1967). See also *Columbia Gas of Pennsylvania, Inc.*, Holding Company Act Release No. 16078 (May 29, 1968), and *The Peoples Natural Gas Company*, Holding Company Act Release No. 16049 (April 30, 1968). While these last two cases were not specifically issued under Section 9 (c) (3), the acquisitions were of the type allowable under that section.

I concur with the majority in finding that the prior authorization did not cover the acquisition of short term notes for the two new projects and that approval of investment by Michigan Consolidated in the housing projects cannot be based upon a finding that the standards of Section 11(b)(1) are met. I reiterate my opinion, expressed in the prior proceeding, that there is no warrant for departing from the prior Commission interpretation that the "other business" clauses of that Section permit the acquisition of a non-utility business only if there is first "an affirmative showing of an operating or functional relationship between the operations of the retainable utility system and the non-utility business sought to be retained."[1] I also adhere to the view that no such relationship has been shown here.

I would, however, consider applications of this kind on an *ad hoc* basis and, dissenting from the majority, I conclude that, as urged by the Division of Corporate Regulation, the special circumstance present here justify a specific exemption under the provisions of Section 9(c)(3) of the Act. That Section provides that we may except from the prohibitions of Section 9(a) the acquisition of securities by a subsidiary of a registered holding company within such limitations as we may prescribe as appropriate in the ordinary course of business and as not detrimental to the public interest or the interest of investors or consumers.

I recognize that the statutory authority in Section 9(c)(3) of the Act is subject to the limitations described therein,[2] and that acquisitions pursuant to that Section should be permitted only in unusual and exceptional circumstances. The Commission has held, however, that the authority conferred upon us to exempt acquisitions by order was intended to permit us to consider the requirements of the particular applicant, rather than of holding companies or their subsidiaries generally.[3] In this case, I have taken into consideration the fact that Michigan Consolidated's proposal entails a relatively small investment in relation to its total net worth; that it is a response to important adverse developments in a major gas service area of the company and is designed to remedy their economic and operating consequences; that it is part of a Federal program under the National Housing Act as amended designed to assist

[1] *Michigan Consolidated Gas Company*, 43 S.E.C. 1108, 1115–16 (1969) cases there cited.

[2] *Cf. In re Electric Bond & Share Co.*, 113 F. Supp. 547 (U.S.D.C., S.D.N.Y. 1953).

[3] *Electric Bond and Share Company*, 35 S.E.C. 236, 240 (1953), plan enforced, U.S.D.C., S.D.N.Y. (Civ. No. 83–49, July 16, 1953, unreported).

private industry in providing housing for low and moderate income families and displaced persons; and that in the carrying out of its project it will be subject to an over-riding system of regulation. As a limited dividend corporation, Homes Corporation, in receiving long term low interest mortgage loans under the program, may not pay dividends in excess of 6 percent per year on its equity investment in the project and will be subject to regulations of the Federal Housing Administration ("FHA") with respect to the rents that may be charged and the maximum construction costs. The FHA requires such a mortgagor to submit data demonstrating the economic feasibility of its project, and to enter into a regulatory agreement covering the operation, maintenance and other aspects of the project. The mortgagor must keep accounts in accordance with a prescribed uniform system of accounts, and all plans and specifications must be approved by the FHA which also inspects construction and supervises all stages of the project. Applicants assert that their proposed projects, which they hope will lead to others joining in a large scale construction of low and moderate cost housing in the blighted inner-city area of Detroit, will effectuate national policy and will help to preserve and rehabilitate the Detroit area as a major service area of Michigan Consolidated.

I think the majority unduly constricts the scope of the Section 9(c)(3) exemption when it holds that to be entitled to such exemption a transaction must also meet the standards of Section 11(b)(1). Section 9(a) prohibits any acquisition of the type described therein unless the Commission has approved that acquisition pursuant to Section 10. Section 10(c)(1) provides that no such approval is to be granted by the Commission if it would be detrimental to the carrying out of the provisions of Section 11. Thus, it is Section 9(a) that makes both Sections 10 and 11 considerations relevant to Commission approval of the acquisition. Section 9(c)(3) states explicitly that Section 9(a) shall not apply to an acquisition approved pursuant to Section 9(c)(3). By permitting an exception from the requirements of Section 9(a), Section 9(c)(3) clearly authorizes a departure from the requirements of Section 11(b)(1) so as to allow as appropriate in the ordinary course of business an acquisition of an interest unrelated to the public-utility functions of the holding company where the other stated exemptive standards are satisfied.

For the reasons I have stated I believe the cautionary standards of Section 9(c)(3) are satisfied in this case, and I would approve the proposed acquisitions as appropriate in the ordinary course of Michigan Consolidated's business and not detrimental to the public interest or the interest of investors or consumers. I am not concerned that applicants may desire to undertake additional projects in the future. Applicants request approval of two specific projects now before us, and any future acquisitions will require an application to the Commission. The authority and discretion granted to the Commission by Section 9(c)(3) provides sufficient assurance that the limitations prescribed thereunder will be observed and applied.

Commissioner SMITH, dissenting:

The majority today overrules a decision of the Commission with respect to the same applicants made only a year ago.[1] I believe that the present application, as the prior one, presents an ample basis for exercise of the Commission's authority to approve acquisitions which are not "detrimental to the carrying out" of the simplification and integration provisions of the Holding Company Act. This is so whether the acquisition is deemed to fall within the "other business" clauses of Section 11(b)(1), upon which I would place primary reliance, or by way of an exemption within the provisions of Section 9(c)(3) upon which Commissioner Owens would grant the application.

In its prior decision, the Commission did not attempt to spell out definitive guidelines to the range of permissible acquisitions which a holding company system might undertake pursuant to Congressionally recognized housing programs. Nor was there any need to do so. Based upon the record developed in that case—which is virtually identical with the record before us here—the Commission determined that the application should be granted.[2] The majority now flatly precludes any administrative accommodation of the policies of the Holding Company Act to the policies of the Housing Act. Yet changes in our social and economic environment, to which many corporations are seeking to respond, affect utility holding companies as well as other members of the corporate community.

As was stated last year:

> "This overwhelmingly necessary and yet relatively limited investment of private capital cannot, in our view, be considered 'detrimental to the carrying out' of the simplification and integration provisions of the

[1] 43 S.E.C. 1108 (1969).

[2] I agree with the majority's conclusion that the Commission's prior decision did not authorize the project here involved.

> Holding Company Act. Investment of private capital for such a purpose has been generally determined by Congress to be in the national interest and specifically determined by management to be in the corporate interest—and both determinations have been made on the basis of compelling and uncontroverted facts of great significance to both the country and the company."

My full views regarding the application of Section 11(b)(1) to a project such as those here involved are set forth in the prior case. While adhering to those views I shall not repeat them here, except to note that I there analyzed the cases and statutory provisions cited by the majority and reached a different conclusion.

The Act is not, as the majority construes it, an inflexible limitation of registered holding company systems to the sole business of providing utility services. If Congress had wished to impose that result, it could readily have done so in the Act. The fact is that it did not. To the contrary, Section 11(b)(1) expressly delegates to the Commission the power to

> "permit as [i] reasonably incidental, or economically necessary or appropriate to the operations of one or more integrated public-utility systems the retention of an interest in *any* business (other than the business of a public-utility company as such) which the Commission shall find [ii] necessary or appropriate in the public interest or for the protection of investors or consumers and [iii] not detrimental to the proper functioning of such system or systems" (emphasis added).

As the majority correctly points out, the Congressional delegation was certainly not an invitation to permit utility systems to engage in any sort of business merely because that enterprise might be located within the utility's primary service district and would thereby provide a source of revenue to the utility.[3] But that is not what is involved here. Here we have two local housing projects, desperately needed by the community which applicants are committed to serve, promoted and regulated by the federal government as a high national priority, and requiring only a relatively small commitment of capital. In the circumstances here I can see no basis for finding that the housing projects would in any way be "detrimental to the proper functioning of" the utility system.

The questions left then are whether the "other business" here is reasonably incidental or economically necessary or

[3] As the Commission said last year (43 S.E.C. 1108, 1113): ". . . in finding that this investment, so relatively small for Michigan Consolidated and its parent but so relatively important for the community, meets the public interest and relationship standards of Section 11, we would certainly not be authorizing companies under the Act to launch into acquisitions of diverse commercial enterprises, or to commit disproportionate resources to unneeded housing projects, or to abuse their natural monopoly position in non-utility activities" (footnote omitted).

appropriate to the operations of the utility system, and necessary or appropriate in the public interest or for the protection of investors or consumers. Essentially the same questions arise under Section 9(c)(3); namely, whether the proposed acquisition may be approved as being "appropriate in the ordinary course of business . . . and as not detrimental to the public interest or the interest of investors or consumers."

The fulcrum of any reasoned analysis of these questions is the term "business." Corporate business functions are becoming broader in concept than a strict limitation to operations, and engagement in relevant community affairs is becoming a customary corporate role. Public utility companies in particular, to a far greater extent than many other industrial concerns, have a basic commitment to the areas they serve. In essence, the Holding Company Act sought to insure that commitment. It is not possible for a utility simply to pull up stakes and move to another area when its existing service district becomes difficult or impossible to service efficiently and at maximum profit to its shareholders. If large portions of the service area become dilapidated and unfit for habitation, the utility must face not only a possible reduction in revenue but the additional expense and burden of servicing areas that lie beyond the service vacuum created by such conditions.

By its enactment of the National Housing Act, Congress sought to involve large American corporations in a concerted effort to alleviate one of the primary social and economic problems of our urban society— inadequate housing, and all that entails. The Congressional mandate stems from a growing recognition by the corporate community itself that primary business purposes cannot be isolated from the fulfillment of basic social needs. It is becoming increasingly difficult to conduct business as usual unless action is taken to alleviate critical problems of our urban communities. In this case the Commission is being asked only to permit (not require) applicants to make a relatively small contribution to their community. The keystone of the Housing Act is a voluntary commitment of capital by private corporations, buttressed by federal mortgage loans and governmental supervision. Applicants made that commitment in an enlightened way and with full appreciation of its business as well as social purpose. Viewed in narrow terms, it is of course true that these investments do not directly facilitate the services of providing energy, heat, light or power. However, as noted in the Commission's opinion last year, the Act does not require a direct relationship if the requirements of the "other business" test are met.

In light of the Congressionally recognized relevance of the present investments, I think it can readily be found that those investments are, under Section 11(b)(1), both reasonably incidental and economically necessary or appropriate to the operations of the utility system. As the applicants have demonstrated, the proposed housing projects involve modest commitments of capital and provide an economic return on those investments both to investors and consumers. For the same reasons the investments are likewise, under Section 9(c)(3), "appropriate in the ordinary course of business" under any construction of that term which takes into account the dynamics of contemporary corporate functions and responsibilities. It is equally clear that the investments are necessary or appropriate in the public interest or for the protection of investors and consumers. The underlying social purpose and policy basis of these investments are entirely consistent with the broad conceptions of the public interest embodied in the Holding Company Act.

The Congressional recognition of the importance of corporate participation in the rehabilitation and rebuilding of our urban communities reflects a realistic view of the changing needs of American society. The same sense of realism should pervade the application of the standards for acquisitions under Sections 9 and 10 of the Holding Company Act. The anachronistic analysis of the majority's decision neither achieves the objective of corporate economic responsibility with which the Act was concerned nor is it in keeping with the broader notions of corporate social responsiblity which have been evolving since its enactment some 35 years ago.

In the Matter of

PAUL M. KAUFMAN

File No. 3–2113. Promulgated July 2, 1970

Securities Exchange Act of 1934—Rule 2(e), Rules of Practice

ATTORNEYS—PRACTICE AND PROCEDURE

Suspension and Denial of Privilege to Practice Before Commission

Conviction of Felony

Where attorney was convicted of felonies based on violations of antifraud provisions of Section 17(a) of Securities Act of 1933, *held*, convictions establish lack of requisite character or integrity to practice before Commission within meaning of Rule 2(e) of Commission's Rules of Practice, notwithstanding pendency of appeal, and attorney should be temporarily disqualified pending determination of appeal, and permanently disqualified should any of the convictions be affirmed and subject to no further review, or reinstated should convictions be reversed.

APPEARANCES:

Paul Gonson, for the Office of the General Counsel of the Commission.

Barry Ivan Slotnick, of Slotnick & Narral, and *Arnold E. Wallach*, for respondent.

FINDINGS AND OPINION OF THE COMMISSION

Following a private hearing in these proceedings pursuant to Rule 2(e) of our Rules of Practice, the hearing examiner filed an initial decision in which he concluded that Paul M. Kaufman, an attorney at law, should be permanently denied the privilege of appearing or practicing before this Commission.[1] We granted a petition for review filed by respondent, and briefs were filed by him and our Office of the General Counsel. Our findings are based upon an independent review of the record.

[1] Rule 2(e) of our Rules of Practice provides:

"The Commission may deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice of and opportunity for hearing in the matter (1) not to possesss the requisite qualifications to represent others, or (2) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct."

Respondent is a member of the New York bar who has been practicing before this Commission for about 12 years and states that at present his entire practice consists of Commission matters. On June 19, 1969, he was found guilty after a trial by a jury in the United States District Court for the Southern District of New York of conspiracy to violate and of violations of Section 17(a) and 24 of the Securities Act of 1933 in the offer and sale of common stock of Donbar Development Corporation.[2] The pertinent counts of the indictment charged that between January and August 1963, pursuant to an arrangement with an officer of Donbar who owned and desired to sell a block of over 40,000 shares of Donbar stock, respondent and others offered and paid secret compensation to securities brokers and others to induce purchases of such stock, effected and induced purchases of Donbar stock through nominee accounts and otherwise for the purpose of manipulating the market price of the stock, and knowingly made and caused to be made representations to customers that were false and misleading in failing to disclose the payment of such compensation and the fact that the price of the stock was being manipulated.

Respondent was sentenced to imprisonment for nine months on the conspiracy count and on each of 11 substantive counts, such sentences to run concurrently, and execution of the prison sentence on the substantive counts was suspended and respondent was placed on probation for two years to commence upon the expiration of the prison sentence on the conspiracy count. In addition, respondent was fined a total of $24,000. On July 31, 1969, respondent filed a notice of appeal in the Court of Appeals for the Second Circuit, and execution of the sentence was stayed pending disposition of the appeal.

Respondent contends that his convictions cannot be considered evidence of lack of character or integrity within the meaning of Rule 2(e) because, pending disposition of his appeal, the convictions are not "final." We agree with the hearing examiner, however, that conviction of a felony, standing alone, establishes that respondent does not possess the requisite character or integrity to appear and practice before us, notwithstanding that it is the subject of a pending appeal.

[2] Section 17(a) of the Securities Act makes it unlawful for any person in the offer or sale of any securities by use of the mails or interstate facilities to employ a scheme to defraud, or to obtain money or property by means of a false or misleading statement of the material fact, or to engage in any transaction, practice or course of business which operates or would operate as a fraud upon the purchaser.

Section 24 of the Securities Act provides that any person who willfully violates any provision of the Act shall upon conviction be fined not more than $5,000 or imprisoned not more than five years or both.

Willful violations of the federal conspiracy statute and of Section 17 of the Securities Act are federal felonies,[3] and it is well established in the courts that conviction of a felony or other crime involving moral turpitude is ground for disbarment.[4] Such conviction bespeaks a serious breach of the obligation of an attorney to conduct himself in a proper manner and to abstain from acts bring discredit upon himself, the profession, and the forums before which he appears, whether such acts were performed in a professional capacity or otherwise.[5] If the public is to be protected and the public's confidence in the legal profession and in this Commission maintained, an attorney convicted of a serious crime such as securities fraud should not be permitted to hold himself out as entitled to represent others in securities matters before us merely because an appeal is pending.

Once the judgment of conviction was entered, respondent was no longer entitled to the presumption of innocence, and he stands convicted until such time as the conviction is reversed or set aside.[6] As stated by the Supreme Court in *Berman* v. *U.S.*, which involved an appeal from a sentence of imprisonment for using the mails to defraud and conspiracy:

> "Petitioner stands a convicted felon and unless the judgment against him is vacated or reversed he is subject to all the disabilities flowing from such a judgment. The record discloses that petitioner is a lawyer and by reason of his conviction his license was subject to revocation (and petitioner says that he has been disbarred) without inquiry into his guilt or innocence."[7]

Although, as stressed by respondent, the courts of California and Missouri have held that a felony conviction must no longer be subject to review to constitute evidence of an attorney's

[3] 18 U.S.C. 1. We do not reach the question whether, as held by the examiner any of the respondent's violations are regarded as felonies under New York law and therefore a statutory ground in that State for an automatic disbarment which would remove respondent's qualification to represent others before us as provided in Rule 2(b) of our Rules of Practice). Respondent disputes that holding, and the Office of General Counsel states that while it would agree with the examiner's analysis, since there does not appear to be any precedent on the question it does not consider that the decision in this case should be based on such a holding.

[4] *Ex Parte Wall*, 107 U.S. 265, 273 (1882): "If regularly convicted of a felony, an attorney will be struck off the roll as of course, whatever the felony may be, because he is rendered infamous. If convicted of a misdemeanor which imports fraud or dishonesty, the same course will be taken." See also *In re Tinkoff*, 95 F.2d 651 (C.A. 7, 1938), *cert. denied* 304 U.S. 580, and 101 F.2d 341 (C.A. 7, 1939); *In re Pontarelli*, 66 N.E. 2d 83 (Ill. 1946); *State ex rel. Wright* v. *Sowards*, 278 N.W. 148 (Neb. 1938); *In re Gottesfeld*, 91 A.494 (Pa.1914).

[5] *State ex rel. Nebraska State Bar* v. *Fitzgerald*, 85 N.W. 2d 323, 324–25 (Neb. 1957); *In re Wilson*, 391 S.W. 2d 914, 918 (Mo. 1965); *In re Welansky*, 65 N.E. 2d 202, 204 (Mass. 1946); In re *Donaghy*, 83 N.E. 2d 560, 562 (Ill. 1948); *In re Goodrich*, 98 N.W. 2d 125, 128 (S.D. 1959).

[6] See, *e.g.*, *Curley* v. *U.S.*, 160 F.2d 229, 233 (C.A.D.C. 1947), *cert. denied* 311 U.S. 837; *Pannell* v. *U.S.*, 320 F.2d 698 (C.A.D.C. 1963); *State* v. *Lenske*, 407 P. 2d 250, 253 (Ore. 1965); *Quattrocchi* v. *Langlois*, 219 A.2d 570, 573 (R.I. 1966); *State* v. *Simpson*, 49 N.W. 2d 777, 789 (N.D. 1951); *State* v. *Levi*, 153 S.E. 587, 588–89 (W. Va. 1930); *Underhill's Criminal Evidence*, Vol. 1, Sec. 42 (5th Ed. 1956).

[7] 302 U.S. 211, 213 (1937).

unfitness, such holdings were based on the Courts' interpretation of statutes of those states providing for disbarment upon proof of a felony conviction.[8] The Supreme Court of South Dakota reached a different conclusion in interpreting a similar statute.[9] We also note that in one of the California cases cited by respondent, the majority opinion conceded that it would be advisable for the statute to be amended to provide for interim suspension pending the appeal and it was so amended subsequently.[10] And the American Bar Association's Special Committee on Evaluation of Disciplinary Enforcement has recently tentatively recommended a rule providing for suspension pending appeal from the conviction of a serious crime, with provision for immediate reinstatement should the conviction be reversed.[11]

We also find no merit in the further argument advanced by respondent that, under principles of *res judicata,* we are bound by the criminal court's stay of execution of the sentence, which it is argued indicated that the Court did not consider the public interest to be in jeopardy pending appellate review. The stay was required under the mandatory provisions of the Federal Rules of Criminal Procedure,[12] and therefore did not indicate any assessment by the Court of the particular situation presented.

We conclude that respondent should be temporarily denied the privilege of appearing or practicing before us pending final disposition of his appeal from the convictions. Should the conviction on any of the counts be affirmed and no longer subject to further review, we shall enter an order permanently disqualifying respondent. Should all the convictions be reversed or otherwise vacated or set aside, we shall, upon an appropriate application, immediately enter an order reinstating respondent's privilege to practice before us.

An appropriate order will issue.

[8] See *In re Riccardi,* 189 P. 694 (Cal. 120); *State* v. *Sale,* 87 S.W. 967 (Mo. 1905).

[9] *In re Kirby,* 73 N.W. 92, 95 (S.D. 1897). Some state statutes specifically provide for disbarment upon conviction of a felony and for vacating the disbarment if the convictiion is reversed on appeal. See, e.g., N.Y. Judiciary Law, Sections 90.4 and 90.5.

[10] *In re Riccardi, supra,* at p. 696. See Annot. Cal. Codes, Sec. 6102 of Business and Professions Code (1939).

[11] *Problems and Recommendations in Disciplinary Enforcement,* pp. 154–66 (January 15, 1970). As stated in the special committee's preliminary draft report (p. 171): "The integrity of the profession simply cannot tolerate any proceeding that makes it possible for an attorney who stands convicted of a crime reflecting upon his fitness as an attorney to continue openly to engage in the practice of law without appropriate disciplinary action."

[12] Rule 38(a) (2) provides that a sentence of imprisonment shall be stayed if an appeal is taken and the defendant is admitted to bail. Rule 46(a) (2) provides that bail may be allowed pending appeal unless it appears that the appeal is frivolous or taken for delay.

By the Commission (chairman BUDGE and Commissioners OWENS, SMITH, NEEDHAM and HERLONG).

IN THE MATTER OF

THE SUSQUEHANNA CORPORATION

File No. 3-1868. Promulgated July 17, 1970

Securities Exchange Act of 1934—Section 15(c)(4)

TENDER OFFER

Failure to Disclose Plan or Proposal in Schedule 13D

Where tender offeror filed Schedule 13D pursuant to Section 13(d) of Securities Exchange Act of 1934 and Rule 13d-1 thereunder, stating that it had no plan or proposal to make major change in business or corporate structure of target company, although it planned to use substantial cash assets of target company to effect acquisitions or mergers, *held*, tender offeror failed to comply with cited provisions in material respect and must amend its Schedule 13D statement to disclose such plan.

PRACTICE AND PROCEDURE

Motion to Dismiss Proceedings

Motion by respondent to dismiss proceedings on grounds that Commission prejudged issues by filing legal memoranda as *amicus curiae* in injunction action against respondent based on substantially same charges of violation of tender offer provisions, and that Court's dismissal of action barred Commission proceedings on principle of *res judicata* or collateral estoppel, *denied*, where memoranda expressed views solely as to remedies available to Court should violations be found, and Commission was not party or in privity with any party to that action.

APPEARANCES:

Thomas N. Holloway and *Walter D. Vinyard, Jr.*, for the Division of Corporation Finance of the Commission.

Charles S. Rhyne, Courts Oulahan, and *David M. Dixon*, of Rhyne & Rhyne, for The Susquehanna Corporation.

FINDINGS AND OPINION OF THE COMMISSION

Following hearings in these proceedings pursuant to Section 15(c)(4) of the Securities Exchange Act of 1934, the hearing examiner filed an initial decision in which he concluded that The Susquehanna Corporation, in connection with a cash tender offer to the stockholders of Pan American Sulphur

Company ("PASCO" or "Pan American"), had failed to comply with Section 13 of the Act and rules thereunder in that it filed a Schedule 13D statement, as amended on December 20, 1968, containing materially false and misleading statements and that an order requiring compliance should be issued.[1] We granted Susquehanna's petition for review, briefs were filed by Susquehanna and our Division of Corporation Finance, and we heard oral argument. Our findings are based upon an independent review of the record.

Susquehanna is engaged in diversified fields, including mining, electronics, building materials, and research and development in various areas. Pan American has substantial interests in sulphur and phosphate companies in Mexico, and, at the time of the tender offer, had about $170 million of assets, of which about $58 million was in cash or its equivalent, and no significant debt. Its common stock is listed on the New York Stock Exchange.

Susquehanna's tender offer was made on November 26, 1968 to acquire 1,800,000 shares or about 38 percent of the approximately 4,751,000 outstanding shares of the common stock of PASCO at a price of $40 per share. As of December 11, 1968, more than the number of shares sought had been tendered, and Susquehanna's amended Schedule 13D statement filed on December 20 reported the purchase of the 1,800,000 shares.[2] That statement represented, as did the original statement filed on November 25, 1968, that if working control of PASCO were achieved as expected it was contemplated that the business of PASCO would be conducted as "natural resources" subsidiary of Susquehanna. The statement further declared:

> "Susquehanna does not plan or propose to liquidate Pan American, to sell its assets to, or merge it with, any other person, or to make any other major change in its business or corporate structure. However, if, at some subsequent time, it should appear the interests of the Pan American stockholders would be better served by any of the foregoing courses of action, Susquehanna may propose or adopt such course." [3]

[1] Under Section 15(c) (4) of the Act, we may, if we find material non-compliance with Section 13 or any rule thereunder, require compliance upon such terms and conditions as we may specify.

[2] In its statement Susquehanna reserved the right to purchase additional PASCO stock on the New York Stock Exchange or otherwise.

[3] Under Section 13(d) (1) (C) of the Act and Rule 13d-1 thereunder, Susquehanna, after obtaining more than 10 percent of PASCO's common stock for the purpose of acquiring control, was required to file a Sechdule 13D statement disclosing "any plans or proposals . . . to liquidate such issuer, to sell its assets to or to merge it with any other persons, or to make any other major change in its business or corporate structure." The initial Schedule 13D statement was filed pursuant to Section 14(d) of the Act and Rule 14d-1 which require such filing at the time a tender offer for more than 10 percent of the target company's stock is first published or given to the security holders.

We find, as did the hearing examiner, that Susquehanna, upon acquiring control of PASCO, planned to use the latter's cash assets to acquire control of, or merge PASCO with, some other company, and thus make a major change in PASCO's business or corporate structure. The evidence on this issue dealt primarily with the activities and statements of Susquehanna's president and chairman of the executive committee, Herbert F. Korholz, prior to and during the tender offer.

In June 1968, Korholz proposed to the president of PASCO a merger of their two companies, but this proposal was rejected. About August 1968 Korholz conferred with an official of Susquehanna's investment banking firm concerning the feasibility of making a tender offer to acquire control of PASCO. That official testified that one of the factors that made PASCO attractive to Korholz was its substantial cash assets which were not being employed in an aggressive acquisition policy. On October 30, 1968, at a meeting with officials of PASCO, Korholz advised them of Susquehanna's plan to make a tender offer, and the president of PASCO outlined his company's unsuccessful efforts to use its cash assets to diversify. On November 6, Korholz and another Susquehanna official discussed those efforts with PASCO's board of directors. On the following day Korholz, in negotiating with a bank official to finance the proposed tender offer, told him that PASCO's cash assets could not be used as collateral because he wished to use the proceeds for "additional potential acquisitions down the road." In a letter to the banker dated November 12, 1968 stressing the soundness of a bank loan to finance the tender offer, Korholz stated:

> "Earnings will be substantially increased when the $60,000,000 cash plus the ability to borrow substantial long term money on Pan American assets is used for acquisition purposes." [4]

The next day, Korholz wrote a letter containing identical language to a research company which had given him an opinion that the tender offer price was too high.

On November 27, the day after the proposed tender offer was first published, Korholz telephoned the president of American Smelting and Refining Company ("ASARCO" or "American

[4] Korholz testified during our staff's investigation:

"What I meant to convey in this letter was that one could take the $60,000,000 in cash, plus their ability to borrow substantial long term money and acquire companies in either related or amenable fields and increase the earnings of Pan American and decrease the risk in their dependency on the foreign asset through an acquisition program. The letter was written to show the possibility that Pan American could represent if it was used intelligently by Susquehanna."

Smelting"), and, being unable to reach him, left the following message for him:

> "During the early part of the year, a short discussion was held with Mr. Tittmann [Chairman of ASARCO's Board] concerning a financial restructuring of ASARCO using a smaller company as a vehicle. My associates and I control a company listed on the New York Stock Exchange [with] approximately 200 million in assets, no bank debts, debentures or preferred stock. The company could be an ideal vehicle for the assets of Asarco. It would insure management and policy continuity since two-thirds of the Board Memberships would be available to Asarco management and the present Board. Terms could be worked out immediately for an exchange superior to those offered by [a named company]."

We agree with the examiner's finding that PASCO was the company Korholz referred to, notwithstanding that PASCO had $170 million instead of $200 million in assets and was not then controlled by Susquehanna. In any event, on December 6, Korholz called PASCO's president and suggested that ASARCO might be a good diversification for PASCO. PASCO's president reacted favorably but was dubious that it could be accomplished because of ASARCO's large size. On December 10, Korholz sent a telegram to ASARCO proposing, subject to the approval of the boards of PASCO and ASARCO, an exchange of specified amounts of PASCO equity and debt securities for ASARCO's outstanding common stock and offering to the incumbent ASARCO directors one-half of the PASCO directorships. It does not appear that ASARCO responded to the offer.

Susquehanna asserts that Korholz' alleged plans with respect to PASCO cannot be attributed to Susquehanna because he was not its chief executive officer, that Susquehanna's Board Chairman and Chief Executive Officer was "the major personality" in the drafting of the Schedule 13D statement, and that neither the shareholders nor directors of Susquehanna knew of or approved the "plan or proposal" found by the examiner. The record shows, however, that Korholz' statements recited above were made in his capacity as president and on behalf of Susquehanna, and that he signed the amended Schedule 13D statement filed on December 20. The official representing Susquehanna's investment banking firm considered him to be the company's spokesman, and PASCO's president stated that throughout his discussion of the tender offer with Korholz, he regarded Korholz as "speaking for and negotiating on behalf of Susquehanna" and as the chief negotiator for Susquehanna. There is no evidence that restrictions had been or would be imposed upon Korholz' plans.

Susquehanna concedes that for a "plan" to exist it is not necessary to find bilateral negotiations with another company regarding the assets of PASCO that had reached the point of agreement in principal, and that a plan need not be in writing. But it contends that a plan should be more definite than a mere possibility or hope. It cites Korholz' testimony that in making the tender offer he hoped to obtain control of PASCO in order to make it into a large company, principally through acquisitions but with no specific companies in mind because the cooperation of the PASCO Board was necessary. While recognizing that the record contains references to acquisitions and mergers, Susquehanna points to the testimony of the investment banker official that he and Korholz "discussed a variety of hopes and possibilities," and to a reference in Korholz' letter to the research firm to another possible acquisition by PASCO which it asserts was presented as an additional example of what could be done by PASCO with its cash.

In our opinion, however, in the words of the examiner, "the energy, aggressiveness and persistence of the Korholz efforts to bring to fruition his intentions to put the cash assets to use by acquisition or merger give to his intentions the substance, quality and character of a plan, as the term is used in the statute." The significant consideration is not whether an acquisition or merger was planned with ASARCO or any other specific company, but whether, as found by the examiner, there was a plan to use the cash assets to acquire or merge with any company upon securing control of PASCO. A tender offeror normally is not able to make definite arrangements for an acquisition by or merger of the target company with a third company before control has been obtained. It is therefore not important that ASARCO did not respond to Susquehanna's proposed merger terms or that no specific proposal to acquire another company was made to or accepted by any such company.

A stockholder who is asked to sell his holding to a tender offeror seeking control of his company is entitled to full and accurate information concerning the offeror's plan or intention to use his company's cash assets for acquisitions or mergers in general, so he can determine whether it is in his best interest to accept or reject the offer. To hold otherwise would emasculate the tender offer provisions which reflected Congressional concern that, absent the disclosure they require, one seeking control of a corporation through a tender offer could operate in virtual secrecy and compel the shareholder to make an uninformed investment decision.[5] As stated in the report of the Senate Committee on Banking and Currency:

> "At present the law does not even require that he [the tender offeror] disclose his identity, the source of his funds, who his associates are or what he intends to do if he gains control of the corporation. As a practical matter, unless incumbent management explains its position publicly, the investor is severely limited in obtaining all the facts on which to base a decision whether to accept or reject the tender offer."[6]

And a sponsor of the bill, with the approval of his co-sponsor, stated:

> "The stockholders have a right to know who they are dealing with, what commitments have been made, and the intentions and plans of the offeror." [7]

Although the protection afforded by the tender offer provisions is in certain respects analogous to that provided by the proxy provisions of Section 14, the need for protection of the stockholder, as testified by the then Chairman of this Commission, may be greater in the case of the tender offer that in a proxy dispute.[8]

We cannot agree with Susquehanna's further assertion that the non-disclosure of Korholz' alleged "ideas, hopes and vague intentions" were not material enough to constitute a plan or proposal required to be disclosed in the Schedule 13D statement. It cites, as dispositive on this question, *Electronic Specialty Co.* v. *International Controls Corp.*,[9] an injunction proceeding and the first appellate decision dealing with the tender offer provisions. That case held, on the facts there presented, that the disclosure in the Schedule 13D statement that the tender offeror would "give consideration" to merging with the target company was accurate and adequate. With respect to a charge in the complaint that the tender offeror violated Section 14(e) of the Act in that it engaged in fraudulent practices prior to the tender offer in order to deflate the market price of the target company's stock and make the tender offer appear more attractive, the Court of Appeals adopted the test of materiality upon which Susquehanna relies: whether any of the stockholders who tendered their shares would probably not have tendered them if the alleged violation of Section 14(e) had

[5] S. Rep. No. 550, 90th Cong., 1st Sess., p. 2 (1967).

[6] *Id.* See also 113 Cong. Rec. 24664 (August 30, 1967).

[7] Hearings on S. 510 Before Subcomm. on Securities of Senate Comm. on Banking and Currency, 90th Cong., 1st Sess. 44 (1967).

[8] *Id.*, p. 181.

[9] 409 F.2d 937 (C.A. 2, 1969).

not occurred. However, even apart from the question whether that test, applied in determining whether an injunction should issue, is appropriate in an administrative proceeding pursuant to Section 15(c)(4) based on an alleged failure to comply with Section 13 and Rule 13d–1 "in any material respect,"[10] it would seem that such test is met here. We have already indicated that Korholz' intention to use PASCO's cash assets for acquisitions or mergers was definite and more than a mere idea or hope. If such intention had been disclosed in the 13D statement, a stockholder who tendered his shares might well have been dissuaded from tendering them. Conversely, those who did not tender would probably have tendered their shares if they were opposed to the proposed use of PASCO's cash.[11]

Finally, there is no substance to Susquehanna's argument that it could not have had a plan or proposal to use the cash assets of PASCO for acquisitions or mergers in view of a press release by PASCO filed with us on November 27, 1968 and published in major newspapers. That release stated that PASCO was concerned that many more shares would be tendered than Susquehanna would accept and that PASCO's directors would therefore give serious consideration to using $50, 000,000 of its cash to purchase PASCO shares so as to enable as many shareholders as possible to obtain their cash value. It is clear, however, that irrespective of the press release, Susquehanna as we have found did have a plan to use PASCO's cash assets. Moreover, PASCO promised only "serious consideration" of the use of its cash for stock purchases, and it does not appear that any resolution to purchase PASCO stock was approved by the PASCO board between December 11, 1968, when the tender offer was already oversubscribed, and December 20, 1968, when the amended Schedule 13D statement was filed.[12]

We conclude that Susquehanna's plan or intention to use PASCO's cash assets for acquisitions or mergers constituted a

[10] Tests of materiality applied in proxy solicitation (Section 14), Rule 10b–5, and other cases also cited by Susquehanna, in determining whether the standard of disclosure has been met, are not necessarily applicable in Section 15(c) (4) proceedings based on the failure to make adequate and accurate disclosure of "plans or proposals" as specifically required by Section 13(d) (1). *Cf. S.E.C.* v. *National Securities, Inc.*, 393 U.S. 453, 466, 468 (1969), which declared that Section 14 and Rule 10b–5 apply to different sets of situations, and the interpretation of one provision cannot affect the interpretation of the other.

[11] Susquehanna's further assertion, that the tendering stockholders were not damaged by any nondisclosure because the present market value of PASCO stock is substantially lower than the price they received, is irrelevant to the question whether Susquehanna's "plan" should have been disclosed.

[12] Susquehanna is not aided by pointing to the testimony of a staff member that he could not say the Schedule 13D statement was "wrong" because he "didn't know." The record shows that this testimony related to the staff's limited knowledge of the facts at the time conferences were being held with counsel for Susquehanna on various proposed drafts of its Schedule 13D statement.

"plan or proposal" within the meaning of the tender offer provisions, irrespective of whether such plan was directed to a specific company. We further conclude that such plan rendered materially false and misleading Susquehanna's Schedule 13D statement that it did not plan to merge PASCO with any other person or make any other major change in its business or corporate structure, and that it might propose or adopt such course at some subsequent time if in the interests of PASCO's stockholders. The latter statement, by describing Susquehanna's intention with respect to merger or acquisition in terms of a future possibility conditioned on the interests of PASCO's stockholders, misrepresented its actual intention on December 20, 1968, to adopt such a course of action as soon as it was in a position to do so.

The statutory and rule provisions governing *tender* offers specifically require disclosure of "*any* plans or proposals" (emphasis added), regardless of their materiality or completeness.The same requirements would not necessarily apply in the case of *exchange* offers (or of any offer to sell securities) which are governed by the provisions of the Securities Act of 1933 and the Commission's rules promulgated thereunder. Where the offeror is essentially urging the offeree to acquire securities, there may be some tendency to make exaggerated claims about the merits of the securities and the issuer, including the company's prospects and plans. In the case where the offeree is being asked only to sell securities, there may be an opposite tendency to understate the prospects of the offeree's company and hence to limit disclosure of any plans or proposals to make use of that company's assets or alter its corporate structure. Neither tendency is to be encouraged. The interests of full and fair disclosure require an honest presentation of the relevant facts within the framework of the applicable statutory provisions and Commission rules. We do not imply that a tender offeror must set forth specific details of a plan or proposal. If the specifics have not been formulated, a statement to that effect should be included in the schedule. Similarly, if it appears to the tender offeror that its plan or proposal may not be consummated or that the plan or proposal is contingent upon the happening of another occurrence (such as obtaining additional financing or the approval of shareholders), such facts should be set forth in the schedule. *See* Rule 12b–20 under the Securities Exchange Act of 1934.

OTHER MATTERS

Susquehanna urges that these proceedings should be dismissed on two grounds. It contends: (1) that this Commission prejudged the issues herein in a memorandum of law and statement filed on its own initiative as *amicus curiae* in an injunction proceeding instituted by PASCO against Susquehanna in March 1969[13] in which PASCO alleged that the Schedule 13D statement was false and misleading (in substantially the same respects charged in the instant proceedings) and sought to enjoin the voting of the shares purchased by Susquehanna pursuant to its tender offer; and (2) that the reversal of the preliminary injunction granted in that proceeding and dismissal of PASCO's suit[14] bars any adjudication of the instant proceedings on the ground of *res judicata* or collateral estoppel.[15] We do not agree with these contentions.

No prejudgment was involved. This Commission, as the federal agency primarily responsible for the administration and enforcement of the securities laws, properly sought to assist the lower Court on the question of appropriate remedies for violation of the tender offer provisions should such a violation be found,[16] and limited its expression of views in that Court solely to that question, and on appeal to questions raised by Susquehanna as to this Commission's enforcement processes.[17] Nor is the decision in that case dispositive of the instant proceedings. Although the issues raised by PASCO in its injunction complaint and by the Division in the Statement of Matters herein are essentially the same, neither the doctrine of *res judicata* nor of collateral estoppel is applicable because this Commission was not a party to the injunction suit or in privity with any of the parties and has no standing to seek review of the decision in the case.[18] The instant proceedings are the first which present for our decision the merits of a matter as to which the Congress has vested primary responsibility in the Commission,[19] and it is appropriate that we decide the issues.

[13] Civil Action No. SA 69 CA 67 (W.D. Tex).

[14] C.A. 5, March 13, 1970.

[15] This contention was made in a motion to dismiss the present proceedings filed after the Court of Appeals decision. The Division filed a brief in reply.

[16] *Cf. Pangburn* v. *C.A.B.*, 311 F.2d 349, 348 (C.A. 1, 1962).

[17] Susquehanna quotes statements in the *amicus curiae* memorandum which assertedly assume violations of the tender offer provisions by Susquehanna. It is clear from the context, however, that the memorandum was only speaking generally concerning the harm to investors resulting from any such violations.

[18] See *Boeing Airplane Co.* v. *Aeronautical Industrial District Lodge*, 91 F. Supp. 596 (W.D. Wash., 1950), *aff'd* 188 F.2d 356 (C.A. 9, 1951), *cert. denied* 342 U.S. 821. See also *June* v. *George Peterson Co.*, 155 F.2d 963, 965–6 (1946): "In order to interpose the defense of res judicata successfully, there must be an identity of parties, subject matter and cause of action . . . The essence of estoppel by judgment [collateral estoppel] is that some like question or fact in dispute has been judicially determined by a court of competent jurisdiction between the same parties or their privies."

[19] See S. Rep. No. 550, 90th Cong., 1st Sess. 4 (1967); S. Rep. No. 379, 88th Cong., 1st Sess. 66 (1963).

We also note that in dismissing the injunction suit the Court stated PASCO's contention to be that Susquehanna did not disclose in its Schedule 13D statements that it intended to merge PASCO with ASARCO, or some other corporation. Although the Court in a footnote expressed disagreement with our hearing examiner's finding that Susquehanna's Schedule 13D statement was false and misleading in a material respect in connection with the planned use of PASCO's cash assets (for acquisition of or mergers with unspecified companies), its discussion in the text was confined to the question whether there was a plan or proposal to merge PASCO with ASARCO, and the Court concluded there was none, stating:

> "The idea for such a merger never got off the ground. It subsisted for a mere two days when PASCO's management repudiated it."

As previously indicated, our conclusions herein do not rest on any finding that Susquehanna had a plan or proposal to merge PASCO with ASARCO, or that such plan should have been disclosed, but rather on the overall plan with respect to the use of PASCO's assets.

CONCLUSION

On the basis of the foregoing, we conclude that Susquehanna's Schedule 13D statement as amended on December 20, 1968, failed to comply with Section 13(d) of the Act and Rule 13d–1 thereunder in material respects.

An appropriate order denying the motion to dismiss and requiring a corrective amendment will issue.

By the Commission (Chairman BUDCE and Commissioners OWENS, SMITH and HERLONG), Commissioner NEEDHAM not participating.

In the Matter of

A.V.C. CORPORATION

U.S. COMMUNICATIONS CORPORATION

BUTCHER & SHERRERD

JOSEPH L. CASTLE

File No. 3-2019. Promulgated July 21, 1970

Inbvestment Company Act of 1940—Sections 6(c) and 17(b)

TRANSACTIONS BETWEEN AFFILIATED PERSONS

Acceptance of Compensation by Affiliated Person Acting As Agent

Application requesting exemption, pursuant to Section 6(c) of Investment Company Act of 1940, from Section 17(e) for acceptance of compensation by broker-dealer firm for services rendered by associated person in connection with acquisition of properties by company controlled by registered investment company, during period when he or partner in broker-dealer firm was affiliate of investment company, *granted*, where compensation paid and proposed to be paid was fair and reasonable and did not involve overreaching.

Sale of Securities by Affiliated Person to Company Controlled by Investment Company

Application requesting exemption, pursuant to Section 17(b) of Investment Company Act of 1940, from Section 17(a) for proposed exchange of stock by stockholder of company upon its merger into company of which he was an officer and director and which was controlled by registered investment company, *granted*, where terms of such exchange met statutory standards.

APPEARANCES

Orval Sebring, *Thomas V. Lefevre*, and *George G. Loveless*, of Morgan, Lewis & Bockius, for A.V.C. Corporation and U.S. Communications Corporation.

John F. Pittas and *John F. Gough*, of White and Williams, for Butcher & Sherrerd and Joseph L. Castle.

Stanley B. Judd, for the Division of Corporate Regulation of the Commission.

Stephen A. Mishkin, for Carrie W. Garrison, a stockholder of A.V.C. Corporation.

FINDINGS AND OPINION OF THE COMMISSION

A joint application has been filed by A.V.C. Corporation, formerly a closed-end non-diversified investment company registered under the Investment Company Act of 1940,[1] U.S. Communications Corporation ("USC"), a majority-owned subsidiary of AVC, Butcher & Sherrerd ("B&S"), a registered broker-dealer, and Joseph L. Castle, a partner in B&S, for (1) an order pursuant to Section 6(c) of that Act exempting from the provisions of Section 17(e) of that Act the acceptance by B&S of compensation for services performed by Castle between January 1967 and April 1968 in connection with USC's acquisition of certain television properties and the merger of a television broadcasting company with USC, and (2) an order pursuant to Section 17(b) of the Act exempting from the provisions of Section 17(a) the proposed exchange by Castle of his stock in the television broadcasting company for securities of USC in connection with such merger.

After appropriate notice a public hearing was held, at which Carrie W. Garrison ("participant"), a stockholder of AVC, was granted leave to be heard. An initial decision by the hearing examiner was waived, and proposed findings and briefs were filed by applicants, participant, and our Division of Corporate Regulation. Our findings are based upon an independent review of the record.

Acceptance of Compensation by B&S

One of B&S's partners, Howard Butcher III, was a director of AVC from May 1967 to February 1968, and Castle was an officer and director of USC from June 1967 to December 1968. Thus, during the period of Castle's services, B&S was an affiliated person of an affiliated person of AVC within the meaning of Section 2(a)(3) of the Act. The compensation to B&S for Castle's services, as described below, comes within the prohibition of Section 17(e)(1) of the Act which makes it unlawful for an affiliated person of an affiliated person of a registered investment company, acting as agent, to accept compensation for the purchase or sale of any property to or for such

[1] In December 1969, we granted an application by AVC for an order pursuant to Section 8(f) of the Act declaring that it had ceased to be an investment company. Investment Company Act Release No. 5937 (December 22, 1969). However, our order provided with AVC's consent for the retention of jurisdiction over the matters encompassed in the instant application.

registered company or any controlled company thereof, except in the course of such person's business as a broker.[2]

Under Section 6(c) of the Act, we may exempt any transaction from any provision of the Act if necessary or appropriate in the public interest and consistent with the protection of investors and the purposes of the Act. We are satisfied on the record before us that, as urged by the Division as well as applicants, the requested exemption should be granted under standards we have held to be applicable. These standards are similar to those expressly provided in Section 17(b) for exemption from Section 17(a) of a proposed transaction with an affiliate acting as principal, namely, that the compensation be fair and reasonable and not involve overreaching.[3]

USC proposes to pay a fee of $100,000 to B&S for Castle's services in connection with USC's acquisition of stock in certain television broadcasting companies from one Daniel H. Overmyer and others. The application also covers $40,000 already paid to B&S by Overmyer.

In December 1966, Castle, then an employee of B&S,[4] met Overmyer who was interested in selling some of his assets in order to raise funds. Castle focused his attention on certain construction permits for five ultra-high frequency ("UHF") television stations issued to Overmyer companies by the Federal Communications Commission ("FCC"). Castle envisaged the collection under a single ownership of the five stations, which were in various stages of construction, and an operating UHF station in Philadelphia owned by Philadelphia Television Broadcasting Company ("WPHL").

In early 1967, Castle interested AVC's president, Frank H. Reichel, Jr., in the prospects of UHF television and the possible acquisition of the Overmyer television interests. With the assistance of Castle and others, Reichel made extensive inquiries into the state of the industry and the outlook for the Overmyer stations, and then entered into negotiations with Overmyer. The negotiations, in which Castle was very active as an intermediary, culminated in the execution of three agreements dated March 28, 1967. These provided for the sale by Overmyer to AVC, subject to FCC approval, of 80 percent of

[2] Since B&S was not acting as a securities broker in the transactions, we do not consider applicants' alternative contention that the proposed compensation to B&S is lawful under Section 17(e) (2) which would permit the firm, if it were acting as broker, to accept up to 1 percent of the purchase price of the securities acquired by USC in such transactions.

[3] See *Transit Investment Corporation*, 28 S.E.C. 10, 17 (1948).

[4] Castle had been a bank vice-president before he joined B&S in 1966. He became a partner in B&S on January 1, 1968.

the stock of the five companies which owned the construction permits, for a consideration of $1 million[5] and AVC's undertaking to lend a total of $3 million to other Overmyer companies.

Towards the conclusion of the negotiations, when it appeared that there would be an agreement, Castle indicated to Reichel that B&S expected a fee of $80,000 for its role in the transactions. Castle persuaded Overmyer to pay half, and while AVC did not specifically agree to pay the remaining $40,000, it did expect to compensate B&S for its services following the closing of the stock purchase agreement.

Beginning in May 1967, Castle initiated and was active in negotiations between AVC and WPHL with a view to combining the latter company with the Overmyer television companies under the control of AVC. An agreement was signed in early June 1967, which, contingent on FCC approval, provided for the merger of WPHL into USC, a new corporation in which AVC would after the merger own 70 percent of the common stock, and AVC assigned its television interests to USC. The agreement also provided that USC would issue 7,937 shares of its common stock to B&S in consideration of B&S's services in connection with the merger.

Because Overmyer and his companies and WPHL, respectively, were to retain control of the television properties pending FCC approval of the transfer of control, Reichel asked Castle, in view of his relationship to each of the parties, to oversee the venture during the interim period. Castle became USC's chief executive officer and board chairman, and during the period until April 1968, when he ceased serving as chief executive officer, he devoted about thirty hours per week to USC's affairs.[6] Among other things, he participated in preparing the applications for FCC approval and planning the operations which would ensue. It was agreed that compensation for such services would be a part of the total compensation to be paid to B&S. In addition, Castle assisted in obtaining certain financing for the television enterprise.[7]

The FCC approved the transfers in December 1967 and the following month the purchase and merger agreements were closed. In February 1968, Reichel agreed with Castle, then a partner in B&S, on a total fee of $25,000 plus the 7,937 shares of USC stock previously agreed upon. The fee was later renegotiated to the $100,000 cash fee now under consideration.

[5] In addition, AVC was given an option to purchase the remaining 20 percent of stock of the five companies at a price to be computed pursuant to a formula but not to exceed $3,000,000.

[6] Castle continued as board chairman after April 1968 but B&S was compensated for those services.

[7] The financing included $9 million of bank loans and the "resetting" of earlier loans of over $1 million.

It is clear that Castle performed an extensive range of services involving the expenditure of a large amount of time and effort, that the transactions were complex, and that he played an important role in their successful conclusion. According to the record, certain standards of compensation are customary for such transactions.[8] An official of an investment banking firm with substantial experience with acquisitions and mergers testified that fees of investment bankers assisting in such transactions are generally keyed to the purchase price; that conventional guidelines used as a starting point are a sliding formula of 5 percent on the first $1 million, 4 percent on the second $1 million, and so on to 1 percent on amounts above $4 million and a flat 3 percent formula; and that in a $4 million transaction, assuming a "full service" had been provided, the fee would range between amounts based on each of those formulas. He further pointed out that the type and extent of the services provided are always important factors in determining the appropriate fee. Reichel testified that with respect to the acquisition of broadcast properties somewhat higher fee rates are customary, with the average finder's fee being "perhaps" 5 percent on the first $3 million and 4 percent on the next $3 or $4 million. According to Castle, 5 percent of the gross consideration, including debt assumed, is a customary finder's fee for acquisitions or mergers in the broadcast industry.

If we consider only the payments in connection with the purchase by AVC and USC of the Overmyer television interests of about $1,775,000, including expenditures for operations and equipment, and the WPHL merger which we find involved a total consideration of about $4 million,[9] and apply either the sliding or flat 3 percent formula to the combined transactions, it would result in a fee exceeding $140,000.[10] We are also of the view that the services of a managerial nature rendered by Castle, to which at least $25,000 of the proposed fee is attrib-

[8] "The purpose of Section 17 is not to insure that affiliated persons perform services for an investment company at less than the established reasonable rates applicable to unaffiliated agents, but to insure that an affiliated agent does not abuse his relationship to obtain through overreaching a compensation greater than that which would be fair and reasonable for an unaffiliated agent." *Transit Investment Corporation, supra,* at 21, n. 33.

[9] Under the terms of the merger the preferred stock of WPHL, with a total face amount of $240,000, was to be converted into USC debentures in like amount, and USC was to assume WPHL's debt totalling about $1,760,000. The common stock of WHPL, which was exchanged for USC common stock, was considered to have a value of $2 million, as evidenced by the price at which certain stockholders for WPHL were given the right to "put" to AVC portions of the USC stock issued to them.

[10] Assuming a $2 million value of the WPHL common stock, the compensation of $25,000 and 7,937 shares of USC stock which was originally agreed upon (in addition to the $40,000 paid by Overmyer) might reasonably be considered as having a value of about $125,000.

uted by applicants, were performed in connection with the transactions and are entitled to recognition in determining the appropriate compensation. Under the circumstances we find the compensation agreed upon to be fair and reasonable even if, as urged by the Division, no compensation may be allowed with respect to Castle's services in obtaining bank financing because AVC was an established company and would have encountered little difficulty in obtaining credit without Castle's help.

The record indicates that there was no overreaching in arriving at the compensation in question. Approval of the Overmyer agreements by AVC preceded the beginning of any affiliation between B&S and AVC, and Butcher, although an AVC director at the time, abstained from voting on the WPHL merger. Castle was not affiliated with AVC at the time he presented the Overmyer and WPHL transactions to AVC, and his affiliation through USC was a result, rather than a cause, of those transactions. At the time Castle arranged for a $40,000 fee to be paid by Overmyer with the understanding that AVC would pay a similar amount, there was no affiliation between AVC and B&S, and the fee to B&S provided for in the WPHL agreement was negotiated at arm's length. The first total fee agreed upon between Reichel and Castle reflected a reduction to $25,000 from the $40,000 which Castle had assumed would be paid. At the meeting of the AVC board which approved that fee, Butcher was absent, having already tendered his resignation. And at the time the fee now before us was negotiated, all affiliation between AVC and B&S had terminated.

Participant urges that we should withhold approval of any payment to B&S beyond that already made by Overmyer, asserting that the chronology of events and affiliations demonstrates overreaching or improper valuations of the acquired properties. No support for that assertion is advanced, however. Nor is it significant, as argued, that no specific fee was agreed upon between AVC and B&S with respect to the Overmyer transactions until after those transactions had been closed. As disclosed in AVC's proxy statement for the May 1, 1967 stockholders meeting, AVC expected to compensate B&S for services rendered in connection with the Overmyer transactions, with the amount to be determined after the closing of the stock purchase agreement. Participant further argues that since the Overmyer transactions were a result of Overmyer's need for capital, he and not AVC or USC should pay any additional fee. Those transactions, however, also involved services in connection with the acquisition of stock and in that area the buyer usually pays for such services where rendered by a single agent. Finally, we find no merit in participant's assertions or arguments that because AVC had paid no fee in connection with certain other acquisitions arranged by B&S no fee should be paid here, and that the amount of the proposed compensation is high in relation to AVC's income, expenses and dividends paid.

ISSUANCE OF U.S.C. SECURITIES TO CASTLE

Applicants request an exemption from Section 17(a) of the Act for the proposed exchange by Castle of his holdings in WPHL of 400 shares or 1.33 percent of its common stock and 400 shares of its preferred stock for 2,000 shares of USC's common stock and $8,000 principal amount of its debentures pursuant to the terms of the merger between USC and WPHL described above. Section 17(a)(1) as here pertinent makes it unlawful for an affiliated person of an affiliated person of a registered investment company, acting as principal, to sell a security to such company or a company controlled by it. At the time the merger agreement was signed in June 1967 as well as at the time of closing in January 1968, Castle, as an officer and director of USC, was an affiliate of AVC. Under Section 17(b), we may exempt a proposed transaction from the prohibition of Section 17(a) if the terms are reasonable and fair and do not involve overreaching, and the transaction is consistent with the policy of the investment company and the general purposes of the Act.

We conclude that the standards of Section 17(b) have been met and that it is appropriate to grant the requested exemption. The merger agreement was negotiated at arm's length between AVC and the controlling stockholders of WPHL, and Castle is to receive only the same proportionate share as the other WPHL stockholders. And the merger appears to be consistent with the investment policies of AVC at the time and the purposes of the Act.

An appropriate order will issue.

By the Commission (Chairman BUDGE and Commissioners OWENS, SMITH, NEEDHAM and HERLONG).

In the Matter of

VERMONT YANKEE NUCLEAR POWER CORPORATION ET AL.

MAINE YANKEE ATOMIC POWER COMPANY ET AL.

File Nos. 3-797, 3-899, 3-1454, 3-1624, 3-1670. Promulgated July 30, 1970

Public Utility Holding Company Act of 1935—Section 10(b)(1)

ACQUISITION OF SECURITIES

Antitrust Policies

Amended applications for acquisition of common stock by sponsors of nuclear generating companies which provide opportunity for participation in power output to all non-sponsor electric utility companies in region and providing to such non-sponsors auxiliary services such as transmission and reserves, *granted*, such applications not requiring adverse findings under Section 10(b)(1) of Public Utility Holding Company Act that proposed acquisitions involve concentration of control detrimental to public interest or interest of investors and consumers.

Appearances:

George H. Lewald and *John A. Pike*, of Ropes & Gray, for Applicants.

Richard B. Dunn, for New England Power Company.

George Spiegel and *James F. Fairman*, for Municipal Electric Association of Massachusetts and the City of Chicopee, Massachusetts, and the Chicopee Municipal Light Plant, the Town of Shrewsbury, Massachusetts and the Shrewsbury Electric Light Plant, and the Town of Wakefield, Massachusetts, and the Wakefield Municipal Light Department.

Donald L. Rushford, for the Public Service Board of the State of Vermont.

Vincent L. McKusick, of Pierce, Atwood, Schribner, Allen & McKusick, for Central Maine Power Company and witness William H. Dunham.

C. Duane Blinn and *Michael F. Halloran*, of Day, Berry & Howard, for The Connecticut Light and Power Company, The Hartford Electric Light Company and Western Massachusetts Electric Company.

R. Moshe Simon and *Gary N. Sundick* for the Division of Corporate Regulation of the Commission.

FINDINGS AND OPINION OF THE COMMISSION

These proceedings under Sections 6(b), 9(a) and 10 of the Public Utility Holding Company Act of 1935 ("Act") relate to the issue and sale of common stock by Vermont Yankee Nuclear Power Corporation ("Vermont Yankee") and Maine Yankee Atomic Power Company ("Maine Yankee") and the acquisition thereof by their respective sponsors. Orders entered by us with respect to the common stock financings[1] were set aside on review and the proceedings remanded to us for hearing and reconsideration.[2] In the course of extensive hearings, a proposed settlement of certain contested matters was reached and post-hearing procedures were waived.

Vermont Yankee and Maine Yankee were each incorporated in 1966 to construct, own and operate a nuclear-fueled electric generating plant to supply low-cost electric energy to their respective New England utility company sponsors. Vermont Yankee's plant, located near Vernon, Vermont, is to have an initial capacity of about 540 megawatts, and Maine Yankee's plant located near Wiscasset, Maine, will have an initial capacity of 800 megawatts.

The capital costs of the plants, excluding the cost of the initial inventory of nuclear fuel, are currently estimated at $125,000,000 for Vermont Yankee and $181,000,000 for Maine Yankee, which under capital funds agreements the two groups of sponsors are respectively obligated to provide. As heretofore authorized and approved by us subject to certain conditions noted below, Vermont Yankee has issued and sold to its ten sponsors, in stated percentages, 400,000 shares of its common stock for a total consideration of $40,000,000,[3] and Maine

[1] *Vermont Yankee Nuclear Power Corporation*, 43 S.E.C. 693 (1968) and Holding Company Act Release No. 16053 (May 1, 1968); *Maine Yankee Atomic Power Company*, 43 S.E.C. 764 (1968).

[2] *Municipal Electric Association of Massachusettes* v. *S.E.C.*, 413 F.2d 1052 (CADC, 1969).

[3] See *Vermont Yankee Nuclear Power Corporation*, Holding Company Act Release Nos. 16467 and 16468 (September 5, 1969), wherein all previous authorizations are cited.

The ten sponsor companies in Vermont Yankee and their respective stock ownership percentages are

Yankee has issued and sold to its eleven sponsors 500,000 of its common stock at an aggregate price of $50,000,000.[4] The balance of capital funds will be obtained by the sale of first mortgage bonds and securities other than common stock. We have also authorized Vermont Yankee and Maine Yankee each to issue and sell subordinated notes to its sponsors in the amount of $60,000,000, and $120,000,000, respectively.[5] We have, in addition, authorized bank borrowings as interim financing of $20,000,000 for Vermont Yankee and $30,000,000 for Maine Yankee.[6]

Pursuant to power contracts the sponsors of Vermont Yankee and Maine Yankee are each required to purchase for a

listed below. (The first seven companies are applicants in these proceedings; the stock acquisition by the other three is not subject to Commission approval):

Sponsor	*Percentage*
Central Vermont Public Service Corp. ("Central Vermont")	35.0
Green Mountain Power Corporation ("Green Mountain")	20.0
New England Power Company ("NEPCO")	20.0
The Connecticut Light and Power Company ("CL&P")	6.0
The Hartford Electric Light Company ("HELCO")	3.5
Montaup Electric Company ("Montaup")	2.5
Western Massachusetts Electric Company ("WMECO")	2.5
Public Service Company of New Hampshire ("PSNH")	4.0
Central Maine Power Company ("Central Maine")	4.0
Cambridge Electric Light Company ("Cambridge")	2.5
	100.0

[4] See *Maine Yankee Atomic Power Company*, Holding Company Act Release No. 16469 (September 5, 1969), wherein all previous authorizations are cited.

The eleven sponsor companies of Maine Yankee and their respective ownership percentages are listed below. (The first nine are applicants in these proceedings and the stock acquisition of the remaining two do not require approval by the Commission):

Sponsor	*Percentage*
Central Maine	38.0
NEPCO	20.0
CL&P	8.0
Bangor Hydro Electric Company	7.0
Maine Public Service Company	5.0
HELCO	4.0
Cambridge	4.0
Montaup	4.0
PSNH	5.0
WMECO	3.0
Central Vermont	2.0
	100.0

[5] *Vermont Yankee Nuclear Power Corporation*, Holding Company Act Release No. 16556 (December 11, 1969); *Maine Yankee Atomic Power Company*, Holding Company Act Release No. 16560 (December 12, 1969).

[6] *Vermont Yankee Nuclear Power Corporation*, Holding Company Act Release No. 16414 (June 27, 1969) and releases cited therein; *Maine Yankee Atomic Power Company*, Holding Company Act Release No. 16057 (May 6, 1968).

The initial orders approving the bank borrowings of Vermont Yankee and Maine Yankee were affirmed on appeal, *Municipal Electric Association of Massachusetts* v. *S.E.C.*, 419 F.2d 757 (CADC, 1969).

period of 30 years in proportion to their stock ownership the total capacity and output of the respective power plants. The price is to be based on each plant's cost of service, including provisions for an appropriate return on the equity investment currently estimated at 8.5 percent for Vermont Yankee and 9.8 percent for Maine Yankee. Power from the two plants will be transmitted over the coordinated New England transmission grid interconnecting the systems of all the sponsors.

In authorizing the sale of common stock by Vermont Yankee and Maine Yankee companies and approving the acquisition thereof by the sponsors, we denied a request for an evidentiary hearing and for imposition of certain conditions sought by the Municipal Electric Association of Massachusetts, and the cities and municipal utility departments of Chicopee, Wakefield and Shrewsbury, Massachusetts (collectively referred to as "Municipals").[7] The Municipals urged that the joint undertakings by the sponsor companies from which the Municipals were excluded, were contrary to Federal antitrust policies, and that accordingly the proposed stock acquisition by the sponsors may not be approved under the standards of Section 10(b)(1) of the Act unless such approval was made subject to the condition that the Municipals be afforded an opportunity to participate in the projects on the same or equivalent basis as the sponsor companies. We held (Commissioner Smith, dissenting) that, while Section 10(b)(1) required consideration of antitrust effects of acquisitions, it did not extend to an issue such as the Municipals' exclusion from participation in projects which were organized solely for the purpose of meeting the sponsors' own generating requirements.

In reversing our decision, the Court of Appeals held that the exclusion of the Municipals was a relevant matter for consideration under Section 10(b)(1) of the Act and the antitrust policies which it embodied. It agreed with us that the proposed transactions satisfied the requirements of the Act in all other respects, including that the issue and sale of the Vermont Yankee and Maine Yankee common stocks satisfied Section 6(b) of the Act. We subsequently directed a consolidated hearing with respect to proposals, by Vermont Yankee and by Maine Yankee, to which all the respective sponsors are signatories, which would afford the Municipals and other public-utility companies in the New England area an opportunity to participate in the power output of Vermont Yankee and Maine Yankee.

AMENDED PROPOSALS

The proposals of Vermont Yankee and Maine Yankee, which as submitted were opposed as inadequate by the Municipals, were amended during the course of the hearings in substantial respects and are now supported by the Municipals. The other electric utilities in the New England region (except one),[8] all of whom had received notice of the hearing and copies of the original proposals, did not appear and have filed no objections to the original or amended proposals.

Under the proposals, as amended, there will be included in the participation in the power output of the Vermont and Maine projects in addition to five non-sponsor electric utility companies named and discussed below, (a) the Municipals in Massachusetts as specially defined and (b) electric utility companies, including cooperatives and municipally-owned systems, in the New England region outside of the State in which the respective plant is to be located, which are collectively referred to as "remaining offerees."[9] The Municipals in Massachusetts include 35 of the 40 municipally-owned systems who have either specifically appeared in the proceedings or were represented herein through the Municipal Electric Association of Massachusetts. One nonmember of the Association and four others who were not represented by the Association are among the "remaining offerees." For the non-sponsor utilities in Vermont and Maine, there are separate and somewhat different arrangements with the Vermont and Maine sponsors, respectively.

The maximum participation for the Municipals as a group is set at 60.21 mw, 22.138 mw from Vermont Yankee and 38.072 from Maine Yankee. For the remaining offerees, the group maximum is fixed at 73.357 mw, 24.156 mw from Vermont Yankee and 49.201 mw from Maine Yankee. These group maxima are based on 1967 kwh sales of each of the groups as a percentage of total sales of the offering sponsors and of all offerees, as originally proposed, but with such percentages doubled under the amended proposals. The offering sponsors

[7] In addition to the Municipals, similar applications were received from Eastern Maine Electric Cooperative, Inc., and Citizens for Public Power, Inc., both of which were also denied. Notice of intervention was also received from the Public Service Board of Vermont.

The refusal by the Atomic Energy Commission to impose the request of the Municipals for the same conditions in connection with the grant of a construction permit to Vermont Yankee was upheld on appeal. See, *Cities of Statesville et al.* v. *AEC*, 441, F.2d 962, (No. 21844) (CADC, 1969).

[8] Eastern Maine Electric Cooperative is the utility other than the Municipals.

[9] This group includes seven electric utility systems in Connecticut, eight in Massachusetts, ten in New Hampshire, two in Rhode Island, and depending on whether the offer is by the Vermont Yankee or Maine Yankee sponsors, twelve in Maine as to the former offer and 27 in Vermont as to the latter.

include only the out-of-state sponsors of Vermont Yankee and of Maine Yankee, respectively. The maximum entitlements of the offering sponsors are 243 mw (45 percent of 540) in the case of Vermont Yankee and 400 mw (50 percent of 800 mw) for Maine Yankee, so that the maximum for both groups of offerees is about 20 percent of the total entitlements of the offering sponsors from both Yankee plants.

For each participant in either of the two groups, the maximum entitlement from both plants is limited to 30 percent of its 1968 peak load. If all participants in each group accept the maximum amount of energy to which each participant is entitled, adjustment will be necessary to decrease the amounts accepted in order to comply with the maximum group limit. Such adjustment may result in some or all of the participants receiving less than the 30 percent. For a specified period prior to the signing of definitive power contracts, the amended proposals permit voluntary intra-group adjustments, but in no event may a single offeree as a result of such adjustment contract for more than 30 percent of its 1968 peak load from both plants.[10] After definitive power contracts are signed, such contracts are assignable to the extent that a contracting offeree is free to sell his committed block of power, from either or both the plants, to another public-utility company. This resale will not relieve the contracting offeree of his obligations to the sponsors, but the sponsors have agreed, upon timely notice, to render bills to or otherwise deal directly with, the subsequent purchaser of the bulk power.

In addition, the Municipals and the remaining offerees will receive certain auxiliary arrangements.[11] A contract for transmission of power over the defined main line transmission system in New England will be made available to every offeree under a formula similar to that now in use for transmission of power from Connecticut Yankee Atomic Power Company, and any offeree which does not directly interconnect to such system but which interconnects with systems of an offering sponsor or affiliate of the sponsor, will be offered terms for subtransmission of its power entitlement.[12] Participants in

[10] The amendments to the proposals provide for material changes in both total and relative participations. For example, Shrewsbury, one of the Municipal group, was offered under the initial proposal a maximum of 391.8 kw from Vermont Yankee sponsors and 674.6 kw from Maine Yankee sponsors, with the maximum for the Municipals as a group fixed at 11,069 kw of Vermont Yankee power 19,036 kw of Maine Yankee power. Under the amended proposal, Shrewsbury can obtain a maximum of 2,046 kw of Vermont Yankee and 3,534 kw of Maine Yankee power, while the Municipals as a group will be entitled to a maximum of 22,138 kw of Vermont Yankee and 38,072 kw of Maine Yankee power.

[11] The amended proposals also provide that if an offeree becomes a participant in the comtemplated New England power pool ("NEPOOL"), the NEPOOL Agreement will supersede these auxiliary arrangements to the extent that it covers the same services.

either group who are now obtaining firm power for partial or total requirements from an offering sponsor, or affiliate thereof, will also be offered a contract for back-up services and reserves; others will not.[13]

The amended proposals also include a special offer by the Maine Yankee sponsors to 12 non-sponsor utilities in the State of Maine, who are also included in the category of "remaining offerees" previously described with respect to Vermont Yankee power. The Maine sponsors, who are entitled to 50 percent of the Maine Yankee output, are offering to each of these utilities, Maine Yankee power in an amount equal to the ratio of its firm kwh sales to ultimate customers in 1967 to all such sales by all utilities in the State of Maine in that year, or an aggregate amount of 11.838 mw. These 12 offerees are also offered the auxillary arrangements for transmission, subtransmission, back-up and reserves, except for one utility which does not qualify for such collateral offers. Each member of this intra-Maine group is also to be offered an opportunity to purchase from the Maine sponsors of Maine Yankee a percentage of the common stock of Maine Yankee not exceeding its percentage of Maine Yankee power it has accepted, without in any way impairing the obligations of any Maine sponsor's obligation under the capital funds agreement between Maine Yankee and its sponsors. If more than 2 percent of the outstanding Maine Yankee common stock is purchased by these offerees, they shall collectively be entitled to a representative on the board of directors of Maine Yankee. In all of these respects the amended proposal regarding Maine Yankee is similar to a prior proposal that the Vermont Yankee sponsors had made to the 27 non-sponsor utilities in the State of Vermont, five of which accepted the offer.

The larger electric utility companies to which a separate offer is to be made consist of Boston Edison Company, United Illuminating Company, Green Mountain, Bangor Hydro-Electric and Maine Public Service. Boston Edison and United Illiminating are not sponsors of either Vermont Yankee or Maine Yankee; Green Mountain is one of the sponsors of Vermont Yankee; and Bangor and Maine Public Service are sponsors of Maine Yankee.[14] Each of these companies is of-

[12] In the event that an offeree is interconnected neither to the main line transmission system nor to the lines of a sponsor (or affiliate thereof), presumably such offeree must make its own substransmission arrangements. There are a total of 18 offerees in both groups in this category.

[13] There are sixc Municipals and fifteen of the remaining offerees which will not be eligible for such back-up services and reserves.

[14] All the other larger electric utility companies in New England are sponsors of both Yankee companies, or affiliates of such sponsors.

fered a portion of the power from the Vermont Yankee and Maine Yankee plants as to which they are not sponsors in amounts based on the ratio of the offerees as to which they are not sponsors in amounts based on the ratio of the offerees firm kwh sales to ultimate customer in 1967 to the aggregate of such sales by all offerees and the offering sponsors and affiliates thereof. Members of this group are not offered any of the collateral terms such as transmission, back-up, etc.

COMPLIANCE WITH SECTION 10(b)(1)

Section 10(b)(1) provides that the Commission shall approve an acquisition unless it finds that "such acquisition will tend towards interlocking relations or concentration of control of public-utility companies, of a kind or to an extent detrimental to the public interest or the interest of investors or consumers." In addition, Section 10(e) of the Act provides that the Commission in any order approving an acquisition subject to Section 10 "may prescribe such terms and conditions in respect of such acquisition, . . . as the Commission may find necessary or appropriate in the public interest or for the protection of investors or consumers." As noted earlier, the Municipals had urged that their exclusion from participation in the power output of the Vermont Yankee and Maine Yankee plants was contrary to Section 10(b)(1) and the policies of the antitrust laws and that the proposed acquisitions of the common stock of Vermont Yankee and Maine Yankee by the respective groups of sponsors should not be approved unless made subject to a condition that the Municipals in the New England region are afforded an opportunity for such participation on the same or equivalent basis as the sponsors.

The Court of Appeals stated (413 F.2d 1057) ". . . violations of the antitrust laws bear upon 'the public interest or the interest of investors or consumers,' terms used in Section 10(b)(1) of the Act now before us." After outlining the basic allegations of the Municipals, it concluded that if such allegations were "substantially correct," then the "plans of sponsors, with the strong economic position they would attain by entitlement to all new low cost power involved, tend towards a concentration of control of public utility companies" and that "this type control, albeit indirect . . . ., does not seem to the court to be beyond the reach of the language of Section 10(b)(1)" (413 F.2d 1058). The Court construed the qualifying language in the latter half of Section 10(b)(1) as requiring us to weigh the detrimental effects of such control against the factors favoring the projects in the terms proposed, and noted that an element to be considered would be Municipals' claim of right, in the interest of the public and consumers, to an opportunity to obtain power at its source.[15]

The amended proposals afford an opportunity to non-sponsors to purchase Yankee power at its source, and we consider that the terms of the proposals, as amended, resolve the issues raised under Section 10(b)(1) . It is unnecessary to decide whether in this and other like cases stock acquisitions cannot meet the standards of Section 10(b)(1) unless accompanied by offers of a kind and to an extent that by settlement have been made to the non-sponsors in the cases before us.

The question under that Section as to whether there would exist a tendency "towards concentration of control of public utility companies" was predicated upon the lack of adequate opportunity to obtain the low cost power at its source. As described above, every non-sponsor electric utility in the New England area will be tendered an offer to obtain Vermont Yankee and/or Maine Yankee power at its source. The variant formulas in the amended proposal appear reasonable in the light of the nature of the respective groups and the fixed amount of power available both to the offerees and sponsors. The fact that the proposals provide for a reversion to the sponsors of all offers not accepted also appears reasonable both because it is the sponsors who have in fact provided substantial equity capital to build these projects, and it is the sponsors who initially based their own long-range generation program on an assumed amount of power available from the two Yankee plants. Nor should the amended proposals be regarded as inadequate because they do not include offers of equity participation to the Municipals, whose basic aim is to obtain low cost power at its source, not the desire of an equity investment. The inclusion in the proposals, as amended, of definitive collateral offers for transmission and back-up eliminates the principal basis for the objection of the Municipals to the initial proposal as inadequate.

In approving the amended applications, we do not thereby affect the jurisdiction of the Federal Power Commission with respect to the related arrangements for transmission and reserves. Our approval is only a determination that the offers to the non-sponsors, within the context of the proposed stock acquisitions, satisfy the standards of Section 10(b)(1). The

[15] 413 F.2d. at 1059.

proposals state that the contracts relating to transmission and reserves will be filed with the appropriate regulatory commission having jurisdiction over such matters, and the Court of Appeals has indicated that the imposition of such conditions as sought by the Municipals "would not invade the jurisdiction of the Federal Power Commission" (413 F.2d at 1060).

We therefore find that the amended proposals resolve the issues raised under Section 10(b)(1) and that no adverse findings are necessary thereunder. We shall issue an order granting the applications in these consolidated proceedings, as amended by the post-effective amendments embodying the amended proposals, and releasing jurisdiction previously reserved.[16]

By the Commission.

[16] Holding Company Act Release Nos. 16469, 16468, 16467, 16347, 16346.

In the Matter of

MISSISSIPPI POWER & LIGHT COMPANY

SUNSET PLAZA APARTMENTS, INC.

File No. 3-2408. Promulgated August 20, 1970

Public Utility Holding Company Act of 1935—Sections 6,7,9,10 and 12
Rules 43 and 45.

MEMORANDUM OPINION AND ORDER

ACQUISITION OF SECURITIES OF NON-UTILITY COMPANY BY PUBLIC UTILITY SUBSIDIARY COMPANY OF REGISTERED HOLDING COMPANY

Application under Sections 9(a) and 10 of Public Utility Holding Company Act of 1935 for approval of proposed acquisition, by public-utility subsidiary company of registered holding company, of securities of non-utility subsidiary company which proposes to construct low and moderate income housing project pursuant to National Housing Act, *denied*, as not meeting standards of that Act.

Mississippi Power & Light Company ("MP&L"), a public-utility subsidiary company of Middle South Utilities, Inc. ("Middle South"), a registered holding company, and its wholly-owned subsidiary company, Sunset Plaza Apartments, Inc. ("Sunset Plaza"), a non-utility company recently organized under Mississippi law, have filed an application-declaration and an amendment thereto with this Commission pursuant to Sections 6, 7, 9, 10 and 12 of the Public Utility Holding Company Act of 1935 ("Act") and Rules 43 and 45 promulgated thereunder regarding the following proposed transactions.

MP&L distributes electric energy at retail in various cities and towns in the State of Mississippi, including the City of Jackson. Sunset Plaza was organized for the purpose of constructing, owning and operating low and moderate income housing projects under Section 221(d)(3) of the National Housing Act, as amended. MP&L proposes, through Sunset Plaza, to construct, as a pilot project, 120 housing units for low and moderate income families in the inner-city area in the City of Jackson. To provide construction funds for the project MP&L

requests authorization to acquire and Sunset Plaza to issue and sell, up to $200,000 of common stock and $2,000,000 of promissory notes. No State commission and no Federal commission, other than this Commission, has jurisdiction over the proposed transactions.

Public notice of the application-declaration was issued (Holding Company Act Release No. 16781), pursuant to which interested persons were given an opportunity to request a hearing. No hearing has been requested or ordered, and MP&L has agreed that we may consider the matter on the basis of the application on file.

In light of our decision in *Michigan Consolidated Homes Corporation* (44 S.E.C. 359 (1970)), we must deny the application-declaration. The housing project, which in all relevant respects is identical with that proposed by Michigan Consolidated, lacks the operating or functional relationship required by Section 10(c)(1), which incorporates Section 11(b)(1), between such a non-utility business and the operations of an integrated public-utility system. The fact that MP&L requests approval of the pending proposal as a pilot project and that it contemplates no additional housing projects, does not serve to distinguish this application from the one rejected in the *Michigan Consolidated* case. The import of the *Michigan Consolidated* decision is that any such venture is prohibited by the Act. Accordingly, we conclude that MP&L's application-declaration cannot be approved. Nor, for reasons there stated, may we exempt the acquisitions under the provisions of Section 9(c)(3) of the Act.

IT IS ORDERED, accordingly, that said application-declaration, as amended, be, and it hereby is, denied and not permitted to become effective.

By the Commission (Chairman BUDGE and Commissioners NEEDHAM and HERLONG), Commissioners OWENS and SMITH dissenting in separate statements.

Commissioner OWENS, concurring in part and dissenting in part:

I reiterate my opinion as expressed in both prior *Michigan Consolidated* proceedings (43 S.E.C. 1108, and 44 S.E.C. 359). While I concur that Sections 10(c)(1) and 11(b)(1) do not permit a public-utility holding company registered under the Act or a subsidiary company thereof to engage in the housing business, I adhere to my views that an exemption under Section 9(c)(3) is appropriate where justified by the special circumstances of a particular application. I feel that the factual situation presented by MP&L's application closely parallels the facts in the *Michigan Consolidated* proceedings. I, therefore, would approve this application pursuant to Section 9(c)(3).

Commissioner SMITH, dissenting:

As the factual pattern of the instant proposal is indistinguishable from that of *Michigan Consolidated,* I adhere to the views I expressed in both prior *Michigan Consolidated* proceedings and conclude that the application-declaration should be granted either as an "other business" permissible under Section 11(b)(1), upon which I, again, place primary reliance, or by way of an exemption under the provisions of Section 9(c)(3).

In the Matter of

MICHIGAN CONSOLIDATED GAS COMPANY

MICHIGAN CONSOLIDATED HOMES CORPORATION

File No. 3-2111. Promulgated August 26, 1970

Public Utility Holding Company Act of 1935—Section 10.

MEMORANDUM OPINION AND ORDER

Michigan Consolidated Gas Company, a gas utility subsidiary company of American Natural Gas Company, a registered holding company under the Public Utility Holding Company Act of 1935, and Michigan Consolidated Homes Corporation, a wholly-owned non-utility subsidiary of Michigan Consolidated Gas, filed a motion for an interim order of the Commission authorizing movants to complete the construction and financing of the two housing projects of which they were directed to divest themselves by the Commission's order of June 22, 1970 (Holding Company Act Release No. 16763).

Movants asserted that the requested authorization is a necessary step in implementing the Commission's divestiture order. They argued that divestment of the housing projects is a complicated and time-consuming process and that the authorizations would avoid undue loss and damage to applicants. The Division of Corporate Regulation of the Commission opposed the motion. It argued that the motion sought to have the Commission approve what the Commission expressly decided it has no authority to approve, although movants did not suggest that the Commission rescind or amend its order of June 22, 1970.

The Commission after consideration of the matter, agreed with the position of the Division that to grant the motion would be inconsistent with and in derogation of the Commission's prior order, which held that construction and operation of the two housing projects could not be authorized under the Act. This case differs from others where acquisitions were authorized subject to divestiture. In those cases the permitted interim acquisitions related to properties which had been lawfully acquired originally, or to properties whose acquisition was incidental to an authorized acquisition of other properties whose acquisition and retention met the standards of the Act. In this case the properties involved were acquired improperly without the requisite prior approval of the Commission, and have been found to be of a kind whose acquisition is prohibited by the Act.

Accordingly, IT IS ORDERED that the motion for interim authorization be, and it hereby is denied.

By the Commission (Chairman BUDGE and Commissioners NEEDHAM and HERLONG, with Commissioner OWENS concurring, Commissioner SMITH dissenting.

Commissioner OWENS, concurring:

Movants assert, in effect, that the majority of the Commission in its decision of June 22, 1970 merely ordered a divestiture which can be stayed by the Commission upon a proper showing. That is not the case. The majority determined that the Commission is not statutorily empowered to permit utility holding companies to engage in activities such as those for which Michigan Consolidated sought exemption. While I dissented from the majority opinion of June 22, 1970, I do not believe that the Commission now should permit movants to do indirectly by motion, even on an interim basis, that which the Commission has already determined it has no power to permit them to do directly by exemption. I therefore concur in the denial of the motion.

Commissioner SMITH dissenting:

Michigan Consolidated asserts that the requested authorization is a necessary and appropriate step in implementing the Commission's divestiture order. In support it contends that divestment of these housing projects is a complicated and time-consuming process, particularly because they involve Government housing programs administered by the Federal Housing Administration, and that the requested authorization is necessary both to an orderly implementation of divestiture and to avoid unnecessary loss and damage. If this were shown to be so, and a concrete program adopted for divestment as soon as practicable, I would grant the authorization rather than further penalizing the company and the projects under the Commission's prior order. The Commission has in the past shown a strong sense of practicality in the area of 1935 Act divestiture.[1] In order to consider the motion, I would have required Michigan Consolidated to provide us with a more detailed and specific statement of the items and amounts of asserted loss and damage that would be involved in a divestiture of the two projects without the interim authorization sought, and also an undertaking detailing the specific steps and time sequences proposed for the prompt divestiture of such projects pursuant to the Commission's prior order assuming the interim authorization were granted.

[1] See, for example, *Louisiana Gas Service Company*, 40 S.E.C. 193, 195, 198–199 (1960); *Pennzoil Company*, 43 S.E.C. 709, 721 (1968); *Pennzoil United, Inc.*, 44 S.E.C. 75, 77 (1960); *Illinois Power Company*, 44 S.E.C. 139, 151 (1970).

IN THE MATTER OF

MAY & COMPANY, INC.

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

File No. 3–2231. Promulgated September 8, 1970

Securities Exchange Act of 1934—Sections 15A(g) and (h)

REGISTERED SECURITIES ASSOCIATION—REVIEW OF DISCIPLINARY PROCEEDINGS

Violations of Rules of Fair Practice

In proceedings for review of action by registered securities association censuring member, fining it $2,000 and suspending it from associatior for two days, association's findings that member's underwriting compensation, including amount estimated as value of certain shares of issuer issued to official of member shortly before public offering at price substantially below public offering price, was unfair and unreasonable, and that member failed to file promptly with association required documents relating to such underwriting, in violation of association's rules of fair practice, *sustained.*

APPEARANCES:

Mark P. Schlefer and *Michael Joseph*, of Kominers, Fort, Schlefer, Farmer & Boyer, and *Nathan Cohen* and *William Rutherford*, for May & Co., Inc.

Lloyd J. Derrickson, *Frank J. Wilson* and *John J. McCarthy, Jr.*, for the National Association of Securities Dealers, Inc.

FINDINGS, OPINION AND ORDER

May & Co., Inc., a member firm of the National Association of Securities Dealers, Inc. ("NASD"), seeks review, pursuant to Section 15A(g) of the Securities Exchange Act of 1934, of disciplinary action taken against it by the Association in which the firm was censured, suspended from membership for two days and fined $2,000.

The NASD action was concerned principally with the underwriting compensation in connection with a public offering in February 1968, as to which the member firm acted as managing underwriter, of 147,500 shares of the common stock of

Fibers, Incorporated at $2 per share pursuant to a filing under Regulation A, which provides for an exemption from the registration provisions of the Securities Act of 1933. At that time the NASD Manual contained an "Interpretation of the Board of Governors", keyed to Article III, Section 1 of the NASD Rules of Fair Practice,[1] entitled "Review of Underwriting Arrangements." That Interpretation noted that a special Committee of the NASD Board of Governors known as the Committee on Underwriting Arrangements had been appointed to review offerings of securities of unseasoned companies to determine in each case whether the underwriting arrangements as a whole appear to be unfair and unreasonable, taking into account all elements of compensation and all of the surrounding circumstances. The "General Guidelines" set forth in the Interpretation stated, among other things, that in determining the amount of underwriters' compensation, the Committee would include the gross amount of the underwriter's discount and that "Stock acquired or to be acquired by the underwriter, finder, or related parties in connection with the offering is valued on the basis of the difference between the cost of such stock and the public offering price." The Interpretation, under the heading "Filing Requirements", requested, among other things, that all members acting as managing underwriters of Regulation A offerings file copies of the initial offering circulars with the NASD at the time such documents were filed with this Commission.

An initial offering circular and a notification under Regulation A covering the Fibers offering were filed with us on February 7, 1968. Counsel then representing the member filed copies of these documents with the NASD by letters dated February 21 and 23, 1968, received by the NASD on February 23 and 26, 1968, respectively. The offering began on February 27, 1968, and all 147,500 shares were sold at $2 per share for gross receipts of $295,000. The underwriting commission was $0.25 per share, for a total of $36,875, representing 12.5 percent of the aggregate offering price.

The notification showed that on December 21, 1967, Fibers had also sold 53,000 unregistered shares at $0.50 per share to four individuals, and issued 5,000 shares to another person for no cash consideration. The notification identified one of these individuals, Meredith K.M. Smith, who had thus acquired

[1] Section 1 of Article III provides that a member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.

40,000 Fibers shares at $0.50 per share, as a person associated with (he was a vice-president) the member firm which was the principal underwriter of the public offering, and the offering circular described the individual who had received 5,000 shares at no cash cost, C. Edward Jacobsen, as a director and promoter of Fibers and a consultant securities analyst for the member.

The NASD Underwriting Committe treated the stock issued to Smith and Jacobsen as stock issued to related parties in connection with the offering for the purpose of computing the overall underwriting compensation, valued the anticipated profits on such stock at $56,000,[2] a sum equal to 19 percent of the aggregate public offering price, and added this amount to the underwriters' commissions, thus arriving at total underwriting compensation of $92,875, equal to 31.5 percent of the aggregate public offering price. Upon the Committee's recommendation the NASD District Business Conduct Committee instituted disciplinary proceedings, its complaint alleging that the member in violation of Article III, Section 1 of the Rules of Practice had entered into underwriting arrangements with respect to the Fibers offering which were unfair and unreasonable, and had failed promptly to file with the NASD the required documents in connection with such offering.

After the member filed an answer and supporting affidavits, the District Committee of the NASD found that the transactions between the issuer and Smith and Jacobsen did not constitute part of an arrangement between the member and the issuer which established compensation in connection with the public offering, and that while theie had been a failure promptly to file the required documents with the NASD there were mitigating circumstances in that the member had relied on its former counsel to make a timely filing. The District Committee accordingly dismissed the charges against the member, but the Board of Governors of the NASD determined to review.[3] Following a hearing, the Board found violations of Article III, Section 1 as alleged in the complaint, and imposed the sanctions described above. The member and the NASD filed briefs with us, and our findings are based on an independent review of the record.

[2] The Committee arrived at the $56,000 by computing the difference between the cost of such stock to Smith and Jacobsen ($20,000) and the value of the shares at the $2 public offering price ($90,000), and reducing the resultant amount by 20 percent to reflect the assumed escrow of all such shares for a year.

[3] Section 14 of the NASD Code of Procedure for Handling Trade Practice Complaints, as here pertinent.

Fairness of Underwriting Arrangements

With regard to the fairness or reasonableness of the underwriting arrangements, the basic question is whether the issuance of Fibers stock to Smith and Jacobsen was "in connection with the offering" so as to be considered part of the underwriting compensation.

Fibers, which is engaged in the business of manufacturing molded pulp products, was organized in 1965 by Bayard L. Carlson, president; Ronald W. Schriber, vice-president; Earle C. May, who is chief executive officer of the member; and Jacobsen. Fibers periodically obtained capital funds raised by the sale of stock to various persons, principally Carlson, Schriber and May and members of their families. About the fall of 1967 Fibers' management anticipated that it would make a public offering of stock and that the member in all likelihood would serve as managing underwriter, and on November 27, 1967, the Board of Directors of Fibers adopted a resolution authorizing the preparation of materials necessary for a public offering pursuant to Regulation A and an underwriting agreement with the member.

Carlson stated that about late November 1967 he decided that Fibers, which had a number of long overdue accounts payable and had not paid either him or Schriber salaries owed them, badly needed working capital. After unsuccessfully attempting to borrow funds, he approached May to purchase more stock in a private transaction. May, who was already the largest stockholder in Fibers and who had last purchased some stock in March 1967, refused but suggested that Smith might be in a position to purchase some. Smith agreed to invest $20,000; and Carlson solicited three other persons, not associated with the member, who agreed to invest another $6,500. Stock was issued to them at 50c per share, and at the same time 5,000 shares were issued to Jacobsen at a stated price of 0.

The member asserts that the issuance of those shares did not involve underwriting compensation but, except in the case of Jacobsen which is discussed below, was designed to raise capital through private placement of stock with persons having some familiarity with the affairs of the issuer. It points out that the price of 50c per share charged Smith and the others in December was the same as the price at which the issuer sold stock in a private transaction in June 1967,[4] and asserts that

provides that action by a District Committee is subject to review by the Board on its own motion.

[4] The 50c per share price was higher than the price charged in prior private sales in March 1967.

at the time it was not known when the public offering would be made or what the offering price would be.

The NASD very properly has been concerned with the arrangements between issuers and underwriters in connection with the public offering of securities of unseasoned companies. Its Interpretation that it is a violation of Article III, Section 1 of its Rules of Fair Practice for a member to act as an underwriter in a public offering in which the underwriting arrangements are unfair or unreasonable is consistent with the Rule and beneficial in the exercise of its function of self-regulation in the securities business. Thus it is important in the application of this Interpretation that there be a strict standard which avoids even the appearance of overreaching.

In this case there are a number of significant factors which warrant the determination reached by the NASD. First, Smith is intimately involved with the member and the underwriting. He is not only a vice-president of the member, but also a director, a substantial stockholder, and the person who signed the underwriting agreement for the member. Second, he acquired his shares when it was known that a public offering was contemplated in which the member firm would be the managing underwriter, and such an offering was made about two months after the issuance of the shares to him. Third, even accepting that the public offering price was not definitely known at the time of such acquisition, the price at which he acquired the shares was very substantially lower than such offering price.

In view of the relationship between the underwriting and the issuance of the shares to Smith shown by these facts, and having in mind the objective of the Rule and the Interpretation, we are constrained to sustain the finding and conclusion of the NASD that the shares sold to Smith are properly considered in determining the fairness and reasonableness of the underwriting compensation.

A somewhat different situation is presented with respect to the shares issued to Jacobsen. Jacobsen was intimately associated with the issuer, having been a principal promoter and organizer as well as serving as one of its directors, and he had no financial interest or position in the member. He was an employee of a management consulting concern that through him furnished the member various services of a type he had furnished it as head of his own management consulting firm prior to November 1965. The member had no proprietary interest in that concern, and the latter had no such interest in the member. The services provided, for which payment was made by the member to Jacobsen's employer, consisted of general consulting in connection with the member's brokerage business, investment research respecting securities to be recommended to the member's customers, and occasionally services in connection with underwriting prospects.[5] There is no evidence, however, and Jacobsen denies, that he was asked to or did perform any services for the member in connection with the Fibers underwriting or public offering.

Jacobsen and Fibers officials variously stated that Jacobsen was instrumental in organizing Fibers; that when the other promoters furnished additional capital through further stock acquisitions he was unable to do so but that he spent considerable time attempting to develop business and financing for Fibers; and that it had been agreed early in 1967 among the promoters that the 5,000 shares would be issued to him in recognition of his original contribution as a promoter and his other expenses and efforts, on which they did not try to place a dollar value, and in order to maintain a minimum percentage of ownership in Fibers by him as shares were issued to the other promoters, although in fact his shares were not issued until December 1967 following the determination to undertake a public offering.

Whether Fibers was warranted in issuing shares to Jacobsen in December 1967 for his prior services or whether a fuller disclosure should have been made in the offering circular or elsewhere of the basis for such issuance are not questions that are before us in this proceeding. On the basis of the record made before the NASD, and in the light of Jacobsen's relationship to the issuer, we are unable to find Jacobsen's relationship to the member, even though it did entail a continuing advisory role, or the other circumstances pertaining to the underwriting sufficient to support a conclusion that the shares in question were issued to him in connection with the offering so as to require that they be included as part of the underwriting compensation.

If the Jacobsen shares are disregarded, the underwriting compensation under the NASD guidelines, including the direct underwriting discount or commission and the anticipated profit on the Smith stock, would be $84,875, equal to 28.8

[5] May stated that Jacobsen, who was located in Chicago, Illinois, and visited the member's offices in Portland, Oregon, every month or two, would perform services as a securities analyst with respect mostly to large Eastern concerns, the member having its own connections or sources for West Coast situations.

percent of the aggregate offering price, or only 2.7 percent less than the 31.5 percent found by the NASD. The 28.8 percent computation would, in our opinion, also support the NASD's determination that the underwriting compensation in this case was unfair and unreasonable under all the circumstances, and accordingly we sustain the NASD's finding of a violation of Article III, Section 1 of the NASD Rules of Fair Practice.[6]

THE LATE FILING

As previously noted, the NASD Interpretation requested members acting as managing underwriters of Regulation A offerings to file with the NASD copies of the initial offering circulars at the time such documents were filed with us; the initial Fibers offering circular was filed with us on February 7, 1968; and a copy of the offering circular was not filed with the NASD until February 23, 1968. The member argues that the admittedly late filing cannot be a violation of Article III, Section 1 because filing of documents cannot be considered as involving "commercial honor" or "principles of trade," and that in any event the late filing would not warrant the imposition of any sanction because it involved merely oversight by counsel.[7]

We are unable to agree with the member's contention that a filing violation cannot be considered related to "high standards of commercial honor." The self-regulatory procedure set up by the NASD through the Underwriting Committee could be set at naught if members failed to file requested documents necessary to a review of the fairness and reasonableness of underwriting compensation. Indeed, in this case the filing failure deprived the Underwriting Committee of the opportu-

[6] As previously noted, the NASD valued the stock in question on the basis of the difference between cost and the public offering price, reduced by 20% to reflect assumed escrow of the shares for one year. It appears that the Oregon Corporation Commissioner under Oregon law required that 60% of all "promotional shares" be held in escrow until the issuer for a period of two successive years showed earnings after taxes of at least 5% of the net invested capital on all shares outstanding, including the escrowed shares, computed on the offering price of $2 per share. If another 20% discount were deducted to adjust for a minimum two year escrow of 60% of the shares, as the NASD did in an alternative computation, the anticipated value of Smith's shares would be reduced to $40,800 or 13.8% of the offering price, which when added to underwriting discount, would give total underwriting compensation of $77,675, or 26.3% of the aggregate offering price. In our opinion this too would be unfair and unreasonable underwriting compensation.

[7] The attorney in the law firm which acted as counsel for the member in connection with the public offering stated that he did not become aware of the fact that the issuer had made a filing with us until February 21, 1968, when he immediately forwarded a copy to the NASD. He further stated that it had been the practice that the law firm send copies of documents to the NASD when required and that if the documents in this case were not submitted timely the NASD it was due to an oversight and not to any intention on the part of the member to avoid or delay the filing.

nity to review the underwriting arrangements prior to the public sale of the stock. While the oversight of counsel may explain the failure, it cannot entirely excuse the member, who has the primary responsibility to insure that the requirements are satisfied. In fact, it appears that in December 1967, shortly before this offering, the NASD sent a notice to all members, which the member firm undoubtedly received, noting that many members had not been filing the proper documents with the NASD at the same time they were filed with this Commission. The notice stated that in order to facilitate the review by the Underwriting Committee it was imperative such filing be made on time, and "strongly" urged all members acting as managing underwriters to call the attention of counsel to these requirements. Under the circumstances, the member should have been especially diligent in instituting procedures which would have insured compliance with the filing requirements. Accordingly, we sustain the NASD's finding of a violation based on the late filing. We shall deal with the question of the appropriate sanctions below.

OTHER MATTERS

The member argues that in any event it cannot be found to have violated Article III, Section 1 of the NASD Rules because the NASD Interpretation at the time of the underwriting did not provide that unreasonable underwriting arrangements and the failure to file documents timely constituted violations of the designated Rule. In support of this contention it points to a subsequent revision of the Interpretation, which became effective in July 1968. In contrast to the earlier Interpretation, the revision specifically stated that "it shall be deemed a violation of Article III, Section 1 of the Rules of Fair Practice for a member to participate as an underwriter in an issue of securities in which the underwriting arrangements as a whole, taking into account all elements of compensation and all of the surrounding circumstances, are unfair and/or unreasonable." The revision also stated in specific terms that failure to make timely filing of requested documents relating to underwritings is a violation of Article III, Section 1.

We cannot accept the contention of the member. While the revision is obviously more clear, specific and detailed, we find that the Interpretation in effect in February 1968 adequately informed the membership that unreasonable underwriting arrangements or failures to submit documents to permit review of such arrangements would constitute violations of Article III, Section 1. The Interpretation was included in the NASD

Manual in a section containing interpretations of Article III, Section 1, and each page of such Interpretation referred to the Rules of Fair Practice and Article III, Section 1. Moreover, in at least two notices circulated to NASD members the NASD gave notice that such Rule was involved. A notice dated December 26, 1961 to all members stated that the NASD Board of Governors was concerned with underwriting arrangements and intended to review offerings of issues of unseasoned companies "to determine whether the arrangements entered into by members in connection with the offerings are fair and consistent with just and equitable principles of trade under Article III, Section 1 of the Rules of Fair Practice," for which purpose a special Underwriting Arrangements Committee had been appointed. Again, in December 1967, shortly before the Fibers offering, another notice was sent to all NASD members, which noted that the Underwriting Arrangements Committee reviewed underwritings "to determine whether the arrangements entered into by members in connection with offerings are fair and consistent with just and equitable principles of trade under Article III, Section 1." This notice, as previously recited, stated that it was "imperative" that the Committee received all required materials on time, "strongly" urged all members to review the Interpretation in the manual and call its requirement to the attention of counsel, and reminded members that failure to file documents as requested might constitute grounds for institution of disciplinary action by a District Committee.

PUBLIC INTEREST

The member urges that the public interest does not require the imposition of any sanction. It claims that it has already suffered a more than sufficient penalty by virtue of an assertedly misleading press-release issued by the NASD,[8] which stated that the member had been charged with making "unfair and unreasonable underwriting arrangements with a client by taking 31.5 percent of the total amount received by the client as compensation for the underwriting" but did not refer to the fact that 19 of the 31 percent represented "anticipated profit," as computed by the NASD, on certain shares of the client's stock.

In determining the appropriateness of the sanctions, we

[8] A resolution of the Board adopted under Section 1, Article V of the Rules provides for notice to the membership and press of, among other things, a decision suspending a member and for the inclusion in such notice of a brief description of the violations found and/or the Section of the Rules violated.

have taken into account the surrounding circumstances and mitigative factors presented.[9] We have also taken into consideration the fact that we have concluded that it has not been shown that the shares issued to Jacobsen should be included as part of the underwriting compensation. Under all the circumstances, and considering the nature of the violations found and the sanctions, we conclude that the sanctions imposed by the NASD should be affirmed.

Accordingly, IT IS ORDERED that the disciplinary action of censure, $2,000 fine, and a suspension from membership of two days taken by the National Association of Securities Dealers, Inc. against May & Co., Inc. be, and it hereby is, affirmed.

By the Commission (Chairman BUUDGE and Commissioners OWENS, SMITH, NEEDHAM and HERLONG).

[9] In connection with the member's contention regarding adverse publicity, we consider that the issuance of a press release by the NASD with respect to a disciplinary proceeding before it is a reasonable procedure and does not obviate or reduce the appropriateness or necessity of a sanction, although it would seem that the press release in this case could have been more precisely drafted to avoid any appearance of overstating the charge against the member.

IN THE MATTER OF

OHIO POWER COMPANY

CAMBRIDGE HOUSING, INC.

File No. 3-2444. Promulgated September 8, 1970

Public Utility Holding Company Act of 1935—Sections 6,7,9(a)(1),9(c)(3),10,11, and 12.

MEMORANDUM OPINION AND ORDER

ACQUISITION OF SECURITIES OF NON-UTILITY COMPANY BY PUBLIC UTILITY SUBSIDIARY COMPANY OF REGISTERED HOLDING COMPANY

Application under Sections 9(a) and 10 of Public Utility Holding Company Act of 1935 for approval of proposed acquisition, by public-utility subsidiary company of registered holding company, of securities of non-utility subsidiary company which proposes to construct low and moderate income housing project pursuant to National Housing Act, *denied*, as not meeting standards of that Act.

Ohio Power Company ("Ohio Power"), a public-utility subsidiary company of American Electric Power Company, Inc., a registered holding company, and its wholly-owned subsidiary company, Cambridge Housing, Inc. ("Cambridge Housing"), a non-utility company recently organized under Ohio law, have filed an application-declaration, and amendments thereto, with this Commission pursuant to Sections 6, 7, 9(a)(1), 9(c)(3), 10, 11, and 12 of the Public Utility Holding Company Act of 1935 ("Act") and Rules 43 and 45 promulgated thereunder regarding the following proposed transactions.

Ohio Power distributes electric energy at retail in various cities and towns in the State of Ohio, including the City of Cambridge. Cambridge Housing was organized for the purpose of constructing, owning and operating low and moderate income housing projects under Section 236 of the National Housing Act, as amended. As an initial project, Cambridge Housing proposes to construct approximately 100 housing units on twelve acres of land in Cambridge.

Ohio Power proposes to acquire, and Cambridge Housing proposes to issue, up to 500 shares of common stock, par value

$1,000, to provide equity capital as required. Cambridge further proposes to obtain funds of up to $2,500,000 for pre-operating and construction expenditures (1) by obtaining construction advances approved by the FHA, (2) by conventional borrowings from local banks (to be guaranteed by Ohio Power if required), or (3) by borrowing from Ohio Power, depending on the availability and attractiveness of each alternative. No approval or consent of any regulatory body, other than this Commission, is necessary for the proposed transactions.

Public notice of the application-declaration was issued (Holding Company Act Release No. 16813), pursuant to which interested persons were given an opportunity to request a hearing. No hearing has been requested or ordered, and Ohio Power has agreed that we may consider the matter on the basis of the record as it now stands.

In light of our decision in *Michigan Consolidated Homes Corporation* 44 S.E.C. 359 (1970), we must deny the application-declaration. The housing project, which in all relevant respects is identical with that proposed by Michigan Consolidated, lacks the operating or functional relationship required by Section 10(c)(1), which incorporates Section 11(b)(1), between such a non-utility business and the operations of an integrated public-utility system. Nor, for reasons there stated, may we exempt the acquisitions under the provisions of Section 9(c)(3) of the Act. We have also denied a similar application in *Mississippi Power & Light Company*, 44 S.E.C. 404 (1970).

IT IS ORDERED, accordingly, that said application-declaration, as amended, be, and it hereby is, denied and not permitted to become effective.

By the Commission (Chairman BUDGE and Commissioners NEEDHAM and HERLONG).

Commissioner OWENS, concurring in part and dissenting in part:

I reiterate my opinion as expressed in the *Michigan Consolidated* and *Mississippi Power & Light Company* proceedings (43 S.E.C. 1108, 44 S.E.C. 359 and 404, respectively). I concur in finding that Sections 10(c)(1) and 11(b)(1) do not permit a public utility holding company registered under the Act or a subsidiary company thereof to engage in the housing business. I feel, however, that the factual situation presented by Ohio Power's application closely parallels the facts in the *Michigan Consolidated* and *Mississippi Power & Light* proceedings, and am of the opinion that, under these special circumstances, an exemption under Section 9(c)(3) is justified. I, therefore, would approve this application pursuant to Section 9(c)(3).

Commissioner SMITH, dissenting:

I adhere to the views I expressed in the *Michigan Consolidated* and *Mississippi Power & Light* proceedings and I would approve the application.

In the Matter of

MICHIGAN CONSOLIDATED GAS COMPANY

MICHIGAN CONSOLIDATED HOMES CORPORATION

File No. 3-2111. Promulgated September 22, 1970

Public Utility Holding Company Act of 1935—Section 6(b)

MEMORANDUM OPINION AND ORDER

Michigan Consolidated Homes Corporation, a wholly-owned non-utility subsidiary of Michigan Consolidated Gas Company,[1] filed a motion requesting "limited relief pending implementation of the Commission's divestiture order of June 22, 1970." In that action, we held that the application of those two companies to finance, construct and operate two housing projects could not be authorized under the Public Utility Holding Company Act of 1935, and we directed applicants to divest themselves of such projects.[2] Thereafter, on August 26, 1970, we denied a motion for an "interim" order authorizing applicants to complete the construction and financing of the two housing projects, holding that such authorization would be in derogation of and inconsistent with our prior decision.[3]

By the present motion, Homes Corporation seeks authority to issue a mortgage note, to be assigned to the Government National Mortgage Association, for approximately $2,166,000 on the Inkster housing project, one of the two housing projects involved in this matter. Homes Corporation states that with the cash so obtained, it would have sufficient funds to provide the necessary working capital to operate the Inkster project and to pay present and prospective bills of contractors working on the Elmwood project, the other housing development, during the period required to implement our divestiture order.

[1] Michigan Consolidated Gas is a subsidiary of American Natural Gas Company, a registered holding company under the Public Utility Holding Company Act of 1935.

[2] Holding Company Act Release No. 16763.

[3] Holding Company Act Release No. 16819.

44 S.E.C.-359

44 S.E.C.-407

Homes Corporation states that the authority it now seeks may be granted under the provisions of Section 6(b) of the Act with respect to the issuance of securities, and that since no authority is being sought to acquire securities, the prohibitions and strictures of Sections 9 and 10 under which the prior application for interim relief was denied are not applicable.

The Division of Corporate Regulation filed an answering brief opposing the motion, to which Homes Corporation filed a reply.

Homes Corporation states that the proceeds of the mortgage note covering the Inkster project, if its issuance were authorized, would be used to permit operation of that project and continued construction of the Elmwood project, only for the limited purpose of keeping the projects going while efforts are made to dispose of them. This is the same contention advanced in support of the prior request for "interim" authority, and to grant the instant request for "limited" relief would be as much in derogation of our order of June 22, 1970, as the requested "interim" authority which we denied on August 26, 1970. And it is clear, under the circumstances, that the provision in Section 6(b) authorizing us to permit a subsidiary of a registered holding company to issue a security where it is solely for the purpose of financing the business of such subsidiary, does not and was not intended to permit the issuance of a security to finance a business which the subsidiary may not engage in and of which it has been ordered to divest itself.

Accordingly, IT IS ORDERED that the motion for an order authorizing the issuance by Homes Corporation of a mortgage note in the approximate amount of $2,166,000 be, and it hereby is, denied.

By the Commission (Chairman BUDGE and Commissioners OWENS, NEEDHAM and HERLONG), Commissioner SMITH dissenting.

Commissioner SMITH dissenting:

For the general reasons set forth in my previous dissents in this case (43 S.E.C. 1108 and 44 S.E.C. 359), I would be disposed to grant the present motion. However, in view of the majority's previous divestiture decision and indeed to effect a reasonable implementation of it, I would attach two conditions to a granting of the motion: one, that Michigan Consolidated come forward with a reasonable plan for disposition of the two housing projects, and two, that no proceeds from the GNMA mortgage note be used for construction of the uncompleted project but rather be used to reduce Michigan Consolidated's loans to Homes Corporation for that project. If so conditioned, granting of the motion would not seem to me to be inconsistent with either the divestiture order or the order denying interim authorization of any further housing investments. It simply permits permanent financing to be emplaced on the completed project in order to facilitate its sale. Without issuance of the mortgage note, some reasonable implementation of the divestiture order is only made more problematical and the cost increased to all—including investors of the holding company and future tenants of the projects.

In the Matter of

THE EQUITY CORPORATION

File No. 3-1800. Promulgated September 23, 1970.

Investment Company Act of 1940—Section 8(f)

MEMORANDUM OPINION

The Equity Corporation, a registered closed-end non-diversified investment company, filed a petition for rehearing with respect to our Findings, Opinion and Order of March 5, 1970 44S.E.C——. In that decision, we denied Equity's application pursuant to Section 8(f) of the Investment Company Act of 1940, for an order declaring that it had ceased to be an investment company and terminating its registration, on the ground that Equity, in violation of Section 13(a)(4) of the Act, had changed the nature of its business so as to cease to be an investment company prior to obtaining stockholder authorization. We stated, however, that if Equity's management still desired that Equity not be an investment company, it would have to present to the stockholders for their vote the question of whether or not they wished Equity to be an investment company in accordance with "a concrete plan prepared in good faith sufficient to constitute a real alternative of a viable investment company business." Equity's petition, in addition to urging rehearing, submitted a plan which it considered might satisfy our requirements. Our Division of Corporation Regulation ("Division") filed a memorandum in opposition to such plan. The group of objecting stockholders who participated in the proceedings ("Nemser group") also filed an answer opposing the plan and urging that the petition be denied.

Thereafter, Equity filed a motion for a deregistration order under Section 8(f) of the Act based upon an alternative plan which was developed as a result of discussions with and is acceptable to the Division.[1] That plan, which has been ap-

[1] The Nemser group had declined to participate in the discussions.

proved by Equity's board of directors, provides that, if it is approved by the stockholders, Equity will sell or otherwise dispose of all operating assets and securities of controlled companies within a period of one year (or such longer period as we may grant upon a showing of good cause); invest all the proceeds in investment securities as defined in Section 3(a) of the Act; and operate as a closed-end diversified investment company in accordance with specified investment objectives and fundamental policies to be adopted under such plan.[2]

The motion states that this plan is believed to represent a "real alternative of a viable investment company business" which accords with our opinion, and that if the shareholders should accept it Equity would remain an investment company. It further states, however, that the management of Equity considers that it would be more desirable for Equity to continue and develop as an operating holding company because of its assertedly greater economic potential, and, in the proxy statement to be submitted to the shareholders, will recommend that they disapprove the plan.

The Nemser group filed a brief in opposition to Equity's motion in which it contended that the alternative plan is inadequate and, particularly in view of Equity's stated intention to recommend votes against it, was not filed in good faith. Among other things, it claimed that the plan is lacking in detail or protections against precipitous sale of large amounts of securities of controlled companies in a manner which would cause losses to securityholders. It also argued that the plan does not give Equity's stockholders the opportunity to vote in favor of a return to the non-diversified investment company business that Equity conducted prior to the illegal change in business we previously found,[3] since it provides for a change to

[2] As provided in the plan, Equity's primary investment objective would be long-term growth of capital, with the annual rate of portfolio turnover anticipated to be less than 50 percent. It would invest substantially all of its assets in common stocks listed on the New York Stock Exchange or securities covertible into such common stock, and would not acquire securities of other investment company. It would not brrrow money, issue senior securities, make short sales, purchase on margin, underwrite securities, invest in companies for purposes of exercising control or management, or purchase securities of any one issuer if, as a result of such purchase, the Market value of such securities would exceed 5 percent of the value of Equity's assets or its would own more than 5 percent of any class of securities of such issuer.

[3] Section 5(b) of the Act defines a "non-diversified company" as any management company other than one with at least 75 percent of its total assets represented by cash items, Government securities, securities of other investment companies, and other securities for the purposes of this calculation limited in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of such management company and to not more than 10 percent of the outstanding voting securities of such issuer.

a diversified investment company having different investment policies and objectives.[4]

After careful consideration of the alternative plan, we have concluded that it satisfies the conditions set forth in our principal decision.[5] Although as presented it does not include the details of the manner of its effectuation, we do not consider it appropriate to assume, as the Nemser group suggests, that the sales of assets or securities under the plan would not be handled in an orderly manner so as to maximize any gains or minimize any losses that the dispositions might entail. Nor do we regard Equity's opposition to its own plan as evidence of bad faith. Such opposition is not inconsistent with the permissible desire of the management of an investment company, under Section 13(a)(4), to change the nature of the company's business so that it ceases to be an investment company, provided only that it obtain stockholder authorization. And in our principal opinion we expressly stated that Equity's management must present a plan for an investment company business if it "still desires that it not be an investment company". With respect to the proposed change from a nondiversified company to a diversified company, it is noted that Section 13(a) does not require stockholder authorization for such a change. Moreover, we find it difficult to accept the Nemser group's suggestion that a stockholder might, notwithstanding a properly articulated proxy statement, vote against the investment company plan and in favor of Equity continuing in its present form, solely because he favors a non-diversified company.

Accordingly, if the stockholders should vote, following the transmission to them of a proxy statement setting forth the terms of the plan and including appropriate details and accompanied by a copy of our Memorandum Opinion herein as well as of our Findings and Opinion of March 5, 1970, to reject that plan, such vote would be viewed as an authorization for a change in status under the Act. We will not at this time, as requested by Equity in its motion, enter a deregistration order conditioned upon rejection of the plan by the stockholders. We

[4] The Nemser group also referred to various asserted adverse developments in Equty's operating subsidiaries which it states Equity has not reported to its stock holders. The proxy material respecting the alternative plan would of course have to contain adequate disclosure of material facts as to subsidiaries bearing upon the choice of whether to vote for the changes from Equity's present operations that the plan envisages.

[5] We do not agree with the Nemser group's contention that the motion is not in order because of the pendency of the petition for rehearing. Our Rules of Practice permit filing of motions at any stage of the proceedings, and we deem it appropriate to consider Equity's motion submitting a proposed means of meeting the views expressed in our prior opinion.

consider that the more appropriate course, as suggested by Equity in its rehearing petition, is to await the outcome of the vote of the stockholders and, if they reject the plan, we will enter an order granting deregistration upon appropriate application.

We have reviewed Equity's petition for rehearing and the contentions made therein. We find those contentions to be essentially the same as those previously put forth by Equity which we fully considered in our decision of March 5, 1970. Accordingly, said petition for rehearing is hereby denied.

By the Commission (Commissioners OWENS, SMITH, NEEDHAM and HERLONG), Chairman BUDGE not participating.

IN THE MATTER OF

INTERNATIONAL AEROSPACE ASSOCIATES, INC.

File No. 3-2135. Promulgated October 30, 1970

Securities Act of 1933—Section 3(b) and Regulation A

EXEMPTION FROM REGISTRATION

Grounds for Suspension of Exemption

Opportunity to Correct Deficiencies

Where notification and statement in lieu of offering circular, filed pursuant to Regulation A for purpose of obtaining exemption from registration under Securities Act of 1933 with respect to offering not in excess of $50,000, were materially deficient because of, among other things, unavailability to issuer of Rule 257 of Regulation which permits statements without inclusion of financials under certain conditions; misleading representations concerning issuer's assets, operating and earnings history and facilities, bankruptcy of affiliate and option to purchase stock by president of issuer; overstatement of number of shares sold in previous offering; and failure to disclose required information concerning that offering and rights of holders of securities offered, *held*, in view of serious deficiencies and lack of care to present adequate and accurate filings, temporary suspension of exemption without issuance by staff of deficiency letter was warranted in public interest, and exemption should be permanently suspended notwithstanding issuer's stated willingness to file correcting amendment.

APPEARANCES:

Willis Riccio and *Arthur Carr*, of the Boston Regional Office of the Commission, ıor the Division of Corporation Finance.

Robert V. Pace, president, for International Aerospace Associates, Inc.

FINDINGS, OPINION AND ORDER

International Aerospace Associates, Inc. ("issuer") is a Massachusetts corporation organized in April 1969 to engage in research and development with respect to airport facilities for supersonic transport planes and selected supporting activities. On July 24, 1969, pursuant to Section 3(b) of the Securities Act of 1933 and Regulation A thereunder, it filed with us a notification and, pursuant to Rule 257 of the Regulation, a statement in lieu of an offering circular, for the purpose of obtaining an exemption from the registration requirements of the Act with respect to a proposed offering of 50,000 shares of its $1 par value common stock at $1 per share.[1] On October 6, 1969, we issued an order pursuant to Rule 261 of Regulation A temporarily suspending the exemption, and the issuer thereafter requested a hearing to determine whether we should vacate the temporary suspension order or enter an order permanently suspending the exemption. Following a hearing, the hearing examiner issued an initial decision in which he concluded that the suspension should be made permanent. We granted the issuer's petition for review of the initial decision, the issuer and our Division of Corporation Finance ("Division") filed briefs, and we heard oral argument. Our findings are based upon an independent review of the record.

DEFICIENCIES

The record establishes that the issuer failed to comply with the terms and conditions of Regulation A in that, among other things, it filed a statement instead of an offering circular containing financial statements; that such statement, hereinafter referred to as the offering circular, contained materially misleading representations concerning, among other things, the issuer's assets, operating and earnings history, and facilities; and that the use of such offering circular in connection with the offering would violate the antifraud provisions of Section 17(a) of the Act.

Rule 257 of Regulation A, which dispenses with the financial statement requirement for offerings not in excess of $50,000, was expressly unavailable for the securities proposed to be offered since the issuer was incorporated within one year prior to the date of filing the notification and had not had a net income from operations and thus came within the terms of the exclusion specified in Rule 253(a)(1).

With the absence of financial statements, there was no disclosure in the offering circular that the issuer had little or no assets other than an office. The issuer had realized about $3,000 from a prior stock offering to residents of Massachusetts, but those funds, together with about $6,000 advanced by Robert V. Pace, president of the issuer, had been used for expenses of the issuer including the costs of an incomplete

[1] Under Rule 257 of Regulation A, a statement containing the information required in an offering circular, except financials, may be filed where the offering does not exceed $50,000 and certain other conditions are met.

study by Pace of locations for a supersonic jet airport. No disclosure was made of Pace's loan or that he claimed an unwritten "debenture option" to acquire one share of the issuer's stock for each dollar advanced by him. The offering circular merely stated that 60 percent of all authorized shares were to be reserved for Pace with "options to buy."

The failure to file financial statements also rendered the information given in the offering circular misleading with respect to the location and general character of the properties held or intended to be acquired and the nature of the title under which such properties were held or proposed to be held. That information was that the issuer proposes to develop a landing facility for supersonic jet planes at a location not presently being disclosed in order to prevent speculation and competition, and that the issuer is negotiating for the acquisition at favorable prices of Bedford Aviation Inc., Acorn Development Inc., and Hookset Airport at Hookset, New Hampshire. The offering circular further stated that Bedford Aviation "is now in litigation in the federal courts relevant to a bankruptcy proceeding" and claims lease rights, which are in dispute, for the fueling of jet planes at the airport at Bedford, Massachusetts, and if the issuer acquired Bedford Aviation and those rights were returned to that company, the issuer would have "an extremely valuable asset"; that Acorn is a real estate holding company specializing in commercial properties and would provide low cost office space for the issuer; and that Hookset Airport had been "made available" to the issuer since April 1969 and the issuer expects to use part of it as a storage and maintenance base for its air taxi activities and to develop the remainder into a fly-in resort.

Pace testified that after making a study of three possible sites for a jet port he had decided on one of them and wished to complete his study of it, but the record shows that neither he nor the issuer had any option to acquire that site. It further appears that Pace is also president of Bedford Aviation as well as of Acorn, that Bedford Aviation had been adjudicated a bankrupt in October 1968 and its assets sold at public auction in December 1968, and that pace personally holds a lease on a portion of the Hookset Airport and an option to acquire the property for $80,000 which expire on September 30, 1970. It is clear that the issuer had no legal claim to Bedford Aviation's asserted lease rights or to Pace's lease of the Hookset Airport. As Pace testified with respect to that airport, the issuer "would have an interest by me saying so and turning it over

. . . at any time it wanted it or needed it or could acquire it." None of these facts is disclosed in the filings. Nor is any disclosure made of the facts that the issuer did not have the necessary funds to exercise the option to acquire the airport, assuming Pace conveyed the option to the issuer, and that the airport's facilities were not then suitable for use as an air taxi storage and maintenance base in that the only hangar was in a state of disrepair, there were no repair facilities, and the runway had no lighting or navigational aids and was suitable only for small aircraft.

Contrary to a statement in the offering circular that the issuer had no expenses in connection with the proposed offering, Pace testified there was considerable expense in preparing for the Regulation A filing and that such expense would be defrayed in part from the proceeds of the offering.[2] Absent such disclosure, investors could not determine the amount of the net proceeds to the issuer.

Finally, the notification stated that 25,000 shares had been sold in the prior offering at $1 per share when, in fact, only 3,030 shares had been sold; failed to disclose, as required, the names of the persons to whom the securities were issued or the basis under the Act for the exemption from registration claimed as to that offering; and failed to include, as exhibits, copies of the provisions of the governing instruments defining the rights of holders of the securities offered.

The issuer has directed its contentions on review primarily to an attack upon the integrity and motives of the Division for which there is no basis or support in the record. It also states that any deficiencies in its Regulation A filings were not intentional, that it believed that it would be given an opportunity to correct any deficiencies in its filings before a temporary suspension order issued, and that thereafter it had indicated a willingness to amend the filings to correect the alleged deficiencies.

The issuer was not entitled to a notice of the deficiencies as a matter of right. While Section 202.3 of the Code of Federal Regulation (17 CFR 202.3) states that the usual practice is to bring deficiencies to the attention of the issuer, it further provides that "this informal procedure is not generally employed where the deficiencies appear to stem from careless disregard of the statutes and rules or a deliberate attempt to conceal or mislead or where the Commission deems formal

[2] The offering circular states that $25,000 of the proceeds would be used for "cost of administration," and the remaining $25,000 for architectural, engineering and surveying costs.

proceedings necessary in the public interest." We consider that the public interest warranted issuance of the temporary suspension order without our staff first sending a deficiency letter in view of the serious questions as to the adequacy of the issuer's filings.[3]

It is equally clear that the issuer does not have an absolute right to amend its filings as an alternative to permanent suspension, and, in any event, no amendment has been submitted. Moreover, as found by the hearing examiner, the offering circular was inaccurate, confusing and misleading, and entirely lacking in the careful and organized description of the issuer's business which would permit a potential investor to assess intelligently the risk involved. Because of the nature and extent of these inadequacies, we find no such clear showing of good faith and of other mitigating factors in connection with the deficiencies as would warrant our consideration of any amendment.[4] In *Illowata Oil Company*, where the issuer had submitted an amendment following our temporary suspension order, we stated:

> ". . . in the case of a Regulation A offering, where suspension of the conditional exemption obtained under the Regulation does not bar the issuer from effecting a public offering if it complies with the registration requirements, we consider the opportunity to amend which should be accorded an issuer which has not properly met the simplified requirements provided by Regulation A to be more limited than the opportunity to amend in the case of a registration statement. The opportunity to amend cannot in any event be permitted to impair the required standards of careful and honest filings under the Regulation and encourage a practice of irresponsible or deliberate submission of inadequate or false material followed by correction by amendment of the deficiencies found by the staff in its examination." [5]

We conclude, as did the examiner, that the suspension should be made permanent.[6]

Accordingly, IT IS ORDERED, pursuant to Rule 261 of Regulation A under the Securities Act of 1933, that the exemption from registration with respect to the proposed public

[3] See *Mutual Employees Trademart, Inc.*, 40 S.E.C. 1092, 1097—98 (1962); *Jackpot Exploration Corp.*, 44 S.E.C. 302, 307 (1970).

[4] See *Illowata Oil Company*, 38 S.E.C. 720, 723—24 (1958); *Hart Oil Corporation*, 39 S.E.C. 427, 431—32 (1959); *Jackpot Exploration Corp.*, 44 S.E.C. 302, 307 (1970).

[5] *Illowata Oil Company, supra*, at p. 723. We there concluded that a sufficient showing to warrant consideration of the amendment had been made, but held that it contained material deficiencies and we permanently suspended the exemption. 39 S.E.C. 342 (1959).

[6] The exceptions to the initial decision of the hearing examiner are overruled or sustained to the extent they are inconsistent or in accord with our decision.

offering by International Aerospace Associates, Inc. be, and it hereby is, permanently suspended.

By the Commission (Chairman BUDGE and Commissioners OWENS, SMITH, NEEDHAM and HERLONG).

In the Matter of

AUGION-UNIPOLAR CORPORATION

File No. 3-2079. Promulgated November 18, 1970

Securities Act of 1933—Section 8(d)

MEMORANDUM OPINION AND ORDER

This is a proceeding instituted under Section 8(d) of the Securities Act of 1933 to determine whether or not a stop order should be issued suspending the effectiveness of a registration statement filed on May 2, 1969 by Augion-Unipolar Corporation ("registrant") with respect to a proposed public offering of 1,000,000 shares of registrant's common stock at $10 per share. Registrant has filed a motion requesting that this Commission and Chairman Budge and Commissioners Owens, Smith and Needham disqualify themselves from further participation in this matter. The stated ground for this motion is that registrant had brought two suits in the United States Court of Appeals for the Second Circuit, one against this Commission, and the other against this Commission and the four members named above.

The first suit in which the Commission alone was named as respondent, was a petition (Civil Action No. 33617, May 21, 1969) seeking review of an alleged determination by us to issue a stop order unless registrant filed an amendment to delay the effective date of its registration statement. Following our filing of a motion to dismiss the petition in which it was pointed out that we had not issued any order with respect to the registration statement and that it had become effective, the petition was dismissed without prejudice, pursuant to a stipulation in which registrant joined.

Subsequently, we instituted the instant proceeding on the basis of a Statement of Matters of our Division of Corporation Finance containing allegations with respect to deficiencies in the registration statement, and a hearing was held with respect to such matters, following which the Division filed proposed findings and supporting brief with the hearing examiner. Thereafter, registrant filed a second petition for review in the Court, which named as respondents the individual Commissioners as well as this Commission and requested that our order instituting this stop-order proceeding be set aside and that we declare certain post-effective amendments to the registration statement effective and dismiss the stop-order proceeding (Civil Action No. 3471, November 20, 1969). We moved for dismissal of that petition on the grounds that our order instituting the stop-order proceeding was not a final order subject to judicial review, that registrant had not exhausted its administrative remedies, and that there was no jurisdiction over the individual members of this Commission upon a petition for review of a Commission order. The Court granted the motion, and the hearing examiner thereupon granted a request that registrant had made to him for reopening of the hearing to present additional testimony and an extension of time in which to file counterstatements of proposed findings and a supporting brief.

Following the reconvened hearing the Division filed supplemental proposed findings, registrant filed a counterstatement and brief, and the Division filed a reply brief. The hearing examiner then issued his initial decision, and we granted registrant's petition for review of such decision. Registrant filed a brief in support of its objections to the initial decision, the Division filed a reply, and on the request of registrant, we scheduled this matter for oral argument before us. Only after all these procedures did registrant file its present motion for disqualification of the Commission and four of its members.

In support of the motion to disqualify, registrant's Secretary filed an affidavit which recited that this Commission and the four named members were respondents in registrant's second action in the Court of Appeals, and concluded that "as a matter of law and constitutional due process" this Commission and those Commissioners "have personal bias and prejudice and interest" against registrant with respect to this stop-order proceeding. Section 7(a) of the Administrative Practice Act, 5 U.S.C. § 556, contemplates that before an agency determines a question of bias involving a presiding officer, a good faith, timely and sufficient affidavit showing personal bias and prejudice must be filed. We have held that a question involving alleged bias of the Commission or Commissioners should not be determined without at least equal requirements as safeguards against delay and harassment.[1]

It is clear that registrant's attempt at disqualification is not well-founded. Initially we note that it is almost a year since registrant filed its second Court petition and more than eight months since the Court dismissed it, and that it has been held that timeliness in the filing of affidavits of bias and prejudice is a most important matter of substance.[2] Moreover, it is also clear that under the established legal "rule of necessity" applicable both to courts and administrative agencies, a motion to disqualify this Commission and a majority of its members cannot operate to prevent this Commission, the only tribunal with power to act with respect to the instant registration statement, from performing its duties.[3]

However, quite apart from the lack of timeliness and the rule of necessity, we think it conclusive that the facts stated in the supporting affidavit are legally insufficient to show any personal bias or prejudice against registrant, and we are not aware of any actual bias or prejudice or of any other facts which would legally support a conclusion of bias or prejudice.

The supporting affidavit does not allege actual bias or prejudice but states that bias exists as a matter of law and constitutional due process. It cites a number of cases as authority for that conclusion, which however do not aid it. In *Tumey* v. *Ohio*,[4] the defendant had been convicted of a criminal offense, fined and committed to jail by a judge who had a direct, personal, substantial, pecuniary interest in reaching his conclusion to convict. Such conviction was held by the Supreme Court to violate procedural due process, but the Court there pointed out that most matter relating to judicial disqualification do not rise to a constitutional level.[5] Other of the cited cases deal with the familiar propositions that a judge should not sit to hear a suit to which he is a party, or in which he has

[1] *San Francisco Mining Exchange*, 41 S.E.C. 860, 861 (1964). *Cf.* 28 U.S.C. § 144, which provides for the disqualification of a judge in a district court upon the filing of a timely and sufficient affidavit of personal bias and prejudice.

[2] *Knoll* v. *Socony Mobil Oil Company*, 369 F.2d 425 (C.A. 10, 1966); *In re Union Leader Company*, 292 F.2d 381 (C.A. 4, 1961). *Cf. San Francisco Mining Exchange*, 41 S.E.C. 560, 564 (1963); *R. A. Holman Co., Inc.*, 40 S.E.C. 1133 (1962).

[3] *Otis & Co.*, 31 S.E.C. 380, 381 (1950). See also: *FTC* v. *Cement Institute*, 333 U.S. 683, 700–703 (1948); *Marquette Cement Mfg. Co.* v. *FTC.*, 147 F.2d 589, 593 (C.A. 7, 1945); *Poirier* v. *Martineau*, 136 A.2d 814 (Sup. Ct. R.I. 1957).

[4] 273 U.S. 510 (1927).

[5] 273 U.S. at 523. See also *FTC* v. *Cement Institute*, 333 U.S. 683, 702 (1948).

a direct interest, or in which he had been previously shown as counsel, or where he is related to a party or to counsel.[6]

It would be anomalous indeed if by registrant's own abortiye legal actions it could disqualify this Commission or individual Commissioners from performing our statutory functions in the instant remedial proceedings. Moreover, even if registrant had been successful in obtaining on judicial review a reversal of any prior ruling by us, such a reversal would not disqualify us or constitute evidence of bias or prejudice. Judges and administrative agencies frequently try the same case more than once,[7] and a discontented litigant may not oust a judge because of adverse rulings made, for such rulings are reviewable and a reversal on review makes a litigant whole for any incorrect or adverse rulings.[8] It is well established that a judge or administrative adjudicator is not disqualified from deciding a case upon remand resulting from reversal of his rulings in the first proceeding.[9] In determining whether or not a stop order shall issue in this proceeding the issues will of course be determined solely on the basis of the record established in this proceeding.[10]

Accordingly, IT IS ORDERED that the motion by registrant to disqualify the Commission and individual Commissioners from further participation in this matter be, and it hereby is, denied.

By the Commission (Chairman BUDGE and Commissioners OWENS, SMITH, NEEDHAM and HERLONG).

[6] *Cf.* 28 U.S.C. § 455, not cited by registrant, which provides that a judge shall disqualify himself in any case in which he has a substantial interest, has been of counsel, or is so related to any party or his attorney as to render it improper for him to sit.

[7] *Cf. FTC* v. *Cement Institute*, 333 U.S. 683, 703 (1948).

[8] *U.S.* v. *Gilboy*, 162 F. Supp. 384, 390 (D.C. Penna. 1958); *In re Federal Facilities Realty Trust*, 140 F. Supp. 522 (D.C. Ill. 1956).

[9] *NLRB* v. *Donnelly Garment Co.*, 330 U.S. 219, 236–237 (1947); *U.S.* v. *Richmond*, 178 F. Supp. 44 (D.C. Conn. 1958).

[10] The Court of Appeals in granting the motion to dismiss registrant's petition for review on the grounds that the order instituting the proceeding was not a final order and that registrant had not exhausted its administrative remedies, obviously contemplated that the administrative proceeding before us would be continued to its conclusion at which time a final order would be issued by us of which registrant then might or might not seek review.

In the Matter of

PROVIDENT MANAGEMENT CORPORATION ET AL.

Securities Act of 1933—Section 8(d)

Securities Exchange Act of 1934—Sections 15(b), 15A and 19(a)(3)

Investment Advisers Act of 1940—Section 203(d)

BROKER-DEALER AND INVESTMENT ADVISER PROCEEDINGS

Grounds for Remedial Action

Violation of Antifraud Provisions

Violation of Section 17(e) of Investment Company Act

Recapture by Affiliates of Commission on Investment Company Portfolio Transactions Through Reciprocal Arrangements with Unaffiliated Broker-Dealers

Receipt of Fees by Investment Company Affiliates in Connection with Tender of Portfolio Securities

False and Misleading Disclosures in Prospectuses and Other Documents

*Porteous and Company, Inc.; Douglas K. Porteous; Jack S. Lautsbaugh; Harry C. Dackerman and Company Inc.; Morris Waber; Harry C. Dackerman; Henry L. McKay; Newburger and Company; Frank L. Newburger, Jr.; Richard L. Newburger; Alfred A. S. Whitaker; Provident Fund for Income, Inc.

Where officers and directors of investment fund, fund's investment manager controlled by one of them, and another controlled broker-dealer participated in arrangements with unaffiliated broker-dealers under which fund portfolio transactions to be executed on New York and American Stock Exchanges were placed with such broker-dealers in return for payment to affiliated broker-dealer of "clearance commissions" on unrelated tran actions which were executed on regional exchange by which broker dealers, and as to which affiliated broker-dealer performed no function; directed portfolio brokerage to another broker-dealer which in return paid certain expenses of retail distributor of fund shares also controlled by one of officers; received and retained solicitation fees although performing no solicitation or other compensable services in connection with tenders; caused fund to use and/or file prospectuses, proxy material and other documents which contained materially false or misleading statements regarding reciprocal arrangements and receipt of payments by affiliated broker-dealers; and caused fund to maintain records which did not accurately reflect basis for allocation of fund's portfolio brokerage, *held*, willful violations of antifraud and other provisions of securities acts, including Section 17(e)(1) of Investment Company Act, and, under all the circumstances, appropriate in the public interest to accept offers of settlement providing for impositions of remedial sanctions with respect to such persons and affiliated broker-dealers.

Where registered broker-dealer participated with fund's officers and adviser and their affiliated broker-dealer in arrangements under which fund portfolio brokerage allocated to them was in part returned to and retained by affiliated broker-dealer, *held*, such broker-dealers willfully violated or aided and abetted violations of antifraud provisions of securities acts and Section 17(e)(1) of Investment Company Act and, under all the circumstances, appropriate in the public interest to accept offers of settlement providing for imposition of remedial sanctions.

STOP ORDER PROCEEDINGS

False and Misleading Statements

Where registration statement filed under Securities Act of 1933 by investment fund contained materially false and misleading statements regarding fund affiliates' recapture and retention of fund's portfolio brokerage and receipt of fees in connection with tenders of portfolio securities, *held*, stop order issued suspending effectiveness of registration statement.

APPEARANCES

Solomon Freedman and *Phil Gross*, for the Division of Corporate Regulation, and *Alexander J. Brown, Jr.*, *William R. Schief* and *Richard L. Sippel*, for the Washington Regional Office, of the Commission.

Mark K. Kessler, of Cohen, Shapiro, Berger, Polisher and Cohen, for Provident Management Corporation, Porteous and Company, Inc. and Douglas K. Porteous.

Richard M. Phillips, of Surrey, Karasik, Greene and Hill, for Provident Fund for Income, Inc. and Jack S. Lautsbaugh.

A. Arthur Miller and *Israel Packel*, of Fox, Rothschild, O'Brien & Frankel, for Newburger and Company, Frank L. Newburger, Jr., Richard L. Newburger and Alfred A. S. Whitaker.

Carl W. Schneider, of Wolf, Block, Schorr and Solis-Cohen, for Harry C. Dackerman and Company, Inc., Morris Waber, Harry C. Dackerman and Henry L. McKay.

FINDINGS AND OPINON OF THE COMMISSION

In these proceedings under Sections 15(b), 15A and 19(a) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(d) of the Investment Advisers Act of 1940 ("Advisers Act"), we issued orders accepting offers of settlement submitted by the above-captioned respondents which provided for the imposition of various sanctions. One order dealt with Provident Management Corporation ("Management"), Porteous and Company, Inc., Douglas K. Porteous and Jack S. Lautsbaugh (referred to hereinafter collectively as the "Porteous respondents");[1] another related to Newburger and Company, and its partners Frank L. Newburger, Jr., Richard L. Newburger and Alfred A. S. Whitaker;[2] and a third to Harry C. Dackerman and Company, Inc., and Morris Waber, Harry C. Dackerman and Henry L. McKay; officers, directors and principal shareholders of that firm.[3] Together with each of those orders we made findings of certain violations and failure of supervision that had been alleged, to which the respondents, solely for the purpose of these proceedings, and without admitting the allegations, and in the case of the Porteous and Dackerman respondents without admitting or denying them, had consented.

We had earlier also issued an order in related proceedings under Section 8(d) of the Securities Act of 1933 suspending the effectiveness of a registration statement, as amended, filed by Provident Fund for Income, Inc. ("Fund"), a registered ivestment company.[4] That order was entered pursuant to a consent in which the Fund, solely for the purpose of the proceedings, agreed to findings that in specified respects the registration statement included untrue and misleading statements of material facts.[5]

We now issue our detailed findin and opinion with respect to the issues presented in these proceeding.[6]

[1] Securities Exchange Act Release No. 8790 (December 31, 1969). Subject to certain specified terms and conditions, we suspended Management's broker-dealer registration, Porteous & Co.'s broker-dealer and investment adviser registrations and Porteous' investment adviser registration for a period of 45 business days, and suspended Porteous and Lautsbaugh from association with any broker-dealer or investment adviser for periods of 45 and 10 business days, respectively.

[2] Securities Exchange Act Release No. 8822 (February 19, 1970). Subject to specified conditions, we suspended Newburger & Co., a registered broker-dealer, from all activities on the Philadelphia-Baltimore-Washington Stock Exchange and from engaging in any institutional business for 10 business days and suspended its investment adviser registration for the same period and suspended the partners of the firm from association with any broker-dealer or investment adviser for periods of 5 business days each.

[3] Securities Exchange Act Release No. 8846 (March 27, 1970). Subject to specified conditions, we suspended Dackerman & Co.'s registration as a broker-dealer for a period of 10 business days and suspended the individual Dackerman respondents from association with any broker-dealer for periods of 15 business days each.

[4] Administrative Proceeding File No. 3-1948.

[5] Following the filing of an amendment to the Fund's registration statement, such amendment was declared effective and the stop order was vacated on April 14, 1969. Securities Act Release No. 4965.

[6] Respondents consented that in making our findings we could take notice of our official files and the testimony, exhibits and other materials obtained by our staff in its investigation of this matter.

ARRANGEMENTS FOR RETURN OF PORTFOLIO BROKERAGE TO AFFILIATES OF THE FUND

Fund has been registered as a management open-end diversified investment company since 1959.[7] Management acts as the Fund's investment adviser, manager and principal underwriter. Porteous has been president and chairman of the board of Fund since its inception, and is president, a director and controlling stockholder of Management and Porteous & Co. and of Pennsylvania Funds Corporation ("Pennsylvania"), a registered broker-dealer which is the primary retail distributor of Fund shares. Lautsbaugh is an officer and director of Fund, Management and Porteous & Co. Porteous and Lautsbaugh comprise the executive and investment committees of Fund's board of directors and, together with Management, exercise managerial responsibility in conducting Fund's daily operations, including the selection of portfolio securities and the placement of orders for their purchase and sale.

With the sponsorship of Dackerman, Porteous in 1966 became a member of the Philadelphia-Baltimore-Washington Stock Exchange ("PBW")[8] in order to enable Porteous & Co., of which Porteous was then sole owner, to "recapture" part of the brokerage commissions resulting from Fund's portfolio transactions executed on the New York Stock Exchange ("NYSE") and American Stock Exchange ("ASE"). Prior to such membership Porteous & Co., which was not a member of those exchanges, could neither execute transactions on any of the three exchanges nor receive any discounts or allowances on transactions executed by members.[9] However, under the rules of the PBW, member firms, at the direction of customers including customers placing NYSE and ASE orders through them, were permitted to "giveup" to other PBW members "clearance commissions", amounting up to 50 percent of the non-member rate, [10] on their PBW transactions. Accordingly, it was agreed that Porteous would direct orders for the purchase and sale of Fund portfolio securities listed on the NYSE and ASE to Dackerman & Co., a member of all three exchanges, and that the latter firm would reciprocate for such business by

[7] As of December 31, 1968, Fund had net assets of $82,345,133 and had approximately 12,500,000 shares outstanding.

[8] At the time of Porteous's application for PBW membership, Dackerman was a member of PBW's Board of Governors and of its committees on business conduct, stock list and budget.

[9] See Article 15, Section 1 of the NYSE Constitution, and Article VI, Section 1 of the ASE Constitution.

[10] A non-member of the PBW was required to pay the full commission for orders executed on that exchange. A member of the PBW could execute an order in its entirety and retain the full commission or could execute through another member acting as floor broker, paying such broker 10 percent of the commission.

designation Porteous & Co. as "clearing broker" on trades executed by Dackerman & Co. on the PBW which were unrelated to Fund's portfolio transactions. This arrangement would enable Porteous & Co. to receive as clearance commissions payments equivalent to 50 percent of the non-member commission charged on such trades, and it was agreed that such payments would amount to approximately 50 percent of the commission on Fund's portfolio transactions executed through Dackerman & Co. on the NYSE and ASE.

Shortly after entering into the arrangement with Dackerman & Co., Porteous, at the suggestion of R. Newburger, entered into a substantially identical arrangement with Newburger & Co., also a member of the NYSE, ASE and PBW. The clearance procedures differed somewhat as between the Dackerman and Newburger transactions,[11] but under both arrangements Porteous & Co. received payments without performing any functions in connection with the PBW transactions.

Pursuant to such arrangements, from on or about August 1, 1966 through December 31, 1968, Porteous and Lautsbaugh directed orders for the purchase and sale of Fund portfolio securities on the NYSE and ASE to Dackerman & Co. in an amount resulting in commissions to the latter of approximately $298,000. During the same period, Porteous & Co. received from Dackerman & Co. and retained payments of about $117,000 in the form of "clearance commissions." From about August 1, 1966 through May 31, 1968, Fund portfolio transactions directed by Porteous and Lautsbaugh to Newburger & Co. resulted in commissions of about $52,000 and Porteous & Co. in turn received and retained PBW "clearance commissions" of about $27,000 from Newburger & Co.

[11] The non-Fund trades by Dackerman & Co. on the PBW were for the most part transactions in which Dackerman & Co. and other PBW members were buying and selling on a principal basis and therefore involved no commissions. Dackerman & Co. maintained accounts for such transactions with the PBW's Stock Clearing Corporation ("SCC"), which provides a central delivery service where securities purchased and sold on the PBW may be delivered by selling members and called for by purchasing members. When Dackerman & Co. sold or bought securities on the floor of the PBW, Porteous & Co. was designated "clearing member sold [bought]" on the SCC transaction tickets which were used. However, Dackerman & Co. in addition attached "off-set" tickets to the transaction tickets instructing SCC to reverse or "off-set" the debits and credits to Porteous & Co. based on the transaction tickets, thus removing the indicated liabilities of Porteous & Co. in the transactions. Porteous & Co. did not deliver or receive securities or pay any money in connection with these non-Fund transactions and they were not entered on Porteous & Co.'s blotter. In fact, Porteous & Co. was unaware that a transaction had taken place until sometime after it was off-set and SCC treated those transactions for all purposes as Dackerman & Co. transactions.

Newburger & Co. was primarily engaged in the retail sale of securities and had no partner or employee executing orders on the trading floor of the PBW. When a Newburger & Co. retail customer purchased or sold securities and the order could be executed on the PBW, Newburger & Co.'s order department was instructed to place such orders on the PBW and the trader who handled Newburger & Co.'s business on the floor of the PBW was instructed to designate Porteous & Co. as the "clearing broker." Thereafter the "off-set" procedures as discussed above were employed.

VIOLATIONS OF ANTIFRAUD PROVISIONS

Porteous and Lautsbaugh, as officers of Fund and as persons responsible for directing the execution of its portfolio transactions, and Management9 by virtue of its position as investment adviser, were fiduciaries of Fund. As such, they were under a duty to act solely in the best interest of Fund and its shareholders.[12] The payments received by Porteous & Co. from the Dackerman and Newburger firms under the guise of "clearance commissions" did not represent compensation for any benefit conferred by it on Fund or for any function performed in connection with transactions on the PBW, but in substance represented reimbursement of a part of the commissions generated by the execution of Fund portfolio transactions directed to those firms. Porteous & Co. retained in their entirety the amounts which it recaptured, in addition to the management fees received by its affiliate.[13] While there is no proof that Fund did not receive the best execution on its transactions, or that the existence of the arrangement described resulted in additional costs to Fund, once the reciprocal arrangements were made, it was improper for Porteous & Co. to keep for itself rather than confer on Fund the benefits attributable to Fund's assets.[14]

We accordingly find that the Porteous respondents violated their fiduciary duty to Fund and its shareholders. These respondents, for their personal benefit, created relationships that did not oermit them to retain the freedom of judgment

[12] See *Delaware Management Co., Inc.*, 43 S.E.C. 392 (1967); *Consumer-Investor Planning Corporation*, 43 S.E.C. 1096 (1969).

[13] Under the terms of the applicable agreement, Management's fees for 1967 and 1968 totalled $463,240. After our staff's investigation and incident to the stop-order proceedings referred to above, Management waived $99,172 of its fee for 1968.

[14] See the recent statement of our General Counsel:

> "It should be understood . . . that if mutual fund management does acquire a seat on a regional stock exchange whose rules permit the recapture of commissions paid by the fund through the use of that seat, there may be circumstances under which such recapture could be required and that the management may not be free to simply retain for itself revenues derived from this source. This is particularly likely to be true where the affiliate on the exchange does not execute or clear transactions for the account of the fund, but merely receives revenue from other brokers, which revenue is attributable to transactions executed for the account of the fund by such other brokers." Securities Exchange Act Release No. 8746 (November 10, 1969).

We do not consider that our conclusion is inconsistent with the recent decision in *Moses* v. *Burgin* (U.S.D.C., D. Mass., August 18, 1970) CCH Sec. L. Rep. § 92, 747. There the court held that the directors and managers of a mutual fund did not violate any duty to the fund and its shareholders by failing to seek methods to employ give-ups and other devices to recapture for the benefit of the fund a part of the commissions on the fund's portfolio transactions, since among other things such recapture would violate stock exchange rules which prohibit rebates to customers. Here, we hold merely that a fund affiliate which has in fact entered into reciprocal arrangements whereby it recaptured a portion of fund brokerage cannot, consistent with its fiduciary obligation to the fund, retain for itself the benefits derived. Nor do we consider that exchange rules are pertinent to that holding.

and action in effecting portfolio transactions that as managers they owed to Fund. The conflict of interests inherent in the making of these arrangements was clearly inimical to Fund and its shareholders.[15]

The Dackerman and Newburger respondents, who knew of Porteous' relationship to Fund, participated in a rebate arrangement which violated the Porteous respondents' fiduciary obligation to Fund and its shareholdess.[16] They knowingly aided Porteous & Co., an affiliate of Fund, in instituting the mechanism whereby the Porteous respondents were enriching themselves by improperly utilizing the brokerage generating capacity of the Fund assets.

Accordingly, we conclude that the Porteous respondents engaged in a scheme to defraud and in a practice which operated as a fraud and deceit upon Fund and its shareholders, in willful violation of the antifraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b–5 thereunder and, as to Porteous, Porteous & Co., and Management, also of Section 206 of the Advisers Act. We further conclude that the Dackerman and Newburger respondents willfully violated or willfully aided and abetted in the violations of those provisions.

VIOLATIONS OF SECTION 17(e) OF INVESTMENT COMPANY ACT

Respondents' conduct also constituted willful violations of Section 17(e)(1) of the Investment Company Act or the aiding and abetting of such violations.[17] As pertinent here, that section makes it unlawful for any affiliated person of a registered investment company, or an affiliated person of such person, "acting as agent, to accept from *any source* any compensation . . . for the purchase or sale of any property to or for such registered investment company . . . except in the course of such person's business as . . . [a] broker." [Emphasis added.] The Porteous respondents were acting as agents for Fund in placing orders for the purchase and sale of Fund's portfolio securities. While Porteous & Co. and Management were registered broker-dealers, as described above they performed no brokerage services in connection with the portfolio transactions which gave rise to the reciprocal commissions, nor in connection with the unrelated PBW transactions.

[15] *Consumer-Investor Planning Corporation, supra.*

[16] Cf. *Delaware Management Co., Inc., supra,* at 398.

[17] See *Consumer-Investor Planning Corp., supra,* p. 1101.

Payment of Pennsylvania's Expenses Through Fund Brokerage

In 1967, Porteous and Management also directed Fund transactions involving brokerage commissions in the amount of approximately $22,000 to a broker which in return furnished to Pennsylvania, without any charge, sales brochures, sales lectures and other selling aids having a value of approximately $8,000. The effect of this arrangement was to use Fund brokerage to pay Pennsylvania's selling expenses.[18] For reasons previously stated, we find that by causing Pennsylvania to receive additional compensation in return for the allocation of Fund brokerage, Porteous and Management, aided and abetted in the violation of Section 17(e)(1) of the Investment Company Act as well as Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b–5 thereunder and Section 206 of the Advisers Act.

Receipt of Fees for Tendering Fund Portfolio Securities

On three occasions during the period August 1966 through December 1968, when Fund tendered its holdings of securities in certain companies pursuant to public tender offers, Porteous caused Porteous & Co. to be designated as soliciting agent, and the firm received and retained approximately $42,000 in tender fees from those inviting the tenders. Porteous & Co. did not in fact have to solicit these tenders and performed no other compensable services for Fund in connection with them. As managers of Fund's portfolio, Porteous and Management simply decided that the securities should be tendered, and Porteous, in his capacity as president of Fund, performed the necessary ministerial acts and instructed the custodian bank to designate Porteous & Co. as the agent soliciting the tenders. The retention of the tender fees by Porteous & Co., Fund's affiliate, constituted an impermissible form of personal enrichment derived from Fund's portfolio transactions. We note, moreover, that to countenance such conduct would permit the determination whether an investment company's portfolio securities should be tendered to be influenced by considerations relating to the affiliate's compensation, and thereby

[18] Pennsylvania was compensated for retailing Fund shares through a dealer's re-allowance received from Management. During the relevant period, the sales load charged to the public in connection with Fund share purchases amounted to 8½ percent of the offering price on purchases of less than $5,000. As principal underwriter and distributor, Management received the 8½ percent sales charge and re-allowed 8 percent thereof to dealers who sold these shares. In 1967 and 1968 Management received an aggregate of $2,201,070 of which $157,694 was retained, $1,684,127 re-allowed to Pennsylvania, and $359,249 re-allowed to independent dealers.

create a conflict of interest between those acting in a fiduciary capacity for the investment company and the fund.

We therefore find that Porteous & Co.'s retention of the tender fees constituted willful violations by Porteous, Porteous & Co. and Management of Section 17(e)(1) of the Investment Company Act and willful violations by Porteous and Management of the antifraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b–5 thereunder and Section 206 of the Advisers Act. We also find that Lautsbaugh aided and abetted these violations.

FALSE AND MISLEADING PROSPECTUSES, FILINGS, PROXY MATERIAL AND BOOKS AND RECORDS

Various documents filed or transmitted by Fund or used in the offer and sale of Fund shares contained false or misleading statements concerning the matters discussed above. Thus, a prospectus filed and used by the Fund in 1967 stated that:

> "Security dealers who sell Fund shares to their clients, participated either directly or through 'give-ups' in these customary brokerage commissions on portfolio transactions in 1966 . . . No such commissions have been paid or directed to Pennsylvania Funds Corporation or any of its affiliated personnel . . ."

This statement was false and misleading because Porteous & Co., which was affiliated with Pennsylvania, received more than $10,000 in 1966 as a result of the reciprocal brokerage arrangements described above. The 1968 prospectus stated that no such commissions had been paid or directed to Pennsylvania in 1967 and that "At present it is not intended that Provident Management Corporation will participate either directly or through 'give-ups' in commissions arising from portfolio transactions." As noted above, however, Pennsylvania received compensation from a broker-dealer in the form of services of a value of about $8,000 as a result of Fund portfolio brokerage being directed to such broker-dealer. These services represented indirect payments of Fund portfolio brokerage commissions to Pennsylvania. The statement that Management did not intend to participate in commissions from portfolio transactions was false and misleading in failing to state that, in 1967, Porteous & Co., which was under common control with Management, received reciprocal commissions of approximately $50,000 in connection with Fund's portfolio transactions and other fees in connection with the tender of Fund portfolio securities and that such reciprocal arrangements were continuing. Moreover, the 1967 prospectus stated that Porteous & Co. had received specified amounts of commissions for executing transactions for Fund in 1966 and the first quarter of 1967 and that the 1966 figure amounted to less than 3 percent of Fund's total commissions paid that year, without disclosing the additional commissions which were directed to Porteous & Co. pursuant to the arrangements discussed above. And the 1968 prospectus, in referring to the commissions received by Porteous & Co. in 1967, failed to disclose the reciprocal commissions and tender fees received by that firm.

In addition, other documents filed by Fund, or used in the solicitation of proxies, including Fund's annual reports for calendar years 1967 and 1968, filed with us on Form N–1R, and proxy solicitation material sent to Fund shareholders in 1967 and 1968 in connection with annual shareholders' meetings did not accurately or adequately disclose the facts with respect to the reciprocal brokerage arrangements, the use of Fund brokerage to pay certain of Pennsylvania's expenses, and the receipt of tender solicitation fees by Porteous & Co. Accordingly, we conclude that Porteous, Management and Lautsbaugh willfully violated or willfully aided and abetted in violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b–5 thereunder, and Section 20(a) and 34(b) of the Investment Company Act and Rule 20a–1 thereunder.[19]

Those respondents also willfully aided and abetted violations of Section 31(a) of the Investment Company Act and Rule 31a–1(b)(9) thereunder in that they caused Fund to make and maintain records which did not accurately reflect the basis for allocating Fund orders to Dackerman & Co., Newburger & Co., and certain other brokers.[20]

In determining to accept the offers of settlement submitted by respondents, we took into account, among other things, the facts that Porteous, Porteous & Co. and Management agreed to make certain payments to Fund and have made indirect pay-

[19] Section 20(a) and Rule 20a–1 prohibit solicitations of proxies by means of a proxy statement containing any false or misleading statement of a material fact. Section 34(b) contains a similar prohibition with respect to documents filed or transmitted pursuant to provisions of the Investment Company Act.

[20] We note that subsequent to an inspection of Fund's books and records in 1965, our staff advised Porteous that the records were deficient in that they failed to reflect the basis for the allocation of Fund portfolio brokerage in accordance with Rule 31a–1 and suggested that steps be taken to remedy this deficiency. While such steps were thereafter taken, records pertaining to Dackerman & Co. and Newburger & Co. falsely reflected direction of brokerage for sale of Fund shares. In fact, Dackerman & Co. sold no Fund shares and, during the relevant period, Newburger & Co. sold only 200 shares.

ments through a credit toward Management's fees.[21] We also took into consideration that, as stressed by the Dackerman and Newburger respondents, reciprocation arrangements are common in the industry and that there may have been uncertainty during the period of the violations regarding the obligations of a reciprocating broker when dealing with an investment company affiliate. In addition, we gave consideration to the facts that there had been publicity concerning respondents' practices and the allegations of our staff respecting them, through our releases relating to these proceedings and through required disclosures in Fund's proxy material and prospectuses. We further considered Fund's consent to the issuance of a stop order, and the recommendations of our staff that the offers be accepted. Under all the circumstances, we deemed it appropriate in the public interest and for the protection of investors to dispose of the proceedings in accordance with such offers.

By the Commission (Chairman BUDGE and Commissioners OWENS, SMITH, NEEDHAM and HERLONG).

[21] The $163,600 which these respondents agreed to pay was comprised of all profits (net after deducting the $99,172 previously credited and certain capital gains) realized by Porteous & Co. from August 1966 through December 1968 derived from brokerage transactions, whether or not attributable to its relationship to Fund, salaries paid to Porteous by Porteous & Co. during that period, and the payments which were made for the benefit of Pennsylvania.

In the Matters of

LOMASNEY & COMPANY

MYRON A. LOMASNEY

File No. 3-2337. Promulgated December 7, 1970

Securities Exchange Act of 1934—Section 15(b) and 15A

BROKER-DEALER PROCEEDINGS

Failure to Comply with Net Capital Requirements

Bids and Purchases During Distribution

Failure to Maintain Accurate Books and Records

Where registered broker-dealer did business with less than required net capital, engaged in sale of registered stock offerings as underwriter on firm commitment basis without disclosing that it lacked sufficient funds to meet obligations of such commitments and to obtain delivery of such stocks for purchasers if offerings were not substantially completed, bid for and purchased stocks during course of stock offerings, and failed to maintain accurate books and records, in willful violation of net capital, antifraud, antimanipulation and record-keeping provisions of securities acts, *held*, in public interest to revoke broker-dealer's registration and bar partner who participated in those violations from securities business.

APPEARANCES:

Donald N. Malawsky, *Marvin G. Pickholz* and *Robert D. Schulman*, of the New York Regional Office of the Commission, for the Division of Trading and Markets.

Aaron Karp, of Galpeer, Altus & Karp, for respondents.

FINDINGS, OPINION AND ORDER

These are proceedings pursuant to Sections 15(b) and 15A of the Securities Exchange Act of 1934 ("Act") with respect to Lomasney & Company ("registrant"), a partnership registered as a broker-dealer, and Myron A. Lomasney, its only general partner. Respondents waived a hearing and post-hearing procedures, and, solely for purposes of these proceedings, and without admitting or denying the allegations in the order for proceedings, consented to findings of willful violations of the securities acts as alleged in such order and to findings, conclusions and inferences based upon any information submitted by or through them to our staff. They further consented to entry of an order revoking registrant's broker-dealer registration and barring Lomasney from association with any broker-dealer, investment adviser, or investment company.

On the basis of the order for proceedings and respondents' consent, it is found that:

1. During the periods from about October 1, 1964 to September 30, 1965, and from about June 20 to August 29, 1969, registrant, willfully aided and abetted by Lomasney, willfully violated Section 15(c)(3) of the Act and Rule 15c3–1 thereunder in that it continued to do business while its net capital was deficient as computed under the Rule.

During these periods, registrant consistently operated with less than the required net capital. In several of the months during the earlier period, Lomasney, in order to conceal the deficiencies in registrant's month-end net capital positions, caused another partnership, of which he was the sole general partner and his wife a limited partner, to borrow funds from a bank and credit them to registrant immediately prior to the trial balance date. The trial balances, which registrant submitted to this Commission and to the National Association of Securities Dealers, Inc., of which it was a member, listed the funds as part of registrant's capital. However, the credits were withdrawn from registrant immediately after the trial balance dates and the bank loans were repaid.[1]

During the second period, registrant was the underwriter on a firm commitment basis of two registered securities offerings: 263,380 shares of the common stock of Consolidated Educational Publishing, Inc. ("Consolidated") at $10 per share, which became effective on June 25, 1969; and 300,000 shares of the common stock of Image Optics, Inc. ("Image") at $10 per share, which became effective on July 3, 1969. By virtue of registrant's open contractual commitments to purchase the entire offerings at a price equal to the net proceeds to the issuers, registrant was required under Section (c)(2)(E) of the net capital rule to deduct from its net capital 30 percent of the value of the net long positions (net proceeds to issuers) contemplated

[1] Lomasney at first stated that the funds could be considered capital of registrant because they were subordinated loans. When confronted with the fact that registrant had not filed copies of any subordination agreements as required by the net capital rule, he stated that they were not subordinated loans but rather contributions to registrant's capital. However, as a practical matter, none of these funds were available for use in registrant's business.

by the commitments.[2] Registrant's commitments in June and July with respect to the two offerings caused substantial deficiencies in its net capital. The net capital deficiency was further substantially increased at the end of July by registrant's breach of its commitments following its failure to dispose of and its termination of the offerings.[3] As of June 30, 1969, even giving registrant credit for its sales of Consolidated stock beyond that date,[4] the net capital deficiency amounted to $134,700. As of July 31, 1969, registrant had a net capital deficiency of $5,229,632, which, by August 20, had increased to $5,582,674.

2. During the period from about June 25 to August 5, 1969, registrant, together with or willfully aided and abetted by Lomasney, willfully violated the antifraud and antimanipulative provisions of Rules 10b–5 and 10b–6 under Section 10(b) of the Act.

As respondents must have been aware, at the time registrant entered into its agreements to underwrite the Consolidated and Image offerings on a firm commitment basis, and during the course of such offerings, it lacked sufficient funds to meet its contractual obligations to the issuers. The failure to disclose to investors the adverse financial condition of registrant rendered materially misleading the statements in the prospectuses to the effect that registrant was underwriting the offerings on a firm commitment basis. Such commitment constituted an assurance to the purchaser that the issuer would receive the net proceeds of the entire offering for use in its business. Moreover, registrant's implied representation to purchasers that it would be able to effect delivery of the shares sold to them was materially false and misleading since, if the offerings were not substantially completed, registrant would be financially unable to pay the issuers for the unsold shares and, under the terms of the underwriting agreements, could not obtain delivery of any of the shares. In fact, as indicated above, when registrant was unable to dispose of the offerings, it re-

[2] As of the effective dates of the Consolidated and Image underwritings, the required deductions from registrant's net capital for the respective issues were $724,378 and $802,500.

[3] In late July 1969, the issuers tendered to registrant the shares being offered, and registrant declined to make payment. Registrant's indebtedness was increased by the amount of its unpaid liabilities of $2,414,596 to Consolidated and $2,675,000 to Image. For net capital purposes, however, the Consolidated and Image stocks registrant had obligated itself to purchase had no value, since those stocks could no longer be considered readily convertible into cash.

[4] Although registrant's sales of Consolidated stock continued at least to July 18, 1969, the record contains only a total sales figure of $202,745 up to that date, so that no allocation can be made between the months of June and July.

neged on its firm commitments. No delivery was made to purchasers and the purchase money was returned to them. In addition, during the course of the offerings, respondents engaged in manipulative activities by entering bids for Consolidated and Image stock in the pink sheets published by the National Quotation Bureau, Inc., and making purchases of those securities for an account in which they had a beneficial interest.

3. During the periods from October 1964 through September 1965, and from about June 1, 1969 to February 17, 1970, registrant, willfully aided and abetted by Lomasney, willfully violated the record-keeping provisions of Section 17(a) of the Act and Rules 17a–3 and 17a–4 thereunder.

During the first period, registrant failed to maintain an accurate general ledger and trial balances. During the second period, it failed to maintain accurately a general ledger, cash and securities transaction journals, records of receipt and delivery of securities and long and short positions, cash and margin account ledgers, and copies of confirmations and debit and credit notices for customers' accounts.

In view of the foregoing, it is in the public interest to impose the sanctions to which respondents have consented.

Accordingly, IT IS ORDERED that the registration as a broker and dealer of Lomasney & Company be, and it hereby is, revoked, and that Myron A. Lomasney be, and he hereby is, barred from being associated with any broker-dealer, investment adviser or investment company.

By the Commission (Chairman BUDGE and Commissioners OWENS, SMITH, NEEDHAM and HERLONG).

In the Matter of

LOUISIANA POWER & LIGHT COMPANY

File No. 3-2678. Promulgated December 29, 1970

Public Utility Holding Company Act of 1935—Sections 6(a) and 7

Rule 50(a)(5)

ORDER

Louisiana Power & Light Company ("Louisiana"), an electric utility subsidiary company of Middle South Utilities, Inc., a registered holding company, has filed a declaration with this Commission pursuant to Sections 6(a) and 7 of the Public Utility Holding Company Act of 1935 ("Act") and Rule 50(a)(5) promulgated thereunder regarding the following proposed transactions.

Louisiana proposes, from time to time but not later than December 31, 1972, to issue and sell short-term notes (including commercial paper), in an aggregate principal amount outstanding at any one time of not more than $40,000,000. Louisiana intends to utilize the proceeds of the sale of its notes for construction expenditures and other corporate expenditures. Louisiana's construction program contemplates construction expenditures of approximately $75,700,000 for 1970, $110,000,000 for 1971, and $120,000,000 for 1972. The notes to be issued to banks will bear interest at the prime commercial bank rate, in effect from time to time or as of the dates the notes are executed and will be subject to prepayment at any time without penalty. No commitments have been obtained for such bank loans, but it is expected that they will be obtained from one or more banks in New York City and Louisiana. Louisiana has listed proposed borrowings from 27 banks aggregating $31,250,000. Any additional notes in excess of this amount will be subject to further order of the Commission. Louisiana also proposes to issue and sell from time to time, commercial paper in the form of short-term promissory notes to an investment banker and dealer in commercial paper to mature not later than December 31, 1972. The commercial paper notes will be of varying maturities, with no such notes maturing more than 270 days after the date of issue. Such notes, in denominations of not less than $50,000 and not more than $1,000,000, will be issued and sold by Louisiana directly to the dealer at a discount which will not be in excess of the discount rate per annum prevailing at the date of issuance for commercial paper of comparable quality and of the particular maturity sold by issuers thereof to commercial paper dealers. No commercial paper notes will be issued having a maturity of more than 90 days if the effective interest cost exceeds that at which Louisiana could borrow from banks.

No commission or fee will be payable in connection with the issue and sale of the commercial paper notes. The dealer, as principal, will reoffer such notes at a discount of 1/8 of 1 percent per annum less than the prevailing discount rate to Louisiana. The notes will be reoffered in a manner which will not constitute a public offering to no more than 100 identified and designated customers in a list (nonpublic) prepared in advance by the dealer.

Louisiana expects to retire the bank notes and commercial paper from the net proceeds of the sale of first mortgage bonds and/or preferred stock and/or other securities prior to December 31, 1972.

Louisiana requests exception from the competitive bidding requirements of Rule 50 for the proposed issue and sale of its commercial paper pursuant to paragraph (a)(5) thereof. It is stated that it is not practical to invite competitive bids for commercial paper and that current rates for commercial paper for such prime borrowers as Louisiana are published daily in financial publications. The company further states that the proposed commercial paper notes will have a maturity of 270 days or less and generally will be sold at effective interest costs that will not exceed the effective interest cost at which the Company could borrow from banks. Louisiana also requests authority to file certificates under Rule 24 with respect to the issue and sale of commercial paper on a quarterly basis.

Louisiana also proposes to transfer $3,125,000 from its Retained Earnings Account to its Common Capital Stock Account. It is stated that the transfer will strengthen Louisiana's capital structure for the benefit of holders of all classes of its securities.

No State commission and no Federal commission, other than this Commission, has jurisdiction over the proposed transactions.

On November 30, 1970, the Cities of Lafayette and Plaquemine, Louisiana ("Cities"), filed a Notice of Appearance as parties pursuant to Rule 9(a) of the Commission's Rules of Practice and requested a hearing in these proceedings. The Cities request that, unless Declarant consents to the imposition of conditions for cessation of activities alleged to be in violation of Federal Antitrust Laws, a hearing be held. The Cities complain that a combination of investor-owned utilities in the State of Louisiana, including the Declarant, have undertaken to thwart construction of large scale generation and transmission facilities by electric cooperatives and the effectuation of a power pool agreement comprising the cooperatives and the Cities. The Cities urge that such activities, detailed in exhibits attached to their petition, are violative of the Federal Antitrust Laws and consequently of the public interest standards of Section 7 of the Act, citing Sections 7(d)(6) and 7(f). The Cities do not directly attack the proposed use of proceeds nor the terms and conditions of the securities to be issued. They maintain that authorization for the proposed financing enhances Louisiana's financial position to pursue the alleged violations of the antitrust laws.

Section 7(d)(6) provides in pertinent part that "the Commission shall permit a declaration regarding the issue or sale of a security to become effective unless the Commission finds that . . . the terms and conditions of the issue or sale of the security are detrimental to the public interest or the interest of investors or consumers." The phrase, "terms and conditions" as here used relates solely to the terms and conditions of the security to be issued, and therefore, the phrase "detrimental to the public interest" refers to such terms and conditions and not to extraneous matters. Section 7(f) provides that "any order permitting a declaration to become effective may contain such terms and conditions as the Commission finds necessary to assure compliance with the conditions specified in this section." Authorization to impose terms and conditions under Section 7(f) does not extend to the resolution of collateral and unrelated controversies in which a declarant may be engaged with other parties. See *Alabama Power Company*, 42 S.E.C. 620 (1965), *affirmed, Alabama Electric Cooperative, Inc.* v. *SEC*, 353 F.2d 905 (1965), *cert denied*. 383 U.S. 968. The Commission finds that the allegations contained in the Cities' petition do not present issues relevant to Section 7 and, therefore, do not justify withholding the requested order. Accordingly, the Commission denies the petition for a hearing requested by the Cities.

Due notice of the filing of said declaration has been given in the manner prescribed in Rule 23 promulgated under the Act (Holding Company Act Release No. 16898), pursuant to which interested persons were given an opportunity to request a hearing. The Commission finding that the standards of Sections 6 and 7 are satisfied; and that it is appropriate in the public interest and in the interest of investors and consumers that said declaration, as amended, be permitted to become effective:

IT IS ORDERED, pursuant to the applicable provisions of the Act and rules thereunder, that said declaration, as amended, be, and it hereby is, permitted to become effective forthwith, subject to the terms and conditions, prescribed in Rule 24 promulgated under the Act, except that the time for filing the certification thereunder with respect to the commercial paper is extended as heretofore indicated.

IT IS FURTHER ORDERED that the petition and request for a hearing filed by the Cities be, and it hereby is, denied.

By the Commission.

IN THE MATTER OF

QUINN AND COMPANY, INC.

JOHN DORNACKER

File No. 3-1958. Promulgated January 25, 1971

Securities Exchange Act of 1934—Section 15(b), 15A and 19(a)(3)

BROKER-DEALER PROCEEDINGS

Sales of Unregistered Securities

Definition of Underwriter

Brokers' and Dealers' Exemptions

Where officer of registered broker-dealer, while partner of predecessor broker-dealer, willfully violated registration provisions of the Securities Act of 1933, *held* under circumstances in public interest to impose suspensions on officer and registrant.

Person who obtains stock directly from issuer with intent immediately to sell such stock on open market, is statutory underwriter under Securities Act, and no exemption under Section 4 of that Act is available for such sales by him and broker-dealer through whom they are made.

Person who obtains stock from issuer with intent to resell to public is statutory underwriter regardless of whether or not he was deceived by issuer respecting saleability of stock without registration.

Exemptions under Section 4 of the Securities Act for brokers and dealers are primarily intended to except normal trading transactions from registration requirements, and such exemptions are not available where broker-dealer is aware of circumstances indicating that seller is underwriter engaged in distribution.

Broker-dealer is not relieved of responsibility to take steps to avoid violations of registration requirements of Securities Act because of issuer's dereliction or failure to take precautions by way of restrictive legend on certificates of unregstered shares.

APPEARANCES:

Joseph F. Krys, *Matthew J. Zale* and *H. Michael Spence*, of the Denver Regional Office of the Commission, for the Division of Trading and Markets.

Ernest W. Lohf, of Lohf & Barnhill, for Quinn and Company, Inc. and John Dornacker.

FINDINGS AND OPINION OF THE COMMISSION

These proceedings pursuant to Sections 15(b), 15A and 19(a)(3) of the Securities Exchange Act of 1934 concern Quinn and Company, Inc. ("Quinn Inc.") which has been a registered broker-dealer since March 15, 1969 and is the successor to Quinn and Co. ("Quinn Co."), a partnership which was registered as a broker-dealer on March 14, 1946, and John Dornacker, who was a general partner in Quinn Co. and is a vice-president of Quinn Inc.[1] The order for proceedings alleges that during the period from May through August 1968, Quinn Co. and Dornacker willfully violated Sections 5(a) and 5(c) of the Securities Act of 1933 in that they offered to sell, sold and delivered after sale shares of the common stock of Mountain States Development Company ("Mountain") when no registration statement had been filed or was in effect as to said securities pursuant to the Securities Act.

Respondents entered into a stipulation with our Division of Trading and Markets in which, for the purposes of these proceedings or any other proceeding pursuant to Section 15(b) of the Exchange Act or Section 203(d) of the Investment Advisers Act of 1940, they stipulated to certain facts. A hearing and a hearing examiner's initial decision were waived, and proposed findings and supporting and reply briefs were filed by respondents and the Division. Our findings are based upon an independent review of the stipulated record.[2]

SALES OF MOUNTAIN SECURITIES

In April 1968, one Ted M. White, a prior customer of Quinn Co.,[3] told Dornacker that he was in the process of obtaining Mountain stock in exchange for certain properties he owned, and that he wanted to sell the stock when he received it. Shortly thereafter White delivered to Quinn Co., to sell for him, six certificates totaling 37,000 shares of Mountain stock in his name, which Mountain had issued on May 1, 1968. In the period May through August 1968, Dornacker executed through Quinn Co. orders to sell 25,000 shares of White's Mountain stock. Of the 25,000 shares, 21,000 shares were sold on the Salt

[1] Quinn Inc. is and Quinn Co. was a member of registered national securities exchanges and of the National Association of Securities Dealers, Inc.

[2] The stipulation provided that oral argument would be subject to an appropriate further order by us. No request for oral argument has been made and we do not deem it necessary.

[3] Dorhacker had opened an account at Quinn Co. for White in January 1963, and two transactions were effected through it in 1963. The account then was inactive until the 1968 transactions in Mountain stock described herein.

Lake Stock Exchange through a member firm which acted as agent for Quinn Co., 1,000 shares each were sold to two other broker-dealers who published quotations on Mountain stock, and the remaining 2,000 shares were sold to a retail customer of Quinn Co., who assertedly entered an unsolicited order. Mountain, which acted as its own transfer agent, transferred the first 17,000 of these shares as requested by Quinn Co., but in September 1968 it refused to transfer the remaining 8,000 shares, stating that the certificates represented unregistered investment stock which could not be transferred without compliance with our Rules and Regulations.[4]

During the following month, Dornacker visited our staff and discussed with it the above transactions in Mountain stock, and was advised that it appeared that his firm had participated in an illegal distribution of unregistered stock. He requested White to refund the proceeds paid him by Quinn Co. from the sale of the 8,000 shares on which transfers had been refused or to furnish other certificates which were registered and could be properly transferred. Quinn Co. also contacted the purchasers of those shares in an attempt to cancel those sales and secured cancellation as to 3,000 shares. White then arranged for the delivery to Quinn Co. of other Mountain shares owned by one Newell R. Hays, a director and large stockholder of Mountain, which Mountain advised Quinn Co. were transferable, and the transactions on the remaining 5,000 shares of Mountain stock were reinstated.

At the time all the above events took place, there was no registration statement under the Securities Act on file or in effect with respect to any Mountain stock.

VIOLATIONS OF SECTION 5 OF THE SECURITIES ACT

It is evident that transactons in unregistered Mountain shares described above were in violations of Sections 5(a) and 5(c) of the Securities Act unless an exemption was available as to them.[5] It is well settled that the burden of proving entitlement to an exemption from the general policy of the Securities

[4] On August 28, 1968, we suspended trading in Mountain stock pursuant to Sections 15(c)(5) and 19(a)(4) of the Exchange Act, because of serious questions as to the accuracy of information about the company and its operations. Securities Exchange Act Release No. 8396. The Salt Lake Stock Exchange, on which the stock is listed, had suspended exchange trading on August 22, 1968. In April 1969, Mountain and certain of its officers and associates (Civil Action No. C–68–69, U.S.D.C., D. Utah) were enjoined on consent from violating the registration, antifraud and reporting provisions of the securities laws. Litigation Release No. 4313 (May 7, 1969). The suspension of trading of Mountain stock terminated on April 28, 1969. Securities Exchange Act Release No. 8583 (April 24, 1969).

[5] See *e.g., Gilligan, Will & Co.*, 38 S.E.C. 388, 391 (1958), *aff'd* 267 F.2d 461 (C.A. 2, 1959), *cert. denied*, 361 U.S. 896.

Act requiring registration rests with the person claiming the exemption.[6] Respondents have not sustained such burden here.

Respondents have urged first that there was available for White's sales the exemption from registration provided by Section 4(1) of the Securities Act for "transactions by any person other than an issuer, underwriter, or dealer." We do not believe that this exemption is available, however. While not an issuer or a dealer, White was an underwriter in the statutory sense. Section 2(11) of the Securities Act defines an underwriter to include "any person who has purchased from an issuer with a view to . . . the distribution of any security." In this case, White acuired his shares directly from the issuer, with the intent, which he carried out, to begin immediately to resell them to the public.

In view of the primary purpose of the Securities Act to protect investors through the registration provisions, the courts have given a broad interpretation to the term "underwriter" and have held that it is not necessary to show that one who participated in and engaged in steps necessary to a flow of securities from an issuer to the public had a conventional relationship to or a contractual privity with the issuer in order to find such a person to be a statutory underwriter.[7] Even though offers and sales may not give the appearance of a conventional public distribution, one who acquires securities from an issuer for public resale becomes an underwriter within the meaning of the Securities Act.[8]

The fact that the general purpose of the Securities Act is to protect "investors" does not mean that all transactions by a person who had characteristics of an ordinary investor are exempt from its registration requirements. On a previous occasion we noted that the term "underwriter" is broadly defined in Section 2(11) and emphasized that individual investors who are not professionals in the securities business may be "underwriters" within the meaning of that term as used in the Securities Act if they act as links in a chain of transactions through which securities move from an issuer to the public.[9]

There is not present here any question concerning the intent

[6] *S.E.C.* v. *Ralston Purina Co.*, 346 U.S. 119 (1953); *S.E.C.* v. *Culpepper*, 270 F.2d 241, 246 (C.A. 2, 1959); *Pennaluna & Co.* v. *S.E.C.*, 410 F.2d 861, 865 (1969).

[7] *Cf. S.E.C.* v. *Chinese Consolidated Benevolent Association*, 120 F.2d 738 (1941), *cert. denied*, 314 U.S. 618; *S.E.C.* v. *Culpepper*, 270 F.2d 241 (C.A. 2, 1959).

[8] *Gilligan, Will & Co.*, 38 S.E.C. 388, 392 (1958, *aff'd* 267 F.2d 461 (C.A. 2, 1959), *cert. denied*, 361 U.S. 896.

[9] Securities Act Release No. 4997, page 15 (September 15, 1969).

with which the securities were acquired from the issuer. It is clear that White intended to resell his Mountain shares on the open market as soon as possible so as to obtain cash for the property interests he sold to Mountain and not to become a stockholder of Mountain. His acceptance of the Mountain stock and immediate resale for cash did not differ in essence from an arrangement whereby the issuer sold the stock to the public for cash and used the cash so raised to buy White's properties, an arrangement which clearly would have required registration for the securities so sold to the public. If the view that the same securities could flow from the issuer to the public without registration merely because of the interposition of the seller of property to the issuer under these circumstances were upheld, public distributions of securities could be readily effected without compliance with the registration, prospectus and other protective provisions of the Securities Act, contrary to the basic policy of that Act.

Respondents seek to escape this result by contending that White was an investor who purchased unregistered securities sold to him by the issuer in furtherance of a fraudulent scheme,[10] and that as a "defrauded" investor he was a member of the class of persons that the Securities Act is intended to protect. They urge that under the circumstances White should not be deemed an underwriter notwithstanding any intent to resell his shares in the public market. There is no exemption from the registration provisions of the Act for a person otherwise subject thereto, on the ground that he was defrauded by the issuer. A person's status as an underwriter under the statutory definition is not changed thereby.

Respondents are not aided by the decision in *Can-Am Petroleum Co.* v. *Beck* cited by them.[11] In that case, the Court held that an investor could maintain an action under Section 12 of

[10] Respondents assert that the sale of stock by Mountain to White was in violation of the registration and antifraud provisions of the Securities Act, in view of the fact that no registration statement was in effect and because of material misstatements and omissions, including misrepresentations to White by Mountain's president that "SEC approval" had been or would be obtained for delivery of the stock to White and the failure to make any statements about any restrictions upon resale by White of the stock delivered to him, to disclose that no registration statement had been filed or was in effect or to place any restrictive legend on the certificates, even though Mountain's president was aware that White planned to resell the stock through a broker.

It appears that White agreed on a price of approximately $17,500 for his properties, that he had received $1,500 in cash, and that his principal concern was to recover approximately $16,000 from the sale of the stock he received from Mountain. He actually received net proceeds of $23,671 from the sale of that stock by Quinn Co. The Division contends that the facts in the stipulated record compel the conclusion that White was not defrauded by Mountain but rather was a party to an illegal distribution of unregistered securities. Neither White nor Mountain is a respondent in the instant proceedings, and we do not undertake here to determine whether or not a fraud was practiced on White by Mountain.

[11] 331 F.2d 371 (C.A. 10, 1964).

the Securities Act to rescind a purchase of securities induced by material misrepresentations by the issuer, despite the claim that she was in *pari delicto* with the issuer and was an underwriter because after making her initial investment she induced purchases by others and assisted in the issuer's promotional efforts or which she received additional securities as compensation. The Court stated that an investor does not waive or lose the shelter of the Securities Act because he becomes to some extent involved in the illegality of the securities sales. Noting that Beck was sought out as a potential investor and was "sold" on her investment through the issuer's misrepresentations, the Court concluded that, for purposes of the issuer's liability to her, her "isolated endeavor to join with Can-Am in disposing of their entire interests did not change her relationship from that of investor to underwriter." [12] The Court's statements in no way stand for the proposition that an investor who becomes a statutory underwriter has a right to resell the securities to the public without registration. Unlike the situation in the instant case, there was no indication that the purchaser acquired her securities from the issuer with the intent to resell them to the public, and she did not resell them. Whatever White's rights might have been or might be as against Mountain and its president, by acquiring his shares directly from the issuer with the intent of immediately selling them on the open market (and doing so) White became a statutory underwriter, and accordingly the exemption under Section 4(1) was not available of his transactions.

Respondents next argue that even if White is deemed to have been a statutory underwriter, Quinn Co. had no interest in the sale of White's shares except for its usual commissions and charges computed in accordance with the New York Stock Exchange Commission schedules [13] and was at most a dealer[14] and entitled to the dealers' exemption under Section 4(3) or the brokers' exemption under Section 4(4) of the Securities Act. We cannot agree.

We start with the basic premise that the provisions of Sections 4(1), 4(3) and 4(4) are intended to exempt trading transactions with respect to securities already issued to the

[12] Id. at 373–374.

[13] Section 2(11) excludes from the definition of underwriter any person "whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission."

[14] Section 2(12) defines the term "dealer" to include both a person who engages in the securities business as principal (dealer) and one who does so as agent (broker).

public and that they cannot be used to exempt distributions by issuers or underwriters or the acts of other persons who engage in steps necessary to such distributions.[15]

Thus, whether or not Quinn Co. is characterized as an underwriter itself,[16] it participated in public sales of unregistered securities by an underwriter, White, and the process of distribution itself, however carried out, is subject to the registration requirements of Section 5.[17]

Clearly the exemption in Section 4(1) was not available to Quinn Co., for it was in any event a dealer as defined in the Act. Accordingly, it must find its exemption, if any, under the provisions of Section 4(3) or Section 4(4) providing exemptions for dealers and brokers. For the reasons set forth below, no exemption under either of these Sections was available to Quinn Co. under the circumstances of this case.

The legislative history of the brokers' exemption indicates that it was meant to preserve the distinction between distribution, with which the Securities Act is mainly concerned, and trading. The exemption in Section 4(1) for transactions by persons other than an issuer, underwriter or dealer evidences Congress' intent that such other persons should be free to trade in securities, and, to allow them to do so through the use of brokers, a special exemption was provided in what is now Section 4(4) for dealers acting as broker.[18] Consistent with the purpose of the Section 4(4) exemption to permit a dealer to act as a broker for an individual's trading transactions, the House Committee Report on the legislation indicates that the brokers' exemption is not available when the selling principal is a dealer.[19] *A fortiori*, the brokers' exemption cannot be available when the broker knows or has reasonable ground to believe that the selling customer's part of the transaction is not exempt since in that event the broker likewise violates Section 5 by participating in a non-exempt transaction.[20]

[15] See *e.g.*, *Sutro Bros & Co.*, 41 S.E.C. 470, 477–478 (1963).

[16] The Division cites the provision in Rule 141(c) under the Securities Act excluding from the term "usual and customary distributors' or sellers' commission" as used in Section 2(11), "amounts paid to any person whose function is the management of the distribution of all or a substantial part of the particular issue." It contends that Quinn Co. managed the distribution of White's shares within the meaning of this Rule and is therefore not excluded from the Section 2(11) definition of underwriter. See *Sutro Bros. & Co.*, *supra*, p. 477.

[17] *Ira Haupt & Co.*, 23 S.E.C. 589, 604 (1946).

[18] Section 4(4) exempts brokers' transactions executed upon customers' orders but not the solicitation thereof. When the Act was adopted, the brokers' exemption appeared as Section 4(2).

[19] H. R. Rep. No. 85, 73d Cong., 1st Sess., pp. 15–16 (1933).

[20] Loss, *Securities Regulation*, Vol. 1, p. 698 (2nd Ed. 1961).

We have previously recognized the obligation of a broker-dealer asked to sell a block of unregistered securities to take whatever steps are necessary to be sure that he is not participating in transactions involving an underwriter and that a broker cannot rely on the Section 4(4) brokers' exemption when he is aware of circumstances indicating that his principal is an underwriter.[21] Here Dornacker knew of the two most critical factors indicating that White was an underwriter and that his sales did not constitute normal trading activity: one, that White had obtained shares directly from the issuer; and two, that White ought to sell such shares to the public as soon as possible after receiving them.

By the same token, the dealers' exemption in Section 4(3) is not available to a dealer who is selling unregistered securities for an underwriter. The House Report, again emphasizing the distinction between trading and distribution, stated that in recogntion of the fact that a dealer is often concerned not only with the distribution of securities but also with trading in securities, an exemption was provided for a dealer as to trading when such trading occurs after period of distribution.[22] It is apparent from that statement that transactions by a dealer during the period of distribution are not exempted from the registration and prospectus requirements,[23] and this conclusion is particularly compelling when the dealer is acting directly for a statutory underwriter.

Moreover, by its specific terms the Section 4(3) dealers' exemption is not available during the 40 days after the first date upon which the security was offered to the public by an underwriter; nor is such exemption available for transactions as to securities constituting the whole or a part of an unsold allotment to the dealer as a participant in the public sale of such securities by an underwriter.[24] Since Quinn Co. through Dornacker undertook to sell all or part of White's block of Mountain stock for him almost immediately after he obtained the stock certificates from the issuer, it is apparent that it was

[21] See *e.g.*, Securities Act Release No. 4445, p. 2 (February 2, 1962); Securities Act Release No. 4818, pp. 1-2 (January 21, 1966); Securities Act Release No. 4997, p. 11 (September 5, 1969); Securities Act Release No. 5087, p. 3 (September 22, 1970). *Cf.* also Rule 154(a)(4) under the Securities Act, under which the term "brokers' transactions" in Section 4(4) is not deemed to include transactions by a broker acting as agent for a person in a control association with an issuer in any situation where the broker is aware of circumstances indicating that his principal is an underwriter. See *e.g.*, *Skiatron Electronics and Television Corp.*, 40 S.E.C. 236, 250-251 (1960).

[22] H. R. Rep. No. 85, 73d Cong., 1st Sess., p. 16 (1933).

[23] *Ira Haupt & Company*, 23 S.E.C. 589, 603 (1946).

[24] Section 4(3)(A) and (C)

not entitled to the exemption under Section 4(3) for trading transactions by dealers.[25]

There being no registration statement in effect for Mountain's securities and no exemption available at the time Quinn Co. and Dornacker effected sales and deliveries after sale of Mountain stock for White's account, we find that they violated Section 5 of the Securities Act. We also find that their violations were willful within the meaning of Section 15(b) of the Exchange Act. It is well settled that a finding of willfulnes under the Exchange Act does not require that we find an intent to violate, but merely an intent to do the act which constitutes a violation.[26] Quinn Co. and Dornacker obviously intended to offer and sell White's securities and it is admitted that at the time of the transactions they were aware that no registration statement as to them was in effect. Moreover, as noted, they also knew that White has obtained his stock directly from the issuer immediately prior to the transactions and that White never intended to keep the stock for investment purposes.

Broker-dealers have a responsibility to be aware of the requirements necessary to establish an exemption from the registration requirements of the Securities Act and should be reasonably certain such an exemption is available.[27] The immediate resale by White of a block of stock he obtained directly from the issuer should have caused Dornacker to question the availability of any exemption from the registration provisions of the Securities Act.[28] While Dornacker apparently realized there was a question as to the availability of an exemption based on the facts known to him, he did not seek legal counsel or consult our staff prior to the transactions,[29] but satisfied himself with merely telling White to obtain certificates in acceptable delivery form.[30] Quinn Co. and Dornacker were not

[25] The dealer's exemption does not extend to the transactions which themselves are the public offering of the securities. *Sutro Bros. & Co.*, 41 S.E.C. 470, 477 (1963); Loss, *Securities Regulation*, Vol. 1, p. 258 (2nd Ed. 1961).

[26] *Gilligan, Will & Co.*, 38 S.E.C. 388, 395 (1958), *aff'd* 267 F.2d 461, 468 (C.A. 2, 1959); *Tager* v. *S.E.C.*, 344 F.2d 5, 8 (C.A. 2, 1965).

[27] See *e.g.*, *Strathmore Securities, Inc.*, 43 S.E.C. 575, 582 (1967).

[28] *Cf. S.E.C.* v. *Mono-Kearsage Consolidated Mining Company*, 167 F. Supp. 248, 259 (D. Utah, 1958), where the Court stated that a dealer cannot "close his eyes to obvious signals" or "red flags" warning him to go slowly. See also *Dlugash* v. *S.E.C.*, 373 F.2d 107, 109 (C.A. 2, 1967).

[29] *Cf. S.E.C.* v. *Culpepper*, 270 F.2d 241, 251 (C.A. 2, 1959).

[30] Although Dornacker told White he would not pay him the proceeds of the sales until after the acceptance of the stock certificates by Mountain for transfer to the purchasers, after Mountain accepted for transfer certificates for the first 17,000 shares that Quinn Co. sold for White, Quinn Co. paid White for the entire 25,000 shares so sold without waiting for the transfer of the last 8,000 shares, which as noted was subsequently refused by Mountain.

entitled, as respondents contend, to rely on the absence of any restrictive or cautionary legends on the Mountain certificates issued to White or any warning by Mountain as to saleability restrictions. While such a legend or instructions to transfer offices may serve as useful devices by issuers to alert buyers to the restricted character of unregistered securities and to prevent violations of the registration requirements,[31] the failure of an issuer to take such measures cannot relieve a broker-dealer from his duty as a professional in the securities business to make a reasonable inquiry into facts known to him indicating that he is participating in an illegal sale of unregistered securities.

PUBLIC INTEREST

Respondents urge that the public interest does not require the imposition of any sanctions. They argue that the conduct in question consisted merely of executing on an ordinary agency basis an unsolicited order to sell a relatively small block of a stock which was listed on an exchnge[32] for a customer who was not affiliated with the issuer or its controlling persons. They point out that Quinn Co. is no longer in existence and its registration has been withdrawn, and they stress that Quinn Inc. has instituted procedures designed to prevent violations of Section 5 and that Quinn Co. and Dornacker, as well as Quinn Inc., have never before been the subject of any disciplinary proceedings by us.

Insofar as Dornacker is concerned, we consider that a sanction should be imposed in the public interest in view of his failure to carry out his responsibility to examine carefully sales by customers who have obtained stock directly from the issuer to insure that violations do not occur. In determining what sanction would be appropriate, however, we have taken into account the various factors urged by respondents in mitigation and the fact that Quinn Co. made full restitution to its only retail purchaser even though it had paid the net sales proceeds to White. Under all the circumstances we conclude that Dornacker should be suspended from association with any broker or dealer for a period of 20 days.

As to Quinn Inc., as respondents concede, a sanction may be imposed upon it, if in the public interest, under the specific

[31] See for example, Securities Exchange Act Release No. 4997, p. 16 (September 5, 1969).

[32] There were 2,982,915 shares of Mountain stock outstanding on December 31, 1967, and 5,469,716 shares outstanding in March 1969.

provisions of Section 15(b)(5) of the Act, upon the basis of the willful violations of Dornacker, who is an officer and an associated person of Quinn Inc., even if such violations took place prior to his current association with Quinn Inc. In considering the public interest, we note that Quinn Inc. is the successor to the business, assets and liabilities, and offices and staff of Quinn Co. and that Dornacker, who was a partner in Quinn Co., continued his functions as an officer of Quinn Inc.[33] On the other hand, we give recognition to the various mitigative factors described above. We conclude that it is appropriate in the public interest to suspend Quinn Inc. from membership in the National Association of Securities Dealers, Inc. for a period of 15 days.

An appropriate order will issue.

By the Commission (Commissioners OWENS, SMITH, NEEDHAM and HERLONG).

[33] Following the filing by both the Division and respondents of briefs as provided for in the stipulation, the Division sought leave to respond to respondents' statement in their reply brief that Quinn Inc. cannot be found to have violated the Act on the basis of Quinn Co.'s actions, and various further related motions and counter motions were filed. We have taken into account in our consideration of the public interest the substantial identity between Quinn Inc. and Quinn Co., and we have noted that respondents concede that a sanction may be imposed on Quinn Inc. under the specific provisions of Section 15(b)(5) of the Act. Under the circumstances we do not consider that the matters raised by the motions, which go beyond the provisions of the stipulation governing the disposition of this matter, are necessary to our conclusions, and all such motions are denied.

IN THE MATTER OF

DUNHILL SECURITIES CORPORATION

PATRICK R. REYNAUD

PATRICK RENE REYNAUD DE ST. OYANT, LTD.

PATRICK RENE REYNAUD
DE ST. OYANT, (a/k/a
PATRICK R. REYNAUD)

File Nos. 3-1961 and 3-2018. Promulgated January 26, 1971

Securities Exchange Act of 1934—Sections 15(b) and 15A

BROKER-DEALER PROCEEDINGS

Revocation and Denial of Registration

Bar from Association with Broker-Dealer

Offer, Sale and Delivery of Unregistered Stock
Fraud in Offer and Sale of Securities
Failure of Supervision
Noncompliance with Record-Keeping and Net Capital Requirements
Injunctions

Where registered broker-dealer and its president and controlling stockholder participated in unlawful distribution of unregistered stock; president and salesman recommended such stock to customers without disclosing adverse and speculative factors; broker-dealer and president failed reasonably to supervise salesman; broker-dealer failed to comply with record-keeping and net capital requirements, notwithstanding prior injunction against violations of those requirements; and broker-dealer and president were also subject to injunctions against violations of securities registration provisions and broker-dealer against violations of fraud provisions, *held*, in public interest to revoke broker-dealer's registration, bar president from association with any broker-dealer, and deny registration application of broker-dealer also controlled by president.

APPEARANCES:

William Nortman and *Thomas R. Beirne*, of the New York Regional Office of the Commission, for the Division of Trading and Markets.

Morris Rosenzweig, for respondents.

FINDINGS, OPINION AND ORDER

Following hearings in these consolidated proceedings pursuant to Sections 15(b) and 15A of the Securities Exchange Act of 1934 ("Exchange Act"), the hearing examiner filed an initial decision concluding that the registration as a broker and dealer of Dunhill Securities Corporation ("registrant") should be revoked and that it should be expelled from the National Association of Securities Dealers, Inc. ("NASD"), that an application for broker-dealer registration filed by Patrick R. Reynaud de Saint Oyant, Ltd. ("applicant") should be denied, and that Patrick R. Reynaud, president and sole stockholder of both registrant and applicant, should be barred from association with any broker-dealer.[1] In reaching this conclusion he found that, as alleged in the orders for proceedings, registrant and/or Reynaud were the subjects of a total of four injunctions and that these respondents had willfully violated, or willfully aided and abetted violations of, certain provisions of the Exchange Act and the Securities Act of 1933 and had failed reasonably to supervise an employee of registrant. We granted a petition for review filed by respondents, and briefs were filed by respondents and by our Division of Trading and Markets.[2] On the basis of an independent review of the record, and for the reasons set forth herein and in the initial decision, we make the following finding.

Reynaud became president and controlling stockholder of registrant in March 1967; one Guido Volante, who had previously been registrant's principal officer and controlling stockholder, retained the remaining stock interest and became vice-president. Volante terminated his association with registrant in about June 1968, and Reynaud remained as its sole principal. Applicant was incorporated in February 1969 and filed its registration application in May 1969.

VIOLATIONS OF REGISTRATION AND ANTIFRAUD PROVISIONS; INJUNCTIONS AGAINST VIOLATIONS OF THOSE PROVISIONS

As found by the examiner, during the period from about February 1, 1968 through May 1968, in connection with the offer, sale, and delivery of common stock of Lynbar Mining Corporation, Ltd., a Canadian corporation, registrant willfully violated, and Reynaud willfully aided and abetted violations of, the registration provisions of Sections 5(a) and 5(c) of the Securities Act of 1933 and the antifraud provisions of Section

[1] We previously suspended registrant's registration pending final determination of whether such registration should be revoked and postponed the effective date of applicant's registration until final determination of whether such application should be denied, 44 S.E.C. 1 1969 and 43 S.E.C. 1143 (1969).

[2] Oral argument before us had been scheduled at respondents' request, but was cancelled upon their subsequent request that we reach our decision without such argument.

17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b–5 thereunder.

As part of a large-scale distribution in the United States of Lynbar stock emanating in part from control persons in Canada, registrant sold 133,000 shares of such stock to 315 retail customers and other broker-dealers through its own trading account, two accounts maintained in the names of relatives of Edward Flinn, a trader and salesman for registrant, and an account in the name of Panamerican Bank & Trust Co., a Panamanian company of which Reynaud was president and for which he made investment decisions. In addition, registrant purchased approximately 16,000 shares of Lynbar stock as agent for some 18 customers. No registration statement had been filed with us with respect to Lynbar stock, and respondents concede that no exemption from the registration requirements was available for registrant's transactions in such stock and that registrant violated Sections 5(a) and 5(c).

Respondents also do not contest the examiner's finding that in connection with the offer and sale of Lynbar stock Flinn made certain misrepresentations and failed to disclose material facts necessary to make statements made not misleading.[3] Lynbar, which was organized to engage in mining activities, had never had any income from operations, and such funds as it had were derived solely from the sale of its stock While it had acquired exclusive rights to a process for the extraction and processing of potash the economic feasibility of that process had not yet been established. Nevertheless, Flinn represented to one customer that Lynbar had one of the largest known potash reserves in the world and had developed a new technique for extracting the potash which would make its stock valuable, and that the stock was or would be a "high flier" which would within 60 days go up to 10 from its then price of 4¹/₈. He made no disclosure concerning the stage of development of the new process, the amount of capital that would be required to make the mining of potash by means of that process economically feasible, or the capability of Lynbar to finance the process. In recommending the stock to other customers, he made no disclosure regarding Lynbar's lack of earnings or financial condition.

In February 1969, registrant and Flinn, upon their consent, but without admitting or denying the allegations of the com-

[3] On the basis of Flinn's consent, in which he neither admitted nor denied the charges as to him, an order was issued on May 9, 1969, barring him from association with any broker or dealer. Securities Exchange Act Release No. 8604.

plaint, were permanently enjoined from violating the registration and antifraud provisions in connection with transactions in Lynbar stock.[4]

Respondents' principal contention with respect to the Lynbar transactions is that they were carried out essentially by Volante and Flinn, who have not been associated with registrant since about June 1968, that Reynaud's position with the firm at the time of those transactions was mainly ministerial, and that his participation in them was peripheral, stemmed from ignorance rather than wrongful intent, and resulted in no harm or loss to public investors. Reynaud testified, in this connection, that he did not become registered with the NASD as a principal until the end of February 1968 and prior thereto did not take, and in his view was precluded from taking, an active part in registrant's business. He further testified that even after February 1968, Volante was primarily in charge of registrant's operations until he terminated his association with registrant. Respondents also point out that the three customer-witnesses who testified were all customers of Flinn and that Reynaud was not named as a defendant in the injunctive proceedings.

The record shows, however, that Reynaud in fact played a substantial role in connection with the Lynbar transactions. He was personally responsible for the purchase and sale of a substantial number of Lynbar shares through the Panamerican account. Moreover, he acknowledged that in connection with the offer and sale by him of Lynbar stock to customers of registrant he did not discuss Lynbar's lack of earnings or other specific details with them. He asserted that his customers generally relied on his judgment and were not interested in the specifics concerning particular securities, but further testified that to the extent he discussed Lynbar, he stated merely that this was a Canadian stock which he was buying, that he felt Lynbar could be "a good company later on" "if everything is all right" and that it was a "gambling operation." In our view these representations, which were tantamount to a recommendation to purchase, were misleading in the absence of specific disclosure of the speculative and adverse factors referred to above.[5] It is not necessary to a finding of violation or

[4] *S.E.C.* v. *Lynbar Mining Corporation, Ltd.*, S.D.N.Y., 68 Civ. Action No. 4493.

[5] See *Richard J. Buck & Co.*, 43 S.E.C. 998 (1968), *aff'd sub nom. Hanly* v. *S.E.C.*, 415 F.2d 589 (C.A. 2, 1969).

willful violation that there be an intention to violate the law[6] or that harm or loss to investors be shown.[7] Nor is it of importance to the decision of the issues in these proceedings that no customers of Reynaud were called to testify or that he was not named in the injunctive action.

We also agree with the examiner's finding that registrant and Reynaud failed reasonably to supervise Flinn with a view to preventing his violations of the registration and antifraud provisions in connection with the offer and sale of Lynbar stock. By virtue of his position as registrant's president and controlling shareholder, and in light of his awareness of the substantial activity of registrant in Lynbar stock, Reynaud was under an obligation to exercise appropriate supervision of Flinn's conduct.[8] That he failed to do so is demonstrated by his own testimony that he did not know or inquire as to what Flinn was telling his customers concerning Lynbar. The fact that Reynaud was not registered as a principal with the NASD when such activity commenced could not in our view relieve him of his obligation, and in any event the Lynbar transaction extended well beyond the date when he became registered.

In addition, prior to or during the period in which registrant was selling Lynbar stock, Reynaud and registrant were enjoined, in connection with other securities, against violations of the registration provisions, and violations of those and the antifraud provisions, respectively. Thus, Reynaud, together with Panamerican, was permanently enjoined in May 1967 from violating Section 5 of the Securities Act in connection with the offer, sale and delivery of Panamerican stock,[9] and in February 1968, registrants, with others, was preliminarily enjoined from violating the registration and antifraud provisions in connection with the offer and sale of stock of North American Research and Development Corporation.[10]

VIOLATIONS OF RECORD-KEEPING AND CAPITAL REQUIREMENTS AND RELATED INJUNCTION

In June 1968 registrant, Reynaud, and Volante were preliminarily enjoined from violating the net capital and record-keeping provisions of the Exchange Act and rules thereun-

[6] It is only necessary that there be an intent to perform the act that is violative of the law. See, *e.g.*, *Tager* v. *S.E.C.*, 344 F.2d 5, 8 (C.A. 2, 1965); *Gilligan, Will & Co.*, 38 S.E.C. 388, 395 (1958), *aff'd* 267 F.2d 461, 468 (C.A. 2, 1959), *cert. denied* 361 U.S. 896 (1959).

[7] See *May-Phinney Company*, 27 S.E.C. 814, 831, n. 21 (1948).

[8] *Cf. Albion Securities Company, Inc.*, 42 S.E.C. 544, 547 (1965); *Aldrich, Scott & Company, Inc.*, 40 S.E.C. 775 (1961).

[9] *S.E.C.* v. *Panamerican Bank & Trust Co.*, S.D.N.Y., 67 Civ. Action No. 1825.

[10] *S.E.C.* v. *North American Research and Development Corporation*, S.D.N.Y., 67 Civ. Action No. 3724.

der.[11] In entering the injunction the Court found that as of May 31, 1968, registrant had a net capital deficiency of over $22,000, and that as of May 24, 1968, entries on 7 different records of registrant had not been currently posted, the last dates of posting ranging from March 29 to May 16, 1968. The Court further found that the record-keeping situation had been substantially improved by May 31, although there were still shortcomings. However, as detailed below, early in 1969, when Reynaud was in complete charge of registrant's operations, its books and records were again seriously non-current and it was operating with a large net capital deficiency. We find, as did the examiner, that during the period from about January 31, to April 21, 1969 (the date on which the proceedings with respect to registrant were instituted), registrant willfully violated, and Reynaud willfully aided and abetted violations of, the record-keeping requirements of Section 17(a) of the Exchange Act and Rule 17a–3 thereunder, and that at and about March 31, 1969, registrant, willfully aided and abetted by Reynaud, willfully violated the net capital requirements of Section 15(c)(3) of the Exchange Act and Rule 15c3–1 thereunder.

An inspection of registrant's books and records on March 10, 1969, disclosed that its general ledger and its failed to deliver ledger were posted only to January 31, the firm's trading account to the end of February, the securities record or ledger to December 13, 1968, and the failed to receive ledger to February 3, 1969. Moreover, although paragraph (11) of Rule 17a–3 requires that a trial balance and a computation of aggregate indebtedness and net capital be prepared currently at least once a month, the latest available trial balance was that of January 31, 1969 and no computation of aggregate indebtedness and net capital as of that date had been prepared. Subsequent inspections of registrant's books and records on April 1 and April 11, while indicating some improvement, disclosed that certain of the records were still deficient.

While not disputing these deficiencies, respondents point out that the extent of noncompliance had been substantially reduced by the time proceedings were instituted and assert that efforts were continued after that date to make the records current. They argue that since registrant's blotter, the original record of its transactions, was current, it was just a matter of manpower to transpose the figures to various "secondary"

[11] *S.E.C.* v. *Dunhill Securities Corporation*, S.D.N.Y., 68 Civ. Action No. 2152. A permanent injunction was entered against registrant and Reynaud in June 1969.

records, and that the delay in doing so was attributable, among other things, to unavoidable personnel problems and absences in January and February 1969 and to the seizure of certain records by the Attorney General of New York.[12]

The fact that registrant's blotter was current cannot excuse its failure to maintain other required books and records on a current basis.[13] Unless records are maintained on a current basis, neither the broker-dealer nor those charged with its regulation are in a position to know whether it is meeting the net capital requirements.[14] And we agree with the examiner that the various allegedly extenuating circumstances cited by respondents cannot excuse the shortcomings in registrant's records and indeed provide no explanation for the deficient state of those records at the time of the March 1969 inspection. We also concur with his observation that Reynaud aggravated the situation resulting from the inexperience of back-office personnel, by pursuing an aggressive program for expanding registrant's business when he should have restricted its activities to a pace consistent with the capacity of its personnel properly to maintain required books and records.

With respect to net capital, the examiner found that registrant had a deficiency of $140,967 as of March 31, 1969. While respondents argue that this finding is not fully supported by the record and that any "apparent deficiency" stems from a novel and unwarranted method of calculation, there is nothing in the record casting any doubt on the validity of the net capital calculation which was made by our staff investigator, or indicating that he departed in any way from accepted standards.[15] Respondents further claim that, largely as a result of a subordinated loan by Reynaud to registrant, any deficiency was more than overcome "in time to avoid serious consequences." In support of this argument they introduced a capital analysis as of April 30, 1969 prepared by an independent accountant who had audited registrant's books for some years. However, as the examiner found, the record does not establish whether or to what extent certain of the assets

[12] Respondents misconstrue the statement in our opinion on the issue of interim suspension to the effect that no willful violations of the record-keeping provisions were being found (Securities Exchange Act Release No. 8653, p. 5) as representing a finding that willful violations had not been established by the record. What we stated was merely that on the issue of interim suspension, it was not necessary to find that such willful violations had been established and that therefore we were making no such finding.

[13] See *Eugene N. Owens*, 42 S.E.C. 149 (1964); *Whitney & Company*, 41 S.E.C. 699, 703 (1963).

[14] *Palombi Securities Co., Inc.*, 41 S.E.C. 266, 276 (1962).

[15] It would appear that respondents' contentions in fact relate only to a net capital computation as of May 29, 1969, whose validity the examiner found it unnecessary to determine since it was as of a date not within the period encompassed by the orders for proceedings.

included by the accountant were properly includible in the computation of net capital so as to be curative of the deficiency. And in any event, a later rectification could not cure the prior substantial deficiency.

PUBLIC INTEREST

Respondents contend that it is not in the public interest, nor required for the protection of investors, to impose any further sanctions on them. They urge that lesser sanctions were imposed in other cases involving assertedly similar circumstances. Respondents state that registrant and Reynaud have been out of the securities business since registrant's registration was suspended in July 1969, and they point to Reynaud's testimony that, if afforded the opportunity to engage again in the securities business, he intends to institute specified procedures to avoid future violations. With reference to applicant, they argue that it is a new entity without a history of its own which should not be subjected to "guilt by association."

We have repeatedly held that the remedial action which is appropriate in the public interest depends upon the facts and circumstances of each particular case and cannot be precisely determined by comparison with action taken in other cases.[16] In reaching our conclusion here, we have considered all the factors adverted to by respondents, together with the fact that the violation in which Reynaud participated or for which he must bear responsibility were serious and occurred despite the prior injunctions against the same or similar types of conduct. Indeed, subsequent to the filing of the initial decision, registrant and Reynaud were charged with and pleaded guilty to criminal contempt of the June 1968 record-keeping and net capital injunction and the permanent injunction entered against them in that case in June 1969; registrant was fined $10,000 and Reynaud was sentenced to four months imprisonment.[17] And it should be noted that frantic efforts to bring records up to date and to remedy capital deficiencies after violations have been uncovered cannot be equated with a conscientious and constant program of compliance.

Respondents' attempt to have us treat applicant as distinct from Reynaud is without merit in light of the fact that the firm is clearly his *alter ego.*

[16] See *Melvyn Hiller,* 43 S.E.C. 969, 971 (1968), *aff'd* 429 F.2d 856 (C.A. 2, 1970).

[17] An appeal by registrant and Reynaud from an order denying their motion to withdraw their pleas of guilty and from the sentences imposed on them is pending (C.A. 2, No. 34940).

Finally, we note that applicant's registration application grossly mistated the amount on deposit in its bank account and the amount of its capital, and that the examiner considered Reynaud's explanation regarding the discrepancies not credible. This latest instance of misconduct indicates that despite the various enforcement action, Reynaud is still not impressed with the necessity for diligent compliance with applicable requirements.

Under all the circumstances, we adopt the examiner's conclusion that the public interest requires imposition of the maximum sanctions against respondents.[18]

Accordingly, IT IS ORDERED that the registration as a broker and dealer of Dunhill Securities Corporation be, and it hereby is, revoked; that it be, and it hereby is, expelled from membership in the National Association of Securities Dealers, Inc.; that the application for registration as a broker-dealer of Patrick R. Reynaud de Saint Oyant, Ltd. be, and it hereby is, denied; and that Patrick R. Reynaud be, and he hereby is, barred from association with any broker or dealer.

By the Commission (Commissioners OWENS, SMITH, NEEDHAM and HERLONG).

[18] The exceptions to the initial decision of the hearing examiner are overruled or sustained to the extent they are inconsistent or in accord with our decision.

In the Matters of

HAIGHT & COMPANY, INC. ET AL.*

File No. 3-533. Promulgated February 19, 1971

Securities Exchange Act of 1934—Section 15(b), 15A and 19(a)(3)

BROKER-DEALER PROCEEDINGS

Grounds for Remedial Action

Fraud in Offer and Sale of Securities

Sale of Unregistered Securities

Falsification of Records

Failure to Amend Applcation for Broker-Dealer Registration

Failure to Transmit Proceeds of Offering Promptly

*A. Dana Hodgon; James F. Haight; Burton Kitain; W. Lyles Carr, Jr.; David M. Adam, Jr.; James W. Harper III; Homer E. Davis; Robert F. Kibler; Louis S. Amann; Harvey A. Baskin.

Where registered broker-dealer and associated persons represented themselves to be financial planning experts who would choose the best securities for their clients but, contrary to such representation, substantially limited their recommendations to securities yielding respondents greatest profits, made false and misleading representations in sale of various securities, sold unregistered securities, and falsified certain of registrant's records; and where registrant failed to amend application for broker-dealer registration to disclose election of certain officers and directors, and, while acting as underwriter, failed to transmit promptly to issuer proceeds of sale of issuer's stock, *held*, willful violations of securities acts, and in public interest to revoke registration of broker-dealer, expel it from memberhip in national securities exchange and registered securities association, and bar associated persons who participated in such violations from association with any broker-dealer.

Practice and Procedure

Respondents' contentions that, among other things, discussion of certain of their activities in Commission's Special Study report evidenced prejudgment, that Commission improperly refused to make proceedings private, that Commission staff suppressed evidence favorable to their defense, that they were prejudiced because of sweeping nature of allegations against them, that institution of proceedings was unduly delayed, and that hearing examiner's initial decision did not comply with Administrative Procedure Act, *rejected.*

APPEARANCES:

Alexander J. Brown, Jr., William R. Schief, Paul F. Leonard, *Harold Webb*, *Wallace L. Timmeny*, and *Charles McCarthy, Jr.*, for the Division of Trading and Markets of the Commission.

Sidney Dickstein and *David I. Shapiro*, of Dickstein, Shapiro & Galligan, and *Harry Heller*, of Simpson Thacher & Bartlett, for Haight & Co., Inc., James F. Haight, W. Lyles Carr, Jr., David M. Adam, Jr., James W. Harper III, Burton Kitain, Homer E. Davis and Robert F. Kibler.

Harold P. Green, *Richard Schifter*, and *David E. Birenbaum*, of Strasser, Spiegelberg, Fried, Frank & Kampelman, for A. Dana Hodgdon.

Louis E. Shomette, Jr., of Shafer, Shomette & Stanhagen, for Louis S. Amann.

Robert B. Hirsch and *Allen G. Siegel*, of Arent, Fox, Kintner, Plotkin & Kahn, for Harvey A. Baskin.

FINDINGS AND OPINION OF THE COMMISSION

Following extensive hearings in these proceedings pursuant to Sections 15(b), 15A and 19(a)(3) of the Securities Exchange Act of 1934 ("Exchange Act"), the hearing examiner filed an initial decision in which he concluded, among other things, that Haight & Co., Inc. ("registrant"), a registered broker-dealer which operated under the name Hodgdon & Co., Inc. during the relevant period, should be suspended from membership on the Philadelphia-Baltimore-Washington Stock Exchange ("PBW") and in the National Association of Securities Dealers, Inc. ("NASD") for four months, and that A. Dana Hodgdon, who was president of registrant, James F. Haight, his successor as president, and David M. Adam, Jr. and James W. Harper III, vice-presidents, sould be barred from association with any broker or dealer. He further concluded that certain lesser sanctions should be imposed upon Louis S. Amann, who was a vice-president of registrant, W. Lyles Carr, Jr., treasurer, Burton Kitain, secretary, Harvey A. Baskin, who was Hodgdon's assistant, and Homer E. Davis and Robert F. Kibler salesmen. We granted petitions for review filed by respondents and our Division of Trading and Markets ("Division") as to certain issues, and, pursuant to Rule 17(c) of our Rules of Practice, ordered review of the examiner's decision with respect to all other issues which were before him concerning respondents.[1] Respondents and the Division filed briefs

[1] Thus, contrary to respondents' contention, the Division was free to object to findings and conclusions in the initial decision although not excepted to in its petition for review.

and we heard oral argument. Our findings are based upon an independent review of the record.

Fraud in Securities Transactions

1. Scheme to Defraud "Financial Planning" Clients

Between May 1960 and June 1964, registrant, together with or willfully aided and abetted by Hodgdon, Haight, Carr, Adam, Harper, Kitain, Davis and Kibler, engaged in a scheme to defraud customers who utilized registrant's financial planning services in the purchase and sale of securities, in willful violation of Section 17(a) of the Securities Act of 1933 and Sections 10(b) and 15(c)(1) of the Exchange Act and Rules 10b–5 and 15c1–2 thereunder. The record shows that the gist of the scheme was respondents' holding themselves out as financial planners who would exercise their talents to make the best choices for their clients from all available securities, when in fact their efforts were directed at liquidating clients' portfolios and utilizing the proceeds and their clients' other assets to purchase securities which would yield respondents the greatest profits, in some instances in complete disregard of their clients' stated investment objectives. This scheme was implemented by, among other things, registrant's advertising and by its training course for salesmen.

a. Advertising and Sales Training and Instructions

During the period in question, frequent advertisements extolling the virtues of registrant's financial planning services and obviously designed to attract unsophisticated investors were broadcast over a local radio station. Representative advertisements, prepared by public relations counsel with Hodgdon's assistance, were:

> "We would like to issue a special invitation to *new investors* . . . [W]hen you talk with a Hodgdon & Company representative about investments, your eyes will really be opened to a fascinating field of financial opportunities—for long range gain, immediate gain—whatever best suits your individual needs."
>
> "[Y]ou'll be welcomed by a counsellor who is an expert in financial planning in the field of securities . . . a man to . . . trust implicitly."
>
> "Hodgdon and Company has . . . a research staff that has thoroughly and competently analyzed the probable course of the market."
>
> "With proper strategy . . . you [can be guided] to a life of financial security."
>
> "Trained investment analysts are on hand to go over your present portfolio and make worthwhile suggestions."
>
> "Registered representatives at Hodgdon are always alert for new opportunities for investment, while never foretting long-established stocks, bonds, mutual funds ad the like. In short, a balance is maintained between the new and the tried-and-true."
>
> "Call in an investment expert, one of the many informed specialists at Hodgdon and Company."
>
> "It is entirely probable that [the next twelve months] could bring

> prosperity . . . if you take the counsel that is available to you—free of charge." [2]

In fact, registrant had no research staff, and its "expert counsellors in financial planning" included inexperienced salesmen who, after about a year's employment at registrant, were allowed to formulate financial plans for clients without supervision. Haight admitted that registrant's so-called "Specialists" in various fields had "something less than expert or professional knowledge," [3] and, as discussed below, registrant largely ignored "long-established" stocks and bonds.

Registrant conducted its training course for new salesmen largely through Haight who, as a vice-president and later executive vice-president, was in charge of training and sales. Salesmen were instructed to tell prospects about registrant's "unique" financial planning service under which securities would be purchased in proportions designed to meet the clients' objectives, with about 50 percent of their funds being placed in mutual fund shares, 30 percent in a middle category lumping "blue chips" and real estate securities, and 20 percent in speculations and/or "special situations." [4]

Despite registrant's emphasis on the availability of all types of securities and the respresentation that high-grade securities or "blue-chips" would be included in the middle category of clients' investments, recommendations of listed securities were infrequent. Instead, registrant stressed securities on which it and the salesmen could make more money, i.e., mutual fund shares and underwritten offerings on which high commissions are charged, and unlisted securities, particularly those in registrant's inventory, that could be sold at a markup.[5] Registrant's policy was reflected in a January 1961 memorandum from Haight and Carr, who was then senior vice-president,

[2] Registrant's radio advertising also suggested that listeners request a copy of its brochure, "Action Makes the Difference," which was written by Hodgdon and used by the firm's sales staff in soliciting new clients. The brochure stated, among other things, that "the 'haves' hold wealth in the form of stocks, real estate and oil, the 'have-nots' . . . in the form of insurance savings, Government Bonds, and deposits in lending institutions," and that financial counselling could help the "have-nots" become "haves" and "provide [the best] financial blueprint for the future."

[3] Several salesmen testified that they did not find the "specialists" who were supposed to assist them in their dealings with clients to be particularly knowledgeable or helpful, and stopped using them.

[4] "Special situations" referred to companies assertedly having a special potential for growth such as a patent or a new process. Carr and Kitain both testified that a "special situation" involved high risk.

[5] Hodgdon testified that registrant's salesmen had only minor activity in listed securities because they were "not attuned to trading back and forth in this type of thing." Carr instructed salesmen to tell prospective clients that registrant handled stocks on "all the Exchanges," but stated to the salesmen that he very seldom recommended blue chip or listed stocks since investors "became discouraged and didn't understand" if the stocks failed to appreciate in value. He told the salesmen that "professionals" (apparently referring to mutual funds) could pick a blue chip stock better than they, and that in recommending securities they should consider the commission to be earned.

secretary and a substantial stockholder, to the other officers of the firm. It recommended that the salesmen be told occasionally what "blue chip" securities investment companies were buying and selling or registrant was recommending so that in "initial" conversations with prospects the salesmen could "discuss" them and thereby show that the firm did not deal in only "high commission situations," but stated that a great deal of listed securities would probably not be sold because of low commissions and greater emphasis on other situations. The lumping of real estate securities, a high percentage of which were underwritten by registrant, with blue chips was, as the examiner found, improper and designed to encourage the inference that such securities were of the same high quality as blue chips.

Various requirements and inducements were created by registrant to make salesmen produce a volume of transactions that would earn a high return. Salesmen were instructed to try to obtain clients who would follow the investment programs suggested by registrant, and were told to make at least 40 telephone calls daily to develop new clients, using lists of names obtained from telephone directories or elsewhere, and to conduct at least two interviews a day. Each salesman who had been with the firm for a year or longer was required either to sell $18,000 in mutual fund shares or the equivalent each month, or five mutual fund contractual plans in each two-month period, or to earn commissions netting him $600 per month from sales of securities designated as "high quality" by registrant, which included most of registrant's underwritings and securities in its inventory.[6] Failure to meet these quotas was ground for and did occasion dismissal. Salesmen were issued lists of "preferred" mutual funds, all of which gave registrant reciprocal business, and registrant paid bonuses semi-annually for sales of $30,000 or more of the shares of those funds. The fund which was most stressed, and most recommended and sold, was Aberdeen Fund of whose distributor Hodgdon was a director and stockholder until sometime in 1963.[7] When registrant engaged in an underwriting, salesmen were asked to indicate the amount of the issue they thought they could sell, and pressure was applied if they failed to

[6] The salesmen's compensation from registrant was based solely on their sales.

[7] The Aberdeen Fund shares were sold either on a contractual plan with a front-end load, or on a lump sum basis.

dispose of the indicated quantity.[8] At weekly staff meetings, salesmen were given a list of securities in inventory, the number of shares registrant wished the salesmen to sell, and the commissions for selling them. If the firm's position in a security became larger than desirable, the sales commission was increased.

Registrant's sales staff was taught by Haight, Carr, Hodgdon and others to utilize a variety of high pressure and fraudulent tactics to obtain financial planning clients and then induce them to convert their assets, including their portfolios, into securities yielding respondents high profits. For example, Haight told salesmen to appeal to the prospect's fears[9] and greed, to give clients only such facts as were necessary to support a sales presentation, and to dominate the interview, dramatize the facts, appeal to the client's sense of prestige,[10] create a sense of urgency, and attempt to make each sale worth more. Another instructor taught the salesmen always to assume a sale when attempting to make one, and to use the "physical action close" in selling mutual funds, which meant to start filling out the application form in front of the client before he had expressed a willingness to buy.

Carr suggested to the salesmen various reasons that could be given to clients to induce them to sell their portfolio securities so as to free funds or investment in securities recommended by registrant. He told salesmen to recommend securities in an area where registrant had something to sell, or try to sell the client whatever was "easiest ." He taught that, in selling, emotion was more important than logic, and that, "An ounce of enthusiasm at the proper time is worth a pound of knowledge." [11] He suggested that if a customer wanted to read a prospectus the salesman should make him buy first by stating that the order could be cancelled later, since once a person owned a stock he read the prospectus differently. However, if the customer later did decide to cancel, Carr told

[8] Hodgdon had a proprietary interest in several of registrant's underwritings. He told one salesman, who did not want to sell one of such underwritings because he considered it "an extremely high risk," that his cooperation on the underwriting was "vital to the interests of the firm" and that he was expected to do his part.

[9] Among other things, salesmen were told to stress the impact of inflation on savings and to dramatize the need for higher returns by citing "statistics" such as "54 men out of every 100 are living on friends, relatives and charity" and "50 percent of all Connecticut doctors who died in the last 10 years died bankrupt."

[10] One of registrant's instructors suggested that, in the sale of a gas and oil security, clients be told that they were being offered the opportunity of associating with the extremely wealthy in offsetting income and reducing tax obligations.

[11] Carr told the salesmen they should "hit [the] 'hot button' ", which he defined as stressing the objective "dearest to [a client's] heart."

the salesman to say, "What cancel! You should have doubled your order."

Another asset of customers stressed in salesmen's training as a source of money for securities purchases was the life insurance policy. The salesmen were instructed by registrant's insurance "specialist," with whom they were required to consult before recommending to clients any changes in their insurance holdings, to "Get [the client's] cash first, then go after insurance, our only purpose in discussing insurance is to free more monies." This instruction stands in stark contrast to the statement in registrant's financial planning brochure that the firm's "insurance counselling service" was "the most important opportunity we can offer the average person who has only seen his protection program from the point of view of the life insurance salesman who sold it to him." In connection with one of registrant's underwritings, Carr told the sales staff to "find the easiest money first, such as savings and loan money [and the] cash value of life insurance policies."

b. Transactions with Clients

We now discuss the manner in which registrant's salesmen, as well as officers, applied the fraudulent techniques described above in their dealings with financial planning clients.

Adam

Adam, who joined registrant as a salesman in 1960, became a "group manager" in 1962, supervising about five salesmen, and in 1963 was appointed an assistant vice-president.

Dr. G, an anaesthesiologist, became a financial planning client of Adam in August 1960. At that time she owned listed securities worth about $30,000 and had a life insurance annuity purchased for $40,000 and $7,000 in cash. In December 1960, at Adam's request, Dr. G gave him discretionary authority over her account, because, according to Adam, she had a "complete lack of knowledge of investments and Financial Planning." At his suggestion, she deposited all dividend checks in her account with registrant for reinvestment as Adam saw fit.

In January 1963 and March 1964, Adam sent to Dr. G analyses of her account under his stewardship. The 1963 report showed a net loss of about $200 on purchases effected up to that time which was attributed to a severe market decline in 1962, but congratulated Dr. G on the overall performance to date. It concluded, "as we continue to work together over the years, we are planning to double the amount of invested capital." The 1964 report showed there had been a profit of about $7,000;[12] and, in an accompanying letter, Adam wrote, "During the next 5–10 years your net worth could easily amount to $120,000 minimum rather than the present $75,000. Let's keep it up." However, neither report took into account or mentioned Dr. G's total loss in 1962 of her $11,000 investment in a speculative security purchased at Adam's suggestion.

During the relevant period, Adam caused Dr. G to sell her entire portfolio of listed securities and cash in her annuity, and to purchase securities with the proceeds. Her total purchases consisted of about $30,000 in Aberdeen and another mutual fund, $12,500 in highly speculative gas and oil programs, and about $50,000 in other securities,[13] almost all of which were new issues that registrant was underwriting or for which it was acting as a member of the selling group, and stocks which registrant sold as principal at a markup.

Capt. S had a portfolio of individual securities valued at $45,567, in addition to shares in two mutual funds, when he became a financial planning client of Adam in 1960. Acting entirely on Adam's advice, Capt. S sold all but about $1,600 worth of his original portfolio aside from the mutual fund shares to buy other securities recommended by Adam, cashed in two life insurance policies to buy into one of registrant's real estate syndications, and obtained three bank loans totaling $12,400 to finance other securities purchases. Of a total of around $71,000 in securities purchased on Adam's recommendations, $61,000 represented securities sold by registrant as underwriter or principal.[14] In September 1962, Adam sent Capt. S a progress report which showed losses in every category of investment except in the two mutual funds in his original portfolio. Adam nevertheless wrote, "You must be complimented on your successful accumulation of wealth over the years. This success places you within the top 4% of all individuals in the country!"

Harper

Harper joined registrant as a salesman about the end of

[12] In a note, the report stated that the client's purchases of gas and oil programs for $7,000 in 1963 and 1964 were not reflected, but no indication was given of the value of those securities.

[13] These figures represent total purchases, including purchases paid for with proceeds of the sale of other securities purchased during the period. This is also the case with respect to the purchases in a number of other customer accounts described below.

[14] In November 1961, Capt. S purchased additional shares of a speculative security, which he had previously purchased at Adam's suggestion at a higher price, on Adam's recommendation that he should average down his cost per share, Adam representing that he had received word that the stock "was still a good buy." On the same day, however, Adam had advised Dr. G to sell the same security, in part because of adverse information he had received concerning the company.

1960. In about 1962, he was designated a "specialist" in the gas and oil programs offered by registrant to investors and he lectured to trainees in that area. He was appointed an assistant vice-president of registrant in 1963.

In about April 1961, Mrs. D, a divorcee with a dependent son, became a financial planning client of Harper. At that time she had a portfolio of high grade securities worth about $200,000 which she had acquired through inheritance and gifts. Her yearly income consisted of about $7,500 from her securities, and $2,400 in alimony which she told Harper she was fearful of losing and which she needed "to sustain herself." She also told Harper that she would like to increase the income from her portfolio but that any changes were to be into safeand well-seasoned stocks. As Harper was aware, Mrs. D was a wholly unsophisticated investor. He told her that registrant specialized in "estate planning," and that she need not be concerned about stocks and bonds since she would have "expert advice." In August 1961, at a time when Mrs. D had already followed Harper's recommendations in selling about $25,000 worth of her portfolio and purchasing about the same amount of securities with the proceeds, Harper suggested a plan which involved the sale of a large additional portion of her portfolio. He told her that the securities to be sold had low yields and were overpriced and that she should move into "less risky" investments. Mrs. D agreed to the plan with with Harper's assurance that his suggested changes made her position more secure.[15] Mrs. D was forced to use proceeds from the sale of securities to pay the capital gains tax with respect to the portfolio securities she sold in 1961. The written financial plan which Harper submitted to her in October of that year placed in the "high grade" investment category registrant's unseasoned real estate syndications which Harper had sold her.

At the end of September 1962, Mrs. D wrote to Harper that her primary reason for making such drastic changes in her portfolio had been additional income, and yet her 1962 income to date, $5,194, had been only $168 more than for the comparable period in 1961. Harper replied that she was much "better off" than $168 and that he still stood by "our projection of $15,000 to $18,000 income by 1964."

[15] Harper wrote to Mrs. D that if she were willing to take risks, he could assure her of $1 million but "we are now keeping you comfortable and moving you towards the $500,000—$750,000 level . . . You are 50 percent better off today than you were [six days earlier] . . . G.M. and Merck could now collapse and you would not be hurt."

During the relevant period, Mrs. D, upon Harper's recommendation, sold more than $122,000 worth of securities from her original portfolio. On his advice she effected purchases of $20,000 in Aberdeen, $2,200 in another mutual fund, about $14,600 in a highly speculative gas and oil program, and about $87,000 in other securities, more than $82,000 of which registrant sold as under writer, selling group member or principal. Of the latter amount, about $69,000 was placed in new issues which registrant was underwriting or for which it was acting as selling group member, notwithstanding her pleas for well-seasoned and safe investments.

Harper told Mrs. M, an inexperienced investor whose goal was retirement income, that she should consider him like a doctor who would be able to diagnose her financial potential. She testified that she relied on Harper and usually followed his recommendations. Although Mrs. M stressed her desire for liquidity, Harper recommended and sold to her limited partnership interests in various real estate syndications which registrant was underwriting, assuring her that, in the event of an emergency, she could get her money out in a relatively short time. However, registrant only maintained "work-out" markets for such securities in which an investor could not dispose of them unless there were a buyer available. When some of the syndications ran into difficulties, registrant was unable to find buyers for all those who wished to sell. After the distributions were reduced on two of the syndications purchased by Mrs. M, she expressed a desire to dispose of them but Harper dissuaded her from attempting to do so. He called her several times before persuading her to buy another security which was highly speculative and about which Mrs. M felt "very insecure," representing to her that she could probably double her money in two or three years. Mr. M's total purchases through Harper amounted to about $27,700. Mutual fund shares accounted for about $2,500 of this amount, and new issues which registrant was underwriting and securities sold by registrant as principal accounted for nearly all of the remainder.

In progress reports to another client, Dr. B, Harper placed Dr. B's investments in registrant's real estate syndications in the "high grade" category along with the client's mutual fund holdings, and in one such report placed a gas and oil program which he had sold Dr. B into that category. On Harper's recommendations, Dr. B sold securities initially held by him for about $19,000, and thereafter effected purchases of about

$26,000 in gas and oil programs, $11,000 in mutual funds and $73,000 in other securities, of which latter amount about $50,000 represented securities underwritten by registrant or sold as principal.

Kitain

Kitain joined a registrant in 1959. In the following year he was appointed manager of a new suburban branch office, and in 1963 became an assistant vice-president.

Mrs. Y became a financial planning client of Kitain early in 1961. At that time she had a diversified portfolio of high grade stocks and bonds valued at between $90,000 and $100,000, the management of which until then had been entrusted to relatives who paid her a quarterly allowance from the dividends and reinvested the remainder. She felt that her portfolio was not being given enough attention, and wanted "closer consultation" with a knowledgeable adviser since she herself was "ill informed" as to investments. Kitain told her that many of her stocks were of doubtful quality, that her portfolio was too conservatively invested for someone who was not dependent on the income, and that she should sell the bulk of it and divide $50,000 of the proceeds equally between Aberdeen and another mutual fund which were more growth oriented. In partial fulfillment of Kitain's plan, Mrs. Y sold more than $30,000 of her portfolio and invested $30,000 in the two mutual funds. She was not told that the mutual fund purchases entailed commission costs substantially higher than those charged on the purchase of listed securities, nor was she advised of the large tax liability on the profits she would realize from the sale of her portfolio stocks.

Mr. R was a foreign service officer, married and with three small children. He had an annual salary of $10,000, a mortgaged home, $4,500 in cash and Government bonds, and small holdings of three listed securities. He told Kitain that his objectives were to provide for the college education of his children and to supplement his retirement income. Although Mr. R had been successful with one speculation and was interested in similar opportunities, he told Kitain that "generally speaking" he wished to continue buying safe growth stocks like those he already held. However, Kitain discouraged Mr. R from purchasing listed securities, recommending instead that he buy Aberdeen and another mutual fund. He also told Mr. R that he could afford to speculate, and that it would be possible to convert his life insurance policies to lower-cost insurance which would give the necessary protection and still free capital to invest in speculative situations. Mr. R converted certain insurance policies and borrowed on others, investing at least part of the proceeds in securities, including two of a speculative nature recommended by Kitain. He also on Kitain's advice made bank borrowings to effect securities purchases.

Mrs. A, another financial planning client of Kitain with a very limited knowledge of securities, had prior to purchasing $15,000 worth of Aberdeen Fund shares pursuant to his recommendation complained that withdrawal of that amount from her savings and loan account would mean a yearly loss of about $600 in interest. Kitain advised that she could make quarterly withdrawals of $125 from her Aberdeen shares which would be covered by the fund's dividends. In fact, those dividends only partially covered the withdrawals and when Mrs. A discovered, after three withdrawals, that she was consuming principal, she stopped the withdrawals. As of the date of her last withdrawal, the price per share was slightly lower than it had been at the time of her purchase. Kitain recommended and sold one speculative stock to Mrs. A on the representation that it was a better investment than the stock of another company in the same industry that had had a rapid rise in value. When the market price of the stock dropped she asked Kitain what was wrong and he replied, according to his testimony, that his firm was "not concerned" and a number of clients who had not had an opportunity to purchase the security could now purchase it at the lower price. Of the $34,500 worth of securities in addition to Aberdeen that Mrs. A purchased through Kitain, all but about $6,000 represented new issues sold by registrant as underwriter or selling group member and securities which it sold as principal.

Davis

Davis joined registrant as a salesman in 1957. Mr. and Mrs. M, who were inexperienced investors with investment objectives of long-term growth with a view to future financial independence, became financial planning clients of Davis early in 1960. Davis explained the concept of financial planning to them and told them that they "would have to have complete confidence in him [and] confide in him totally," and that with his expert help and that of registrant's staff of experts, the proper type of investments would be made for them. He recommended mutual funds and also told the M's they could afford to buy speculative issues, stating that he did not know of anyone who ever got rich on blue chips because such stocks just varied a few points, and that the speculative securities he recommended would be "the blue chips of tomorrow."

In recommendng investments to the M's, Davis represented that they would make great profits, generally within a specified time. He stated, for example, that one speculative security would double in value in about two years and that another security being issued at $4 would rise 1 to 3 points. As a rule, the M's did not receive a prospectus on new issues which they purchased until they got their confirmations, and relied on Davis' representations. On one occasion, however, Mr. M insisted on seeing a prospectus before purchasing a speculative issue Davis was recommending. Davis reluctantly agreed, stating "I will send it, but don't pay attention to it. It will not reflect what the situation truly is." When Mr. M read the prospectus and told Davis that the stock looked "dreadful," Davis replied that he should ignore the prospectus, that prospectuses always painted a very bleak picture and that if people based their investment decisions on them "no one would ever put a cent into anything."

Davis and registrant's insurance "specialist" also advised the M's to cash in their life insurance and purchase lower-cost term insurance, telling them that they would be notified when, with proper investments, they had become self-insured, at which point they could cancel their term insurance as well. The M's followed the advice, purchasing term insurance through registrant's specialist, and investing the proceeds obtained by surrendering their original policies in securities which Davis recommended. Again acting on Davis' advice, they borrowed $5,200 for investment in two of registrant's real estate syndications and abandoned their original intention of purchasing a farm, Davis telling them that they were better off investing in things that "would be making [them] money." Apart from two purchases of listed securities initiated by the M's, virtually all of their total securities purchases of $22,574 effected upon Davis' recommendation represented mutual funds, new issues underwritten by registrant, and securities which registrant sold as principal.

Davis had discretionary authority with respect to the financial planning account of Cdr. C, a naval aviator stationed overseas. Consistent with respondents' scheme, of total purchases of $14,981 in that account, $13,256 represented new issues of which registrant was the underwriter and secuities which it sold as principal.

Kibler

Kibler joined registrant as a salesman in 1960. Mrs. S, an
elderly widow with a portfolio consisting largely of listed
securities having a value of about $50,000, became his client in
1962. Her stated objectives were greater income and safety,
which, according to Kibler and as he advised her, were to be
achieved by raising portfolio quality through elimination o
weaker issues, increasing the efficiency of management b
reducing the number of securities held, and placing the proceeds of sales in "high quality, diversified, and professionall
managed investments." Acting on Kibler's advice, Mrs. S sol
more than half of her portfolio and invested about $12,500 i
mutual fund shares and $19,500 in other securities, of which a
but one small purchase were new issue which registrant wa
underwriting and securities which it sold as principal.

Dr. J, a federally-employed veterinarian, had a portfoli
consisting of $7,000 invested in Government bonds and abou
$18,000 in high-grade securities. The financial plan whic
Kibler prepared for him specified a minimum financial goal
$87,000 to be accumulated by age 65, and safety as one obje
tive. It recommended, among other things, that the Gover
ment bonds be sold, and that Dr. J's life insurance policies
converted to decreasing term insurance "to increase dea
protection coverage during period of growth of investme
program." Among other things, Kibler told Dr. J that reg
trant's real estate syndications which he recommended wou
be "easily marketable," and that this Commission requir
that prospectuses "not be particularly glowing" and "pl
down the future or well being" of the company whose secu
ties were being offered. Dr. J sold his Government bonds a
other securities and reinvested the proceeds pursuant to K
ler's recommendations. During the relevant period, apart fr
the replacement of a few of the listed securities in his portfo
with other listed securities, Dr. J invested about $25,500
mutual fund shares, new issues which registrant was und
writing, and stocks which registrant sold as principal.

Hodgdon

Mrs. W, who lacked investment experience, owned securi
in a custodial account managed by a bank. She told Hodg
that she was dissatisfied with the income from that acco
and, at his suggestion, transferred a substantial amoun
municipal bonds from the bank to her account with regist
so that Hodgdon could sell them and reinvest the proce

During the relevant period, Mrs. W, acting on Hodgdon's recommendation, sold about $33,000 worth of municipal bonds and purchased $35,000 worth of other securities, of which $30,000 was invested in two speculative new stock issues that registrant was underwriting, and the remainder in stocks which registrant sold as principal. The yield on the securities purchased at Hodgdon's recommendation was "a good deal less" than she had been receving before transferring the bonds from her custodial account.

Haight

Miss T, an elderly woman with a high-grade diversified securities portfolio worth about $62,000, became a financial planning client of Haight in 1960. She told him she wanted increased income for her impending retirement. The financial plan which Haight prepared recommended, among other things, that 50 percent of Miss T's investment capital be placed in Aberdeen and another fund, 35 percent in individual securities and real estate "all having outstanding quality characteristics," [16] and 15 percent in "special situations and/or intelligent speculations." He told Miss T that "investment companies were safer than having everything in stocks." Miss T sold about $28,000 worth of securities from her original portfolio. She purchased shares of Aberdeen and another mutual fund totaling $17,000, and other securities totaling $55,500, of which all but about $700 represented new issues being underwritten by registrant and securities sold by registrant as principal.

Miss B, also an elderly woman, witha portfolio of high-grade securities worth $120,500, sold mainly on Haight's advice over $52,000 worth of that portfolio. On his recommendation, she purchased shares of Aberdeen and another mutual fund totaling $20,000, and other securities totaling about $54,000, over $48,000 of which represented new issues which registrant was underwriting and securities which registrant sold as principal.

Carr

In 1961, Col. F, who was stationed overseas and had limited means, gave Carr discretionary authority over his financial planning account. All of the 10 stocks in his portfolio were sold for about $7,800 and replaced with securities selected by Carr which, except for one minor purchase, consisted of Aberdeen

[16] In his testimony, Haight attempted to make a distinction between the "real estate" referred to in the financial plan and the limited partnership interests in registrant's real estate syndications which he sold to Miss T, and took the position that his characterization of "outstanding quality characteristics" applied to the real estate, not to the security interests in such real estate. We find this distinction unacceptable.

shares and five new issues registrant was underwriting. Although all the securities purchased declined in value, Carr in 1962 advised their retention and suggested additional securities purchases before the market rose again. In 1963, after a further decline, Carr stated that the outlook for those securities was still hopeful and that he did not recommend any change. He also suggested that the client borrow on his life insurance to make an investment in a real estate syndication, but this advice was not followed. On Carr's recommendations to another client, Gen. A, certain stocks in his portfolio were sold, and he invested $2,500 in Aberdeen, and more than $33,000 in other securities consisting of new issues underwritten by registrant and stocks which it sold as principal.

Other Salesmen

Testimony was received with respect to two other financial planning accounts serviced by non-respondent salesmen which exhibited characteristics similar to those already described. In both accounts the customers were induced, by representations that they would fare much better, to sell securities they owned, worth about $40,000 and $19,000, respectively, and in one instance including mutual fund shares, and to buy other mutual fund shares and securities being underwritten or sold as principal by registrant.

c. Conclusions

It is abundantly clear from this record that under the guise of comprehensive "financial planning" encompassing the purchase of varied securities, including listed securities, the above respondents induced customers, who were generally inexperienced and unsophisiticated, to believe that their best interests would be served by following the investment program designed for them by respondents. In fact, such programs were designed to sell securities that would provide the greatest gain to respondents, rather than to promote the customers' interests; indeed, in some instances, the recommendations were directly contrary to the customers' expressed investment needs and objectives. Moreover, various representations were made to clients to lull them into a feeling of security or to believe that their complaints were unjustified, and thereby sustain their confidence for further recommendations. Such conduct was clearly contrary to the basic obligation of professionals in the securities business to deal fairly with the investing public.[17]

Respondents contend that they did not engage in a scheme to defraud since the evidence does not establish any "agreement" to defraud clients, but, at most, non-fraudulent parallel action. Hodgdon in addition contends that mutual fund sales, which were required by registrant's financial planning approach, may not be treated as "self-enriching" recommendations for purposes of determining whether a scheme to defraud existed, and he and other respondents argue that it is not possible to derive any pattern or draw any inferences from the "handful of cases" considered by the examiner.

There is no merit in these contentions. No express "agreement" is necessary to establish the existence of a scheme to defraud. It is enough that each of the individual respondents knowingly joined or participated in a common undertaking that he knew or should have known was fraudulent.[18] As we have seen, registrant conducted training programs and staff meetings where instruction was given in the sales techniques which we have described and which were used by respondents to obtain clients and induce them to purchase certain types of securities. Since, as we have concluded, these sales techniques were designed and operated to defraud clients, it is clear that registrant and the individual respondents engaged in a scheme to defraud investors. The fact that mutual fund share may be considered a desirable investment does not militate against our conclusion that such shares, as well as other securities, were recommended to clients for the primary purpose of obtaining greater compensation for respondents, which was the gist of the scheme we have found. Nor is the finding of a scheme to defraud precluded because of the absence of evidence as to respondents' transactions with clients who were not called as witnesses, with respect to which transactions respondents assert they were misled into not adducing evidence. Such evidence would not have derogated from the pattern of conduct that was established not merely by the

[17] See *Mac Robbins & Co., Inc.*, 41 S.E.C. 116, 117–19 (1962), *aff'd sub nom. Berko* v. *S.E.C.*, 316 F.2d 137 (C.A. 2, 1963); *J. Logan & Co.*, 41 S.E.C. 88, 98 (1962). See also *Richard N. Cea*, 44 S.E.C. 8, 18, (1969): "Although the customers described their financial situations and objectives to these respondent salesmen, the salesmen recommended purchases of securities that were far from commensurate with the investment objectives disclosed by such customers. It was incumbent on the salesmen in these cirumcstances, as part of their basic obligation to deal fairly with the investing public, to make only such recommendations as they had reasonable grounds to believe met the customers' expressed needs and objectives."

[18] See *Blue* v. *U.S.*, 138 F.2d 351, 358, 360 (C.A. 6, 1943), *cert. denied* 322 U.S. 736; *Oliver* v. *U.S.*, 121 F.2d 245, 249 (C.A. 10, 1941), *cert. denied* 314 U.S. 66.

testimony of the clients who were called as witnesses by the staff, but also by registrant's entire method of operation including its training program. We do not hold that the "cold calls" to prospects and the obtaining of financial information from them were fraudulent *per se*, and do not interpret the examiner as so holding, as respondents contend he did, but that these were merely elements in the overall fraudulent scheme.

Hodgdon's assertion that there is "a paucity of evidence" implicating him in the fraudulent scheme is particularly untenable. He was in active charge of registrant's business, held weekly officers' meetings at which every aspect of running the firm was discussed, and instituted the "financial planning" program. He assisted in preparing the firm's fraudulent radio advertising, wrote its financial planning brochure, a blatant "come-on" for the unsophisticated investor, and participated in registrant's training program. He attended the firm's staff meetings at which particular securities were recommended to the salesmen for sale to clients and the firm's underwritings, which he selected, were described to the salesmen and their indications of interest taken. Although the radio advertising stated that registrant, while alert for new opportunities, never forgot "long-established stocks," and registrant's ratio system placed blue chips in the middle category of the financial plans drawn up for its clients, he fostered a negative attitude towards recommendations of listed securities. Finally, he treated Mrs. W's financial planning account in the same manner as registrant's salesmen were trained to deal with their clients' accounts, causing her to sell high-grade securities from her portfolio and reinvest the bulk of the proceeds in new and speculative issues that registrant was underwriting. We think it evident that Hodgdon was not only fully cognizant of but directed the fraudulent scheme we have found here.

Finally, respondents contend that the hearing examiner applied improper standards in determining that their securities recommendations to clients were unsuitable. This contention reflects a misapprehension of the examiner's decision. Neither the examiner's conclusions, nor our own, as is evident from the foregoing discussion, rest on a determination that the securities recommended and sold were "unsuitable."

We discuss now materially false and misleading statements made by various respondents in the offer and sale of particular securities.

2. Fraudulent Representations in Sale of Securities

a. Van-Pak, Inc.

Van-Pak, Inc. was organized in 1959 to operate as a freight forwarder of individuals' household goods by the so-called "containerization" method, primarily to and from overseas military installations. In February 1962, pursuant to a registration statement filed under the Securities Act, the company commenced a public offering of 80,000 shares of its common stock at $5 per share through registrant as underwriter. The State of Virginia refused to allow the issue to be sold there because it found Van-Pak to be insolvent, and Hodgdon so advised registrant's other officers and the salesmen. Registrant had difficulty in disposing of the shares and the offering was not completed until mid-April 1962.

In the offer and sale of Van-Pak stock, Hodgdon represented to a financial planning client that Van-Pak had developed a new type of container, that it had or expected to get government contracts and should therefore grow rapidly, that it expected to start paying dividends, and that the client would realize a good profit in a short time. Haight told one customer that "when" the price of Van-Pak doubled, she could sell half of her stock and regain her original investment, and represented to another that Van-Pak had defense contracts and should have a bright future. He did not disclose to the latter customer, a Virginia resident, that Van-Pak stock was disqualified from sale in that state because of Virginia's finding of insolvency.

Carr told a customer, in February 1962, that Van-Pak had developed a new type of shipping container for which there was a great demand, and that he felt certain that the stock would appreciate considerably and would "double or better" in six months. The customer asked for a prospectus but Carr told him that it was "fairly urgent" that he make up his mind at once since there was only a very limited number of shares left. The customer then purchased 100 shares.[19] Carr told another customer, a Virginia resident, that Van-Pak was "one of the most promising issues that had come to his attention" and that "it couldn't miss." He did not disclose that Van-Pak could not be sold in Virginia on the ground of insolvency.

[19] When the customer received the prospectus, he called Carr and told him he was upset by the financial condition of the company and the fact that the prospectus said nothing about Van-Pak manufacturing containers. Carr replied that he could cancel if he wished, but that it was Carr's judgment that Van-Pak was going to "come out of the red" and do well in the manufacture and sale of its container.

Davis stated to one customer that Van-Pak had a new process of storage or moving and expected to get substantial Government contracts that would materially increase the value of its stock, and that it was a "real hot issue" and would be a "terrific" and sound investment that was likely to appreciate 2 or 3 or 4 times in a very short period. He told a second customer of Van-Pak's "revolutionary" moving process and that it expected Government contracts, and another, that Van-Pak had a virtual monopoly on transporting the effects of military people to and from overseas installations. Kibler represented to two customers that Van-Pak had Government contracts for the transportation of household goods in a new type of container developed by it. He told one that the stock was an "excellent buy," and in all probability would increase in price a point or two by late fall and rather rapidly within a year or two. He did not disclose to the other, a Virginia resident, that the stock could not be sold in Virginia on the ground of the company's insolvency. Harper told one financial planning client that Van-Pak had a new system of transportation and that she might be able to sell the stock later at a much higher price, and another that Van-Pak was very progressive with new methods of moving, and looked like it had a very good future. Kitain represented to one customer that the president of Van-Pak had stated there were possibilities of getting a Defense Department contract, and to a second, that Van-Pak stock "had very fine prospects of doubling itself" in about 6 to 9 months.

Respondents' representations were entirely at variance with the picture given in the Van-Pak prospectus. That document stated that the containerization method of shipment was not new in the industry and had not been originated by Van-Pak, that the Military Traffic Management Agency had approved the company's tender of service which, however, merely authorized Van-Pak to compete for business at various military installations, that the company was in competition not only with vanline movers, many of which had larger financial resources, but also with the Military Sea Transport Service, an instrumentality of the Government, and that Van-Pak had never paid any dividends nor did it presently intend to do so. The prospectus did not refer to the manufacturing of containers for sale. It merely stated that Van-Pak had leased some of its containers to industry, which operation had not accounted for a significant percentage of total revenue, and that the company had plans to pursue this business further.

Finally, the prospectus revealed that Van-Pak was insolvent by an amount exceeding $100,000. Van-Pak's president testified that his company had no contracts with the Defense Department or any other Government agency and that he never told any representative of registrant that it had or anticipated getting any, and that approval of Van-Pak's tender of service did not guarantee it any income.

Respondents are not aided by their assertion that they were justified in expressing optimism concerning Van-Pak because of its improved business for the five months ending February 1962, the lifting of certain travel restrictions on military dependents by the Government, and a number of favorable factors occurring after the prospectus was written. Such factors could not justify the outright falsehoods and the extravagant predictions which they made, particularly in view of Van-Pak's insolvency. Moreover, we have repeatedly held that price predictions of the kind made here are inherently fraudulent.[20] Nor is there any merit to respondents' contention that the hearing examiner improperly credited the testimony of customers instead of their own. The hearing examiner heard the witnesses, observed their demeanor, and noted that at least ten customers had testified to similar representations being made to them concerning Van-Pak Government contracts. We find nothing in the record to warrant overturning the examiner's determination to credit the customers' testimony.

We find that in the offer and sale of Van-Pak stock, fraud of a serious nature was practiced on registrant's customers, and conclude that, in connection therewith, registrant, together with or willfully aided and abetted by Hodgdon, Haight, Carr, Harper, Kitain, Davis and Kibler, willfully violated the above cited antifraud provisions.

b. U.S. Infrared Corporation

U.S. Infrared Corporation ("USI") was incorporated in August 1960 to develop and manufacture an infrared heat detector for use chiefly in spotting railroad "hot boxes." Amann, then a vice-president of registrant, was one of the promoters of USI and sought to interest Hodgdon in having ıegistrant undertake a private offering of the company's stock. Hodgdon investigated the situation and was unimpressed, and he, Haight and other officers of the firm sought to dissuade Amann from proceeding with this venture. However, upon

[20] See, *e.g.*, *Richard N. Cea*, 44 S.E.C. 8, 14 (1969); *Kennedy, Cabot & Co., Inc.*, 44 S.E.C. 215, 221 (1970).

Amann's representation that he had made a commitment to obtain financing for USI, Hodgdon agreed to allow a "private placement" of the company's stock through registrant, although he issued a memorandum to all salesmen stating that USI was a gross speculation and directing any of them who wished to offer USI stock to their clients to tell them that registrant regarded it as too speculative to merit approval at that time. Between August 30 and October 7, 1960, registrant sold 45,430 shares of USI stock at $1.10 per share to 18 customers. Thereafter, in July 1961, USI solicited its stockholders, by a letter and accompanying memorandum which were signed by Amann as both chairman of USI's executive committee and vice-president of registrant, to purchase USI convertible debentures. When Hodgdon saw these documents, he sent out telegrams stating that Amann had not been authorized to sign the documents on behalf of registrant and that registrant disavowed them, and discharged Amann.[21]

In the stock offering, Amann represented to one customer that USI's device was being well received by the railroads, that the results of their tests were excellent, and that registrant might subsequently underwrite a public offering of USI stock at $4 per share. This customer was not told of registrant's unfavorable opinion of USI, and he testified that he would not have bought the stock if he had been told. Amann stated to another customer that USI's device had tremendous potential, and that he was being given an opportunity to buy at a low price before USI made a public offering through registrant. A third investor, who purchased a $10,000 convertible debenture in July 1961, was told by Amann that he had received a "fantastic" report on USI's device by a group of engineers that included foreigners, which would give the product a potential foreign as well as a domestic market, that it was a good time to buy since there was a large potential market for the product, and that Amann visualized the common stock into which the debenture was convertible as "really rising." Amann did not inform the investor that by then USI was in desperate financial straits.

Kitain told a customer during the private stock offering that an investment in USI would be profitable, and that the customer would be coming in on the ground floor since USI would go public at a higher price later on.

There was no reasonable basis for the representations made.

[21] Amann was reemployed by registrant as a salesman in October 1961.

USI's infrared device was never placed in production or successfully marketed. Amann admitted that every time the device was shown to the railroads, at whom it was primarily aimed, it was found to require further refinement.[22] USI never made a profit and experienced continual losses. In September 1961, it became inactive for lack of funds to carry on its business. There was no justification for representations that a highly favorable engineering report had been received, that USI would be profitable, that there would be a public offering through registrant as underwriter, or that the offering price would be higher than the current sales price.

We conclude that in the offer and sale of USI stock, registrant, together with or willfully aided and abetted by Amann and Kitain, willfully violated the above cited antifraud provisions.

c. Paragon Electrical Manufacturing Corporation

Paragon Electrical Manufacturing Corporation was incorporated in 1960 to develop and market a resuable crimp-type wire connector and its related tool. In January 1961, registrant undertook to place privately 20,000 shares of Paragon stock at $5.50 per share.

Carr represented to a customer that Paragon had agreements with General Electric Co. and Westinghouse Electric Co. for the distribution of its wire connector, that the customer would make a very nice profit after the stock was offered publicly, and that there was even talk of a 3 for 1 stock split prior to such offering. There was no basis for these representations. Although the two named electric companies purchased some connectors from Paragon, they had no distribution agreements with it. Paragon never made a public offering of its stock and, while the possibility of such an offering may have been discussed, there was no justification for the statement made to the customer which assumed it would take place. Nor was a stock split ever contemplated.

We conclude that in the offer and sale of Paragon stock, registrant, together with or willfully aided and abetted by Carr, willfully violated the cited antifraud provisions.

d. Apache Canadian Gas and Oil Program 1961

Registrant, beginning in August 1961, participated in a

[22] A USI progress report of February 24, 1961 stated that sales visits to two railroads indicated that its heat detector was not sufficiently engineered for any particular applications to'be of great value. USI eventually obtained orders for two of its devices, but they were never delivered because the company lacked the production capability.

registered offering of 100 units of Apache Canadian Gas and Oil Program 1961 at $5,000 per unit. The proceeds of the offering were to be used for the acquisition, exploration and development of gas and oil leaseholds in Canada.

Harper sold an Apache unit to Mrs. D, a financial planning client. Mrs. D soon became dissatisfied with her investment and tried several times to get Harper to sell it for her, but Harper dissuaded her, stating with strong emphasis that it would be a grave error to do so and that he knew of anxious buyers for the units. In his February 1962 report to Mrs. D on the status of her account, Harper listed her investment in Apache at $7,500 (representing the cost price of $5,000 for one unit and assessments of $2,500) followed by a plus sign, with the notation that such figure might be considered an undervaluation since bids had run as high as $25,000 per unit. He also told Mrs. D that a unit would be valued higher than $25,000. In August 1964, he represented to Mrs. D that the value of her investment was $35,000, advising her that several buyers "would pay that price," and that it would be "a great mistake" to sell. Harper made similar lulling representations to Dr. B, a financial planning client, who had purchased an Apache unit for $12,050 subsequent to the offering. In a January 1963 report to Dr. B, Harper valued the unit at $22,000, and in February 1964 he represented the value to be $30,000 with a potential worth of $100,000.

Harper asserted that he obtained his valuation figures from the corporate sponsor of the Apache program. An officer of the sponsor testified, however, that there was no basis for the figures which Harper supplied to his clients. It is obvious from Harper's testimony, moreover, that the figures he used were the sponsor's estimates of total future income per unit. We conclude that registrant, together with or willfully aided and abetted by Harper, willfully violated the above antifraud provisions.

e. Data Processing Corporation of America

Davis, in connection with a transaction in 1961 in the stock of Data Processing Corporation of America ("DPCA"), which had been organized two years earlier to establish and operate data processing service centers, wrote to his customer that there would shortly be a public offering of the stock at a price considerably more than the $3.50 per share paid by him and that market interest should make the price behave favorably after the public offering.

There was no reasonable basis for these representations. As Davis admittedly was aware, a DPCA underwriting was only in the talking stage and there was no assurance that there would be a public offering. We conclude that Davis willfully violated the antifraud provisions of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b–5 thereunder. We make no adverse finding as to registrant in this respect because Davis' transactions, like other transactions in DPCA stock by Amann, Kitain, and another salesman, were concealed from registrant and not recorded on its books. The participation of Amann, Kitain, and Davis in sales of the stock on behalf of DPCA in alleged violation of the registration provisions of the Securities Act is treated below.

Sales of Unregistered Securities

The examiner found that the offer and sale of unregistered USI, DPCA and Paragon stock discussed above did not qualify for the claimed "private offering" exemption from registration, and that, accordingly, registrant and the various respondents who participated willfully violated the registration provisions of the Securities Act.

Respondents assert that the investors in these three stocks understood the nature of the issuers' businesses and the speculative and venture capital quality of their investment, and that under the circumstances the offerings qualified for the exemption. They additionally contend that they relied on a 1935 Commission interpretation, published in the Federal Register in 1946 and assertedly applicable at the time of the offerings in question, which they claim exempted from registration all offerings, including the ones in question, made to less than 25 persons.

We agree with the examiner that there was no basis for the claimed exemption. The USI, DPCA and Paragon offerings were made to various inadequately informed persons who clearly did not occupy a relationship to the issuers giving them access to the same kind of information that a registration statement under the Securities Act would have supplied, nor did they possess such information. Under such circumstances, as held by the Supreme Court in *S.E.C.* v. *Ralston Purina Co.*,[23] the small number of offerees is not determinative of whether an offering is private. And, as one Court has recently

[23] 346 U.S. 119 (1953). See also *Gilligan, Will & Co.* v. *S.E.C.*, 267 F.2d 461 (C.A. 2, 1959), *cert. denied* 361 U.S. 896.

pointed out, "Sophistication is not a substitute for 'access to the kind of information which registration would disclose.' "[24]

Aside from the fact that the landmark *Ralston Purina* decision was issued in 1953, long before the transactions at issue here, respondents' asserted reliance on the interpretation published in the 1946 Federal Register was wholly misplaced since it was based on an excerpt taken out of context. That interpretation specifically states that "the determination of what constitutes a public offering is essentially a question of fact, in which all surrounding circumstances are of moment. In no sense is the question to be determined exclusively by the number of prospective offerees."[25] Nor was Amann relieved of responsibility by the reliance he assertedly placed on the advice of counsel and Hodgdon.[26]

Hodgon approved the sale of the USI and Paragon offerings through registrant and reviewed lists of prospective offerees which he required the salesmen to submit to him. He should have been aware that no private offering exemption was available.[27] We conclude that registrant and Hodgdon, together with Amann and Kitain in the offer and sale of USI stock, and with Carr in the offer and sale of Paragon stock, willfully violated Sections 5(a) and 5(c) of the Securities Act, and that Amann, Kitain and Davis willfully violated those provisions in the offer and sale of DPCA stock.

Other Violations

a. False Records

When Hodgdon learned that the State of Virginia had banned sales of Van-Pak stock, he told registrant's salesmen that, in the opinion of counsel, sales could be made to Virginia residents provided they were solicited outside the state, and that, if possible, legitimate non-Virginia business addresses for such customers should be used for purposes of such transactions, since it was desired to have "as little occasion as possible to irritate anybody in the Virginia Securities Commission." Where an address out of the State could not be used, the salesmen and registrant's clerical staff were instructed to

[24] *U.S.* v. *Custer Channel Wing Corporation*, 376 F.2d 675, 678 (C.A. 4, 1967), *cert. denied* 389 U.S. 850.

[25] Securities Act Release No. 285 (1935), 11 Fed. Reg. 10952 (1946).

[26] *Gearhart & Otis, Inc.*, 42 S.E.C. 1, 28 (1964), *aff'd* 348 F.2d 798 (C.A.D.C. 1965); *Mark E. O'Leary*, 43 S.E.C. 842, 848 (1968).

[27] See *Century Securities Company*, 43 S.E.C. 371, 380–81 (1967), *aff'd sub nom. Nees* v. *S.E.C.*, 414 F.2d 211, 220 (C.A. 9, 1969). We reject Hodgdon's contention that a violation of the registration provisions cannot be found as to him because the more definite statement of charges furnished by the Division did not name him as having "singly" violated them. That statement did not affect the sufficiency of the allegation in the order for proceedings that he committed such violations "in concert with" others.

mark order tickets and confirmations "unsolicited." Haight and Adam admitted marking order tickets in accordance with this instruction. It is clear that confirmations of transactions with Virginia residents who were solicited outside that state but had only a Virginia address were marked "unsolicited." In addition, the record contains several instances where Virginia residents who were solicited to purchase Van-Pak stock in Virginia received confirmations similarly marked. The record does not show that Hodgdon, Haight or Adam knew or should have known of these latter instances.

Hodgdon argues that the notation "unsolicited" was merely "a shorthand expression" for "not solicited in Virginia" and that inclusion of the term "was of no relevance from the standpoint of the Commission's legitimate interests." We disagree. Without taking any position on whether registrant's sales complied with Virginia law, we think it clear that the use of the term "unsolicited" where the order was in fact solicited constituted a false entry which could hamper this Commission in its investigatory functions.

We conclude that registrant, willfully aided and abetted by Hodgdon, Haight and Adam with respect to sales solicited outside of Virginia, made false entries on its records in willful violation of Section 17(a) of the Exchange Act and Rule 17a–3 thereunder.

b. Failure to Amend Application for Broker-Dealer Registration

During the relevant period, registrant's application for broker-dealer registration was not amended to reflect the election of certain officers and directors. Registrant argues that its failure to amend was inadvertent, and therefore not willful, and Hodgdon points to his testimony that he had delegated responsibility for preparing such amendments to his executive secretary and was unaware that they were not timely filed.

A finding of willfulness within the meaning of Section 15(b) of the Exchange Act does not require a finding of intention to violate the law. Hodgdon was responsible for registrant's compliance with amendment requirements. His delegation of responsibility to a ministerial employee did not relieve him of his obligation to make certain that appropriate filings were made.[28] We conclude that registrant, willfully aided and abetted by Hodgdon, willfully violated Section 15(b) of the Exchange Act and Rule 15b3–1 thereunder.

[28] See *Sterling Securities Company*, 39 S.E.C. 487, 495 (1959); *Peoples Securities Company*, 39 S.E.C. 641, 645 (1960); *Alfred Miller*, 43 S.E.C. 233, 239–40 (1966).

c. Failure to Transmit Funds Promptly

Rule 15c2–4 under the Exchange Act provides in pertinent part that it is a "fraudulent, deceptive or manipulative act or practice" within the meaning of Section 15(c)(2) of the Act for a broker or dealer participating in a distribution of securities to accept the proceeds thereof unless "promptly transmitted" to the persons entitled thereto.

Registrant was the underwriter on a "best efforts" basis of an offering of stock of Southeastern Mortgage Investors Trust. During the period January 20 to February 28, 1964, registrant transmitted the proceeds of sales of Southeastern stock to the issuer after varying periods of time. Such transmittal, in our view, was not prompt at least with respect to 46 sales where it occurred 11 to 15 days after receipt of the funds.[29] Accordingly, we conclude that registrant willfully violated Section 15(c)(2) of the Exchange Act and Rule 15c2–4 thereunder.

OTHER MATTERS

Respondents pursue various contentions that we previously considered and rejected on interlocutory appeals from rulings of the hearing examiner. They argue that we are precluded from imposing sanctions upon them by reasons of prejudgment, chiefly because of the discussion of certain of registrant's activities in the 1963 Report of Special Study of Securities Markets;[30] that respondents' request for production of Special Study memoranda by or between the Commission and its staff relating to respondents was improperly denied; and that we wrongfully rejected their requests to make these proceedings private and to grant oral argument on such requests. These arguments are without merit.

Respondents' contention with respect to prejudgment, if it prevailed, would have the effect of immunizing from administrative proceedings not only every firm named in the Special Study as to which an adverse comment was made, but also

[29] Contrary to registrant's contention, we consider that it received payment for a purchase upon receipt of a customer's check, not on the settlement date when it merely made the bookkeeping entry. In cases, however, where the customer had a credit balance in his account sufficient to cover the purchase price, we have treated payment as having been received by registrant on the settlement date, when the account was charged with payment.

[30] H. Doc. No. 95, Pt. 1, 88th Cong., 1st Sess., 109–110, 261–2 (1963). The Special Study, after observing that specialization is "in many respects desirable," cited registrant as an example of a broker-dealer who specializes but projects an image to the public of "equal willingness to sell, and equal knowledge about, securities other than those within his specialty." Noting that the firm recommended investments by its customers primarily in real estate syndications, a number of which were promoted by the firm, and mutual funds, with one of which the proprietor of the firm was affiliated, the Special Study stated that "in such instances, specialization strains the broker's obligation to deal fairly with his customer and strains it even further where a relationship of trust and confidence has been developed."

every unnamed firm whose activities were considered in making an adverse comment. There is no basis for such a result, and it certainly was not contemplated by the Congress when, in Section 19(d) of the Exchange Act, it expressly directed the investigation to ascertain the adequacy of investor protection in the securities markets which resulted in the Special Study report. Our letter transmitting that report to the Congress made it clear that the investigation which was made and the writing of the report were the work of a separate staf established within this Commission under the supervision of a director appointed for that purpose, and while the Commission "worked very closely" with the staff and went over its report, "the judgments, analyses and recommendations in the report were those of the staff and not the Commission." [31] Even assuming that consideration of the report played some part in the much later determination to institute these proceedings against respondents,[32] this would in no sense constitute prejudgment of the issues raised herein.[33] The Commission, in carrying out its statutory responsibilities, could hardly be required to ignore the report, the consideration of which would, as recognized by the Administrative Procedure Act ("APA"), be entirely consistent with the dual functions of a prosecutory and adjudicatory nature exercised by the Commission. The Special Study memoranda, being investigatory in character, were properly kept confidential. Finally, it may be noted that none of the present Commissioners was associated with this Commission at the time the Special Study report was prepared and submitted to Congress, and that our decision herein is based solely on the record made by the parties before the hearing examiner.[34]

The determination of whether a proceeding shall be public or private rests within our discretion.[35] In this case we considered

[31] Special Study, *supra*, p. IV.

[32] Although the report was submitted to Congress in 1963, these proceedings were not instituted until 1966 after a further investigation, initiated in late 1964, had been made by our staff. The allegations in the order for proceedings and the evidence in the record cover a period of time subsequent to the report's submission, and include matters that were not even mentioned in the report.

[33] See *San Francisco Mining Exchange* v. *S.E.C.*, 378 F.2d 162, 167 (C.A. 9, 1967). See also *Federal Trade Commission* v. *Cement Institute*, 333 U.S. 863 (1948); *Pangburn* v. *C.A.B.*, 311 F.2d 349 (C.A. 1, 1962).

[34] As further "evidence" of prejudgment, respondents point to the press release issued when these proceedings were instituted. That release, however, made it clear that the violations were alleged, not found, that the allegations were those of the staff, not the Commission, and that a hearing would be held to determine whether the alleged violations had occurred, and, if so, whether any remedial action should be ordered. Securities Exchange Act Release No. 7833 (March 3, 1966). *Cf. Federal Trade Commission* v. *Cinderella Career and Finishing Schools, Inc.*, 404 F.2d 1308, 1312–15 (C.A.D.C. 1968).

[35] Section 22 of the Exchange Act provides that "hearings may be public," and Rule 11(b) of our Rules of Practice states that all hearings with certain exceptions not applicable here "shall be public unless otherwise ordered by the Commission."

that, in view of the gravity of the charges made against registrant and its management and salesmen, their desire for privacy was outweighed by the general public interest and the interest of investors.[36] These considerations were still applicable when respondents, three months after the proceedings were instituted and after hearings had begun, requested that all further proceedings be kept private.[37] And, in the absence of a statutory requirement, respondents were not entitled to oral argument on the issue of public or private proceedings.[38]

We also reject respondents' further contentions that the Division improperly suppressed evidence favorable to their defense, that these proceedings were unfairly based upon "sweeping allegations," and that "undue delay" in instituting them denied respondents due process and violated the APA.

Respondents cite *Brady* v. *Maryland* [39] for the proposition that prior to the hearings the Division was required to furnish a list of all prospective witnesses, oral and written statements taken from them, summaries or memoranda of staff interviews with such witnesses, and copies of all completed questionnaires received from them. The *Brady* case held that suppression by the prosecution of material evidence favorable to an accused who has requested it is a denial of due process. It did not, however, authorize a wholesale "fishing expedition" into investigative material such as respondents attempted to embark upon here.[40] The Division was not required to furnish the names of its prospective witnesses to respondents.[41] And statements of staff witnesses obtained in the course of an investiga-

[36] See *R. A. Holman & Co., Inc.*, 42 S.E.C. 866, 879, n. 25 (1965), *aff'd* 366 F.2d 446 (C.A. 2, 1966). In *J. H. Goddard & Co., Inc.*, 41 S.E.C. 964, 966 (1964), in setting forth some of the considerations which favor public proceedings, we stated that such proceedings enable investors to institute causes of action against broker-dealers promptly before any of their witnesses have become unavailable, may encourage persons to come forward to testify or to request leave to be heard or to intervene, may alert investors to certain activities of broker-dealers, and inform the industry that the Commission has instituted action with respect to such activities.

[37] Respondents also complain that they were not furnished with a statement they requested of the number of private Commission proceedings within the year prior to institution of the instant proceedings and the nature of the charges involved in such proceedings. Aside from the fact that the request does not appear to have been properly presented to us because it was raised for the first time in a brief seeking review of an examiner's ruling which did not relate to such request, the information sought would not have disclosed the bases for our action making the other cases private.

[38] Neither Section 6 of the APA (5 U.S.C. § 555(b)) which respondents cite nor the statutes administered by us contain such a requirement. See *Morgan* v. *United States*, 298 U.S. 468, 481 (1936); *F.C.C.* v. *WJR*, 377 U.S. 265, 281 (1949); *McGraw Electric Co.* v. *United States*, 120 F. Supp. 354, 358–9 (E.D. Mo., 1954), *aff'd* 348 U.S. 804 (1954).

[39] 373 U.S. 83 (1963).

[40] See *Harris, Clare & Co., Inc.*, 43 S.E.C. 198, 201 (1966).

[41] *Armstrong, Jones & Co.* v. *S.E.C.*, 421 F.2d 359, 364 (C.A. 6, 1970), *cert. denied* 398 U.S. 958, *aff'd Armstrong, Jones & Co.*, Securities Exchange Act Release No. 8420, p. 15 (October 3, 1968); *Dlugash* v. *S.E.C.*, 373 F.2d 107, 110 (C.A. 2, 1967), *aff'd F. S. Johns & Company, Inc.*, 43 S.E.C. 124, 141 (1966); *Richard N. Cea*, 44 S.E.C. 8, 22 (1969).

tion are confidential except that after such witnesses' direct testimony in the principal proceedings, any respondent may request and obtain production of such statements for the purpose of impeaching their testimony.[42] The charges against respondents were necessarily broad since they encompassed registrant's whole method of operation. However, respondents' motion for a more definite statement of such charges was in large part granted, and a vigorous defense was presented to all of the allegations raised.

Respondents assert that although this proceeding was not instituted until March 1966, the Division, as a result of the investigation conducted by the Special Study staff, had all of the information it needed by 1963. As previously noted, however, the allegations in these proceedings and the evidence introduced cover a period extending until mid-1964, and the Division asserts it did not begin to gather the necessary evidence until the Commission issued its investigative order of November 24, 1964. In any event, the law is clear that the doctrine of laches or estoppel cannot be invoked against the Government acting in a sovereign capacity to protect the public interest.[43] Respondents' position is not supported by their citation of Section 6 of the APA.[44] Moreover, if, as respondents assert, they considered that the memory of any witnesses who testified against them had dimmed, they had ample opportunity to explore their testimony on cross-examination. And the lapse of time did not appear to hamper the recollection of the respondent-witnesses.[45]

PUBLIC INTEREST

In view of the willful violations we have found on the part of registrant and the individual respondents other than Baskin, we must determine what sanctions are necessary or appropri-

[42] See Rule 11.1 of the Commission's Rules of Practice which codified the Commission's practice with respect to pre-hearing statements of staff witnesses, following the decision in *Jencks* v. *U.S.*, 353 U.S. 657 (1957). See *R. A. Holman & Co., Inc.*, 42 S.E.C. 866, 879, n, 24 (1965), *aff'd* 366 F.2d 446, 455 (C.A. 2, 1966).

[43] See *Richard N. Cea*, S.E.C. 8, 21, and cases cited in n. 18 (1969).

[44] That section merely provides: "With due regard for the convenience and necessity of the parties or their representatives and within a reasonable time, each agency shall proceed to conclude a matter presented to it."

[45] Various respondents also contend that the examiner's initial decision was not in conformity with the requirements of Section 8 of the APA (5 U.S.C. § 557(c)) in that it failed to make appropriate findings with respect to credibility and "other matters," or to rule on each proposed finding and conclusion. Our review of that decision satisfies us that it comports with the standards set forth in the APA. See *Stauffer Laboratories, Inc.* v. *F.T.C.*, 343 F.2d 75, 81–2 (C.A. 9, 1965); *Coyle Lines, Inc.* v. *U.S.*, 115 F. Supp. 272, 276 (E.D. La., 1953); *Norman Pollisky*, 43 S.E.C. 852, 861–62 (1968). We note further as to the examiner's credibility determinations that, aside from his findings with respect to representations made in the sale of Van-Pak stock which we have discussed above, respondents raise specific objections to only three such determinations. None of the evidence as to which those determinations were made is the basis for any of our findings.

ate in the public interest. With respect to Baskin, we were unable to conclude, on the record before us, that he participated in any of the violations found, and accordingly the proceedings with respect to him will be dismissed.[46] As previously mentioned, the hearing examiner determined to suspend registrant from the NASD and PBW for four months, and to bar Hodgdon, Haight, Adam, and Harper. In addition, he concluded that Kitain and Davis should each be suspended from association with any broker or dealer for one year, and Carr and Kibler for ten months and five months, respectively, and that Amann should be barred with the proviso that upon an appropriate showing he might become associated with a broker-dealer in a supervised capacity after nine months.

Various factors have been urged by respondents as warranting the imposition of no sanction or a lesser sanction than was imposed by the examiner. Among other things, they variously assert that the sanctions assessed are "grossly disproportionate" to those imposed for similar offenses in non-"boiler-shop" cases, that to assess sanctions for conduct that occurred so long ago would be "*per se* punitive," and that there is no evidence in this record that respondents are not now or have not been for a number of years "in total compliance with the law." At the least, it is urged these proceedings should be remanded to the examiner to receive the additional evidence "timely proffered" as to "compliance with the law" since the record was closed.

The remedial action which is appropriate in the public interest depends upon the facts and circumstances of each particular case and cannot be precisely determined by comparison with action taken in other cases.[47] In determining the appropriateness of a particular sanction, we consider, among other things, the nature, extent and seriousness of the violations found, whether the firm's officials participated in the misconduct, and the ever-developing standards of the securities industry, as well as any mitigating circumstances presented. The cases cited by respondents to show discrimination in the imposition of sanctions do not support their position, and a number of them involved settlements. In settlement cases, where as a rule there is no admission of violations, we take

[46] Our references hereinafter to "respondents" will not include Baskin.

[47] See *Winkler* v. *S.E.C.*, 377 F.2d 517, 518 (C.A. 2, 1967); *Dlugash* v. *S.E.C.*, 373 F.2d 107 (C.A. 2, 1967); *Hiller* v. *S.E.C.*, 429 F.2d 856 (C.A. 2, 1970); *Martin A. Fleishman*, 43 S.E.C. 185, 190 (1966); 2 Loss, *Securities Regulation*, (2d ed. 1961), pp. 1323–24.

into account pragmatic considerations such as the avoidance of time- and manpower-consuming adversary proceedings.

The imposition of sanctions here is no less remedial because of the lapse of time since the misconduct occurred. Respondents' argument would in effect require the dismissal of broker-dealer proceedings in any case where an extensive investigation was made, a large number of respondents were involved and the many issues raised were vigorously litigated. The Division was under no duty to adduce evidence that respondents had not complied with the securities laws since the alleged violations occurred. As to respondents' request for a remand of the proceedings so as to adduce evidence of compliance, we note that the evidence referred to had been offered by registrant and Haight merely to show that after the hearings registrant had added supervisory personnel, installed new equipment, and adopted new policies and procedures. We reaffirm our previous ruling which denied such proffer.[48]

Various other factors have also been cited by the examiner or urged by' various respondents: the damage suffered as a result of unfavorable publicity; measures adopted by registrant to prevent a recurrence of the alleged violations; the fact that Hodgdon has left the securities business with no intention of return—ng;[49] Hodgdon's direction of other individual respondents; the fact that registrant's employment of Davis, Kibler, Carr, Adam, Harper, and Kitain was their first as registered representatives; the fact that this was the first disciplinary proceeding against the individual respondents; and Amann's belief in the merits of the USI and DPCA offerings and his investment of personal and family funds in them.

We conclude that the various mitigative factors cited are insufficient to overcome the serious fraud and other violations of the respondents. We agree with the hearing examiner's determination that Hodgdon, Haight, Adam and Harper should be barred. We find, however, that the sanctions which

[48] In our prior ruling we noted that we had in prior cases denied requests to reopen hearings for such purpose. *Norris & Hirshberg, Inc.*, 22 S.E.C. 558, 559 (1946); *Isthmus Steamship & Salvage Co., Inc.*, 42 S.E.C. 465, 469 (1964); *Crow, Brourman & Chatkin, Inc.*, Securities Exchange Act Release No. 7876, p. 2 (April 29, 1966). We further stated the requested reopening would be an inappropriate departure from orderly procedures and an unwarranted prolongation of the proceedings, particularly since the evidence sought to be introduced appeared essentially cumulative.

[49] In July 1964, Hodgdon ceased participation in the day-to-day management of registrant and sold a portion of his shares divesting himself of control. It appears that his association with the firm was completely terminated in December 1965. Haight has been president, a director, and the major stockholder of registrant since July 1964.

the examiner imposed on registrant and the other individual respondents were inadequate in the public interest.

As we have seen, registrant, various of its officers with the exception of Amann, and the other individual respondents participated in a nefarious scheme to defraud financial planning clients and betrayed the trust clients were induced to place in them. Although we have not found that Amann participated in that scheme, he made serious misrepresentations in the sale of USI stock and was to a major degree responsible for the violations of the registration requirements that occurred with respect to the USI and DPCA stock offerings. In addition to Amann, moreover, registrant and the individual respondents other than Adam made fraudulent representations to customers in the offer and sale of various securities, and registrant, Hodgdon, Carr, Kitain and Davis violated the registration provisions of the Securities Act. Although Hodgdon has left registrant, its so-called new management consists of Haight, Carr, Adam, Harper and Kitain, each of whom owns 10 percent or more of the firm's stock.

We conclude that registrant's broker-dealer registration should be revoked, that it should be expelled from NASD and PBW membership, and that Carr, Kitain, Davis, Kibler, and Amann as well as the other individual respondents should be barred. In our judgment the sanctions we are imposing are appropriate in the public interest notwithstanding that we have not affirmed all of the adverse findings made by the hearing examiner with respect to various of the respondents.[50]

An appropriate order will issue.

By the Commission (Commissioners OWENS, SMITH, NEEDHAM and HERLONG).

[50] Among other things, we have not sustained the examiner's findings that fraudulent representations were made with respect to the rate of return on certain real estate securities offered and sold by respondents.

The exceptions to the initial decision of the hearing examiner are overruled to the extent that they are inconsistent with our decision and sustained to the extent that they are in accord therewith.

In the Matter of

WASHINGTON GAS LIGHT COMPANY

File No. 3-2494. Promulgated March 16, 1971

Public Utility Holding Company Act of 1935—Sections 11(b)(2) and 11(e).

SIMPLIFICATION OF HOLDING-COMPANY SYSTEM

Distribution of Voting Power

Where small publicly-held interest exists in common stock of public-utility subsidiary company of registered holding company, *held*, such stock interest constitutes unfair and inequitable distribution of voting power among security holders of subsidiary company contrary to requirements of Section 11(b)(2) of Public Utility Holding Company Act of 1935.

Plan Under Section 11(e)

Necessity

Plan filed under Section 11(e) of Public Utility Holding Company Act of 1935 which provides for elimination of publicly-held shares of common stock of public-utility subsidiary company of registered holding company through purchase of such shares for cash, *held*, necessary to effectuate provisions of Section 11(b).

Fairness and Equity

Plan filed under Section 11(e) of Public Utility Holding Company Act of 1935 for purchase of publicly-held common stock of subsidiary company of registered holding company for cash to be paid by holding company upon basis providing holders equitable equivalent of rights surrendered and having no appreciable effect on existing holders of holding company's stock, *held*, fair and equitable to persons affected by plan.

APPEARANCES:

Paul H. Ford and *S.S. Hollingsworth* for Washington Gas Light Company and Shenandoah Gas Company.

Charles Feldman for the Jador Corporation, a stockholder of Shenandoah Gas Company.

Robert F. McCulloch for the Division of Corporate Regulation of the Commission.

FINDINGS AND OPINION OF THE COMMISSION

INTRODUCTION

Washington Gas Light Company ("Washington"), a gas utility company and a registered holding company, has filed a plan pursuant to Section 11(e) of the Public Utility Holding Company Act of 1935 ("Act"), providing for the acquisition by Washington, for cash, of the publicly-held shares of the common stock of Shenandoah Gas Company ("Shenandoah"), a public-utility subsidiary company of Washington. We consolidated the proceeding respecting this plan with a proceeding instituted by us pursuant to Section 11(b)(2) of the Act to determine what steps are necessary to ensure that the corporate structure of Shenandoah does not unfairly or inequitably distribute voting power among its security holders.

By order dated February 29, 1940, we granted Washington's application for exemption from the provisions of the Act pursuant to Section 3(a)(2) thereof.[1] Subsequently, the then subsidiary public-utility companies were merged into Washington and in 1959, when Washington acquired more than 10 percent of stock of Shenandoah, its exemption as a holding company was continued pursuant to Rule 2 promulgated thereunder.[2] On May 1, 1970, we granted an application for exemption filed by Washington, and under our order Washington is presently exempt under Section 3(a)(2) from all provisions of the Act except Sections 11(b)(2), 11(d), and 11(e).[3] The intent of such exception, to which Washington consented, was to have Washington register as a holding company under the Act solely for the limited purpose of filing a plan under Section 11(e) to eliminate the outstanding minority stock interest of Shenandoah. Washington thereupon registered as a holding company and filed the pending plan.

After appropriate notice,[4] a public hearing was held at which evidence was adduced in support of the plan. Post-hearing procedures were waived by the parties to the proceedings, and, on the basis of the record, we make the following findings.

THE PROPOSED PLAN

Shenandoah has outstanding 339,325 shares of common

[1] *Washington Gas Light Company*, 6 S.E.C. 954.

[2] For subsequent acquisitions, see *Washington Gas Light Company*, Holding Company Act Release Nos. 14846 (April 9, 1963) and 15319 (October 7, 1965).

[3] *Washington Gas Light Company*, Holding Company Act Release No. 16706.

[4] *Washington Gas Light Company*, Holding Company Act Release No. 16784 (July 15, 1970).

stock. Washington owns 337,146 shares and the balance of 2,179 (0.6 percent) is held by 26 public holders. Under the plan, the public holders of Shenandoah's common stock will be entitled to $6.50 for each share, or a total of $14,163.50.

The plan is subject to our approval and to the entry of an order by an appropriate District Court of the United States approving and enforcing the plan. Washington and Shenandoah have requested that we apply for such District Court order in accordance with the provisions of Sections 11(e) and 18(f) of the Act. The plan will become effective on a date set by Washington ("effective date"), which date shall not exceed thirty days from the entry of an order by a District Court of the United States approving and enforcing the plan. On and after the effective date, the public holders of shares of Shenandoah stock will cease to have any rights as shareholders of such company and, upon the surrender of their stock certificates, will be entitled to receive only the sum of $6.50 for each share.[5]

THE COMPANIES INVOLVED

Washington, incorporated both in the District of Columbia and the State of Virginia, is engaged in the retail distribution and sale of natural gas in the metropolitan area of Washington, D.C., including adjacent sections of Maryland and Virginia. As of December 31, 1969, Washington's corporate net plant was $260,397,000, and its consolidated net plant was $274,216,000. For the twelve months then ended, corporate operating revenues were $122,236,000, and consolidated operating revenues were $126,349,000. As of December 31, 1969, it had outstanding 3,604,756 shares of common stock, no par value, which are publicly held and are listed and traded on the New York Stock Exchange.

Washington has four active subsidiary companies, three of which sell natural gas at retail. Washington owns all of the common stock of its subsidiary companies other than Shenandoah. Frederick Gas Company, Inc., a Maryland corporation, sells natural gas at retail in the City of Frederick, Maryland, and areas adjacent thereto. It also sells at wholesale to Washington to supply the latter's customers in Montgomery County, Maryland, contiguous to the Frederick transmission lines.

[5] At the end of fifteen years from the effective date of the plan, public Shenandoah stockholders who have not surrendered their certificates will cease to have any rights or claims against Washington or Shenandoah, and sums theretofore payable to such stockholders will become the property of Washington.

Martinsburg Gas & Heating Company, a West Virginia corporation, purchases its gas supply from Shenandoah and distributes and sells natural gas at retail in the City of Martinsburg, West Virginia, and adjacent areas. Hampshire Gas Company, a West Virginia corporation, was organized for the purpose of acquiring oil and gas leases. It sells no natural gas at retail.

Shenandoah, a Virginia corporation, is engaged in the purchase and sale at retail of natural gas in Winchester, Middletown, Strasburg, Stephens City, and New Market, Virginia, and at wholesale to Martinsburg Gas & Heating Company. It also serves certain industrial and retail customers from its transmission pipelines in Virginia and West Virginia. As of July 31, 1970, Shenandoah's net plant was $4,485,000, and its operating revenues for the twelve months then ended were $2,992,000.

Washington first acquired Shenandoah common stock in 1959. In that year it acquired from an investment banking firm 91,637 shares of Shenandoah common stock at a cost of $2.375 per share and 6 percent convertible notes in principal amounts totaling $300,000, which, in accordance with their terms, Washington converted into 150,000 shares of Shenandoah common stock.[6]

Subsequently Washington acquired through offers to stockholders or market purchases an additional 95,509 shares. These purchases were made pursuant to orders of the Virginia State Corporation Commission and of the Public Service Coimission of the District of Columbia.[7] The original orders authorized acquisitions at not in excess of $2.375 per share, and maximum prices were increased in subsequent orders as the financial condition of Shenandoah improved. The periods of the acquisitions, the amounts acquired and the range of prices per share were as follows:

[6] Washington paid $296,875 for a Shenandoah note in principal amount of $250,000, convertible into 125,000 shares of common stock, resulting in a cost of $2.375 per share. It paid $52,500 for a $50,000 note convertible into 25,000 shares, resulting in a price of $2.10 per share.

[7] In its last order of May 12, 1969, authorizing further acquisitions at $6.50 per share, the D.C. Commission said that financing arrangements for a subsidiary with outstanding minority interests were cumbersome and inefficient and that other fiscal affairs of such a subsidiary can be conducted with improved efficiency if the minority interests are extinguished.

TABLE I

Dates Acquired	Number of Shares	Price Range Per Share
Nov. 2, 1959 to April 6, 1966	48,822	$2.205 to $2.375
May 3, 1966 to May 15, 1969	44,742	$5.00
May 16, 1969 to Sept. 14, 1970	1,945	$6.50
Total	95,509	

The capitalization and surplus of Shenandoah as at July 31, 1970 were:

TABLE II

	Amount	Percent
First Mortgage Bonds, 4½% due November 1, 1975	$ 448,000	10.1
4¾% Serial Notes due October 1, 1978	360,000	8.2
Advances from Parent Company	1,725,000	39.2
Total Long-term Debt	2,533,000	57.5
Common Stock and Surplus	1,869,000	42.5
Total Capitalization and Surplus	$4,402,000	100.0

The first mortgage bonds were outstanding at the time of the acquisition in 1959 and have been reduced from $637,000 to $448,000 outstanding at July 31, 1970. The 4¾ percent Serial notes due October 1, 1978, with a remaining balance of $360, 000, were initially issued to Washington in 1964 for funds it provided to permit Shenandoah in that year to redeem $590, 200 principal amount of 6 percent Sinking Fund Debentures due 1979.[8]

Since 1959, Washington advanced an aggregate of about $4.5 million to Shenandoah, which amounts were used by Shenandoah for plant expansion and other purposes. During the years 1959 through 1963, no interest was charged on advances, which had outstanding balances at year-end ranging up to $225,000. Washington states that thereafter funds were advanced to Shenandoah at an interest cost lower than Shenandoah would have paid on loans from unaffiliated sources.[9] All repayments of advances were applied by Washington first to the highest interest bearing accounts.

[8] The original issue was $560,000 principal amount, consisting of 14 notes each in the principal amount of $40,000, one note maturing each year commencing October 1, 1965.

[9] Commencing January 1, 1964, Shenandoah was charged 4½ percent per annum on advances. In 1966, the interest rate was increased to 5¼ percent and reached a high of 7 percent in 1968 and 1969. In these years the prime rate had reached a high of 8½ percent, and the cost of permanent debt financing to Washington was as much as 8.81 percent. For the $85,000 of advances in 1970, the interest rate was increased to 8½ percent, the prime rate then in effect.

COMPLIANCE WITH STATUTORY STANDARDS

Before we may approve a plan filed pursuant to Section 11(e) of the Act, we must find it necessary to effectuate the provisions of Section 11(b) thereof and fair and equitable to the persons affected thereby.

NECESSITY

As noted, the plan is designed to eliminate the minority interest in the common stock of Shenandoah. Washington states that it is not practical for a company like Shenandoah to sell its own bonds publicly and that, with Shenandoah as a wholly-owned subsidiary company, Washington would be in a position to issue its own bonds against Shenandoah's property additions.

The existence of a publicly-held minority interest, as we have previously held, contravenes the standards of Section 11(b)(2),[10] and our order will direct that the minority interest in Shenandoah be eliminated. We find, accordingly, that the plan is necessary to effectuate the provisions of Section 11(b) of the Act.

FAIRNESS

The "fair and equitable" standard of Section 11(e) requires that each security holder affected by a plan thereunder receive "the equitable equivalent of the rights surrendered." [11] In determining fairness, we give primary weight to Shenandoah's earnings.

Table III below presents total net income and net income per share of Shenandoah for the years 1965 through 1969, and for the twelve months ended July 31, 1970:

TABLE III

	Net Income	Net Income Per Share
1965	$135,900	$0.40
1966	140,100	0.41
1967	129,000	0.38
1968	141,700	0.42
1969	146,000[a]	0.43[a]
Twelve months ended 7/31/70	144,400[a]	0.43[a]

[a] Before extraordinary item ($0.03 per share) representing approximately $9,000 net gain from sale of a warehouse.

[10] See *American Electric Power Company, Inc.*, 43 S.E.C. 942 (1968); *Peoples Gas Company*, 43 S.E.C. 805 (1968); *Northeast Utilities*, 43 S.E.C. 445 (1967); *Eastern Utilities Associates*, 43 S.E.C. 243 (1967) and cases therein cited; *Cities Service Company*, 37 S.E.C. 342 (1956), *aff'd*, 247 F.2d 646 (C.A. 2, 1957), *cert. denied*, 355 U.S. 912 (1958).

[11] *Otis & Co.* v. *S.E.C.*, 323 U.S. 624, 639–40 (1945); *S.E.C.* v. *Central Illinois Securities Corp.*, 338 U.S. 96, 130 (1949).

When Washington acquired its initial interest in Shenandoah in 1959, Shenandoah had an earned surplus deficit of $509,690. Through retention of earnings, the deficit was reduced each successive year and was eliminated in 1964. At July 31, 1970, Shenandoah's earned surplus was $892,307, and net book value of its outstanding common stock was $5.51 per share. Shenandoah has paid no dividends on its common stock because, according to Washington, earnings were reinvested to meet Shenandoah's capital requirements.

There is no independent market for the Shenandoah common stock; past transactions reflect largely acquisitions by Washington. Edgar R. Mellon, Vice President of Washington, based his opinion as to a fair value for the Shenandoah common stock upon market prices, earnings and price-earnings ratios with respect to Washington's common stock.[12] Based on the high and low market prices and price earnings ratios in 1968 and 1969, he derived values for the Shenandoah common stock, ranging from $5.46 to $4.62 per share in 1968 and $4.30 to $3.01 per share in 1969. On the basis of these and other comparisons, it was his judgment that a value in the range of $5.50 to $5.75 per share represents a maximum value for the Shenandoah common stock, and he stated that Washington's proposal to pay $6.50 per share is designed to facilitate termination of the minority interest.

The proposed payment is clearly fair to Shenandoah's minority stockholders. The price of $6.50 per share, which the plan provides for the minority stockholders, is about 15 times 1969 reported net income of $0.43 per share. Yearly earnings for Shenandoah in 1971 and 1972 are estimated by management at $0.41 per share, and the price Washington proposes to pay is about 16 times these estimated earnings. These multiples are higher than the price earnings ratios in recent years for the common stock of Washington, whose public-utility system is

[12] Market prices and price/earnings ratios of Washington's common stock for the years indicated are:

	Market Prices			Price/Earnings Ratios	
	High	Low	Average	High	Low
1965	$39⅝	$32¾	$36.2	18	15
1966	34⅞	27½	31.2	16	12
1967	30½	27⅝	29.1	11	10
1968	30½	26½	28.5	13	11
1969	30½	23⅝	27.1	10	7
1970 (1/1–7/31)	27¼	23	25.1		

many times as large as that of Shenandoah and whose common stock value includes also Shenandoah's small contribution to system or consolidated earnings.

One shareholder, owning 1,000 shares of Shenandoah common stock, appeared in the proceedings, arguing that Shenandoah's assets have a present value in excess of original cost reflected on the books of Shenandoah. He offered no supporting particulars, and he ignored the fact that the price of $6.50 per share is 18 percent above the book value of $5.51 per share.[13]

OTHER MATTERS

As a condition precedent to its consummation, the plan provides that it be approved and ordered enforced by an appropriate District Court of the United States. As requested by Washington, we shall apply to such appropriate court for approval and enforcement of the plan, and our order will provide that it is not to operate as authorizing or directing the consummation of the plan until such court order has been entered.

The plan provides that Washington will pay fees and expenses relating to the plan estimated at $500, which amount is clearly reasonable.

CONCLUSION

Based upon the foregoing, we shall enter an order (1) directing that Washington, pursuant to Section 11(b)(2) of the Act, take appropriate action to effectuate the elimination of the publicly-held interest in the common stock of Shenandoah and (2) approving the plan filed pursuant to Section 11(e) of the Act. Our order will provide that none of the transactions involved in the plan may be carried out until an appropriate United States District Court has entered an order approving and enforcing the plan.

By the Commission.

[13] One stockholder of Shenandoah objected, by letter, to the plan, stating that he did not wish to sell his stock for $6.50 per share and that he did not wish to lose his property rights. However, as we have found, the price of $6.50 is fair and equitable and the retirement of the minority common stock is required by Section 11(b)(2) of the Act. Another stockholder wrote a letter requesting to be heard bnt, although notified of the hearing, he did not appear.

IN THE MATTERS OF

EDWARD SINCLAIR

JOHN HARDY

RICHARD CLARK ANDERSON

File Nos. 3-1596 and 3-1597. Promulgated March 24, 1971

Securities Exchange Act of 1934—Sections 15(b), 15A and 19(a)(3)

BROKER-DEALER PROCEEDINGS

Grounds for Bar from Association with Broker-Dealer

Interpositioning

Classification of Records

Where order clerk in over-the-counter department of registered broker-dealer, in execution of transactions for customers, interposed broker-dealer, who did not make market in security, between registrant and best available market pursuant to reciprocal arrangement to generate listed business for registrant which paid clerk commission on such business; and, in order to conceal interpositioning from registrant, falsely listed on order tickets as executing dealer a broker-dealer who quoted security in daily quotation sheets, *held*, order clerk willfully violated and aided and abetted violations of antifraud and record-keeping provisions of Securities Act of 1933 and Securities Exchange Act of 1934 and applicable rules thereunder, and under all the circumstances appropriate in public interest to bar him from association with broker-dealer.

Where order clerks in over-the-counter department of registered broker-dealer, in execution of transactions for customers, interposed broker-dealer between registrant and best available market pursuant to secret arrangement under which interpoed broker-dealer paid them percentage of gross profits on such transactions, and failed to record on order tickets time when customers' orders were transmitted for execution, *held*, order clerks willfully violated and aided and abetted violations of antifraud and record-keeping provisions of Securities Act of 1933 and Securities Exchange Act of 1934 and applicable rules thereunder, and under all the circumstances appropriate in the public interest to bar them from association with broker-dealer.

Lack of Due Diligence in Execution

Where order clerk in registrant's over-the-counter department obtained quotations with respect to securities from three or more dealers, who quoted such securities in daily quotation sheets, before giving another dealer who did not make market in such securities opportunity to meet best price, but where latter dealer, although in no better position than registrant to negotiate for best price, was able to obtain better price from market-makers in large number of transactions either simultaneously or within short period of time, *held*, order clerk failed to exercise due diligence to obtain best execution for customers.

PRACTICE AND PROCEDURE

Contention that prior Commission decision, which pursuant to offer of settlement imposed sanction upon registered broker-dealer for alleged failure to supervise order clerk, prejudged issues with respect to order clerk, *rejected*.

APPEARANCES:

Lawrence Greenapple and *Arthur S. Olick*, of Otterbourg, Steindler, Houston & Rosen, for Edward Sinclair.

John Hardy, *pro se*.

Lawrence F. Westlock, for Richard Clark Anderson.

William D. Moran, *Kenneth S. Spirer*, *Samuel M. Feder* and *Ralph K. Keffler*, for the Division of Trading and Markets of the Commission.

FINDINGS, OPINION AND ORDER

These were private consolidated broker-dealer proceedings pursuant to Sections 15(b), 15A and 19(a)(3) of the Securities Exchange Act of 1934 ("Exchange Act") with respect to, among others, Edward Sinclair, who was the order clerk in the over-the-counter trading department of Filor, Bullard & Smyth ("Filor"), a registered broker-dealer, and John Hardy and Richard Clark Anderson, who held similar positions with Folger, Nolan, Fleming & Co., Inc. ("Folger"), a registered broker-dealer. The issues pertaining to Filor and Folger and the other respondents named in the proceedings have been resolved.[1] Following hearings, the hearing examiner filed an initial decision in which he concluded that Sinclair, Hardy, and Anderson should be barred from association with a broker or dealer, provided that after a period of 6 months applications may be made for our approval of their employment upon assurance as to assignment and supervision designed to prevent a recurrence of the violations found. We granted a petition for review filed by our Division of Trading and Markets ("Division") with respect to the adequacy of the sanctions imposed upon respondents, and a petition for review filed by Sinclair. Briefs were filed by the Division and Sinclair and we heard oral

[1] *Folger, Nolan, Fleming & Co., Inc.*, Securities Exchange Act Release No. 8489 (January 8, 1969); *Hoit, Rose & Co.*, Securities Exchange Act Release No. 8563 (April 7, 1969).

argument.[2] Our findings are based upon an independent review of the record.

INTERPOSITIONING

Between January and December 1965, Sinclair willfully violated or aided and abetted violations of the antifraud provisions of Section 17(a) of the Securities Act of 1933 and Sections 10(b) and 15(c)(1) of the Exchange Act and Rules 10b–5, 15c1–2, and 15c1–4 thereunder.[3]

Sinclair, pursuant to Filor's policy, received 30 percent of the commissions realized by Filor on business generated by him. In order to increase such business and commissions, he entered into a reciprocal arrangement with Hoit, Rose & Co. ("Hoit"), then an over-the-counter firm registered as a broker-dealer, under which Hoit directed business in securities listed on the New York Stock Exchange to Filor, and Sinclair, who handled all orders for unlisted securities for Filor, directed over-the-counter business to Hoit. When he directed a transaction to Hoit, Sinclair, as required by Filor, first called at least three broker-dealers who quoted the security involved in the daily sheets published by the National Quotation Bureau, Inc. He then advised Hoit of the best quotation obtained and offered to deal with Hoit at that figure irrespective of whether Hoit made a market in that security and notwithstanding Filor's instruction that all over-the-counter orders be executed with market makers listed in the sheets. In 1965, Sinclair directed 189 orders to Hoit in a large variety of securities which Hoit did not quote in the sheets or in which it did not maintain a position.[4] In 90 percent of the transactions where Hoit was thus interposed, it was able to execute the transaction simultaneously or within 10 minutes with another broker-dealer who customarily quoted the security in the sheets. An average of nine broker-dealers listed quotations in the current sheets for each of the securities involved in the transactions in question. In many instances the broker-dealer who executed the transaction for Hoit was one of those from whom Sinclair had obtained a quotation. Hoit's profit generally ranged from 1/8 to 1/2 and reached a high of 5 1/2, and its total profit on the 189 transactions in question amounted to about $8,500. About

[2] Hardy and Anderson did not file briefs on review or participate in the oral argument.

[3] Since the only issue before us on review with respect to Hardy and Anderson is the adequacy of the sanctions imposed upon them by the examiner, their violations are described below in our discussion of the "Public Interest".

[4] The 189 orders represented about 60 percent of the total number of over-the-counter orders directed by Sinclair to Hoit in 1965.

55 percent of Sinclair's commissions in 1965 were derived from the reciprocal business received from Hoit pursuant to their arrangement.

In order to conceal the interpositioning of Hoit from his supervisor, Sinclair as a rule falsely listed on the order ticket as executing dealer one of the broker-dealers appearing in the sheets, usually one he had called for a quotation. However, his practice was to enter Hoit's name on the copy of the ticket from which accounting entries were made and confirmations sent but which was not reviewed by the supervisor.[5] In 41, or 22 percent, of the transactions, the broker-dealer falsely listed by Sinclair was the one Hoit had used, and in two of those instances such executing dealers had not entered quotations in the sheets for the securities in question.

Sinclair argues that he exercised due diligence to obtain the best execution for Filor's customers because he obtained quotations from three or more dealers listed in the sheets before giving Hoit the opportunity to meet the best quotation and that there is no evidence that he could have obtained a better price by dealing directly with a dealer in the sheets. We reject this argument. As found by the hearing examiner, Sinclair has not overcome the case of interpositioning presented by the Division.[6] Hoit was in no better position to negotiate for and obtain the best price than Filor, which was a much larger firm than Hoit and had direct lines to about 20 over-the-counter dealers, including a number with whom Hoit executed some of the transactions.[7] Sinclair knew or should have known that he could obtain a better execution from the fact that Hoit was able to obtain a better price in a large number of transactions, simultaneously in 70 percent of them and within ten minutes in 20 percent more, and in many cases with the same dealers Sinclair had called for quotations. Indeed, the short amount of time needed by Hoit to better the so-called "best price" obtained by Sinclair would seem to indicate that the quotations recorded on the order tickets by Sinclair were false, or that he did not negotiate with the dealers from whom he obtained quotations, or that he did not negotiate in good faith to

[5] Filor terminated Sinclair's employment in December 1965 following discovery of his failure to comply with its directive requiring execution of over-the-counter transactions with broker-dealers quoting the particular security in the sheets and of his entry of false information on order tickets.

[6] See *Thomson & McKinnon*, 43 S.E.C. 785, 789 (1968): "In view of the obligation of a broker to obtain the most favorable price for his customer, where he interposes another broker-dealer between himself and a third broker-dealer, he *prima facie* has not met that obligation and he has the burden of showing that the customer's total cost or proceeds of the transaction is the most favorable obtainable under the circumstances."

[7] Cf. *H. C. Keister & Company*, 43 S.E.C. 164, 168 (1966).

ascertain the best price obtainable.[8] We cannot sanction any erosion of the broker's obligation to secure the best execution for his customers. As stated in *Thomson & McKinnon:*

> "We have on numerous occasions stressed the importance of the broker's fiduciary obligation to get the best price for his customer. Footnote omitted. That obligation is basic and vital to the broker-customer relationship. However, notwithstanding that obligation, . . . respondents engaged in the practice, over an extended period, of interposing a number of broker-dealers between their customers and the best market. It is evident that respondents subverted the interests of their customers to obtain profitable business in listed securities . . ., thus enriching themselves at the expense of their customers."[9]

We further note that Sinclair failed to disclose or cause disclosure to the customers that he interposed Hoit between them and the best available market, or the extent to which they paid more or received less than they would have if there had been no interpositioning and Sinclair had secured the best execution. This is not to imply, however, that disclosure of the interpositioning practice would have obviated its fraudulent character.[10]

There is also no merit in Sinclair's argument that because interpositioning is not expressly proscribed by statute or rule, the Commission should have adopted a rule outlawing it rather than doing so by adjudication. It is clear that we may interpret the antifraud provisions decisionally and that a specific rule is not necessary.[11]

[8] See *Report of Special Study of Securities Markets*, 88th Cong., 1st Sess., H. Doc. No. 95, Pt. 2, pp. 616–17 (1963).

Sinclair denied that he ever referred Hoit to another dealer with whom it could profitably effect the transactions, and asserted that his entry on order tickets of the names of the dealers who actually executed the transactions with Hoit was the result of coincidence. However, the number of tickets listing the names of such actual dealers, as well as the number of transactions executed simultaneously by Hoit at a better price than Sinclair quoted, would appear to cast doubt upon his assertion that only chance was involved.

[9] *Supra*, at pp. 788–89.

[10] We do not reach the question whether Sinclair's reciprocal arrangement with Hoit would be *prima facie* inconsistent with his duty to obtain best execution because of an inherent conflict of interest on Sinclair's part even in those transactions where Hoit made a market in the security so that no interpositioning as such was involved, or whether the reciprocal arrangement should have been disclosed to customers in such transactions.

[11] See *S.E.C.* v. *Chenery Corporation*, 332 U.S. 194, 203 (1947); *Charles Hughes & Co.* v. *S.E.C.*, 139 F.2d 434, 437–38 (C.A. 2, 1943). See also *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), where, in holding that the use of adverse inside information in the sale of a security violated the antifraud provisions although not expressly prohibited, we stated (at p. 911):

> "These anti-fraud provisions are not intended as a specification of particular acts or practices which constitute fraud, but rather are designed to encompass the infinite variety of devices by which undue advantage may be taken of investors and others.

Contrary to Sinclair's assertion, the prohibition against interpositioning is not based upon our 1968 ruling in *Thomson* v. *McKinnon, supra*, quoted above, which deals with the broker's burden of overcoming a showing that he interposed another broker between himself and a third broker. We held interpositioning to be violative of the antifraud provisions as early as 1942. *W. K. Archer & Company*, 11 S.E.C. 635, 642, *aff'd* 133 F.2d 795 (C.A. 8, 1943). Subsequent cases dealing with interpositioning and decided before *Thomson & McKinnon* include *H. C. Keister & Company, supra; Thomas Brown III*, 43 S.E.C. 285, 286 (1967); and *Delaware Management Company, Inc.*, 43 S.E.C. 392 (1967).

RECORD-KEEPING VIOLATIONS

In entering false information on the order tickets as to the name of the executing broker-dealer, Sinclair willfully aided and :betted violations of the record-keeping provisions of Section 17(a) of the Exchange Act and Rule 17a–3 thereunder. He also caused violations of those provisions in 19 instances in which he inadvertently recorded as the executing broker on copies of the order tickets the same false names as the ones on the original tickcts, which resulted in erroneous accounting entries and confirmations. He cannot escape responsibility for these additional violations because of their unintentional nature and the fact that they resulted from his own negligence in his efforts to conceal the interpositioning from his employer.

We disagree with Sinclair's contention that his falsification of the executing broker's name on the order tickets did not violate the records provisions because Rule 17a–3(b) does not require the order ticket to show the name of the executing broker. Sinclair was required by Filor's rules to enter the name of the executing broker on the order ticket, in addition to the names of the brokers he called and the quotations he received from them. We think that such information, which pertained to the order in a significant way and, if false, could mislead an investigator, was material and that entering material false information on an order ticket, although such information is not specifically required, constitutes a violation of the Rule.[12] Moreover, the requirement in Rule 17a–4 that order tickets be preserved would have little meaning if such tickets may contain material false information.

OTHER MATTERS

Sinclair filed a motion requesting that any Commissioner who participated in the Commission decision of January 8, 1969, which pursuant to an offer of settlement suspended the over-the-counter stock department of Filor for a period of days because of its alleged failure to supervise Sinclair,[13] should disqualify himself in the instant case. The motion further requested that consideration of this case be postponed until there were three Commissioners who had not participated in that decision.

There is no merit in the motion and it is denied. No prejudgment was involved. The 1969 decision was based on a stipu-

[12] *Cf. Southeastern Industrial Loan Company*, 10 S.E.C. 617, 631–32 (1941): "We have uniformly held that a volunteered statement not required in answering an item in a registration statement, if false and material may be the basis for a stop order."

[13] Securities Exchange Act Release No. 8489.

lated record and expressly stated that it was not binding on other respondents.[14] Our present decision is based solely on the record before us and in no way is influenced by our findings as to Filor based on its offer of settlement.

PUBLIC INTEREST

Sinclair asserts that the sanction imposed upon him by the hearing examiner is harsh in comparison to that imposed in other cases involving more serious misconduct and should be substantially reduced; that the customers were not harmed; that he was only 25 years old in 1965 and relatively new in the securities industry, having started in 1960 as a teletype operator and order clerk for Filor on the floor of the New York Stock Exchange; and that his previous record is clean.

It is well established that the remedial action which is appropriate in the public interest depends upon the facts and circumstances of each particular case and cannot be precisely determined by comparison with action taken in other cases.[15] It is clearly untenable to urge that customers who did not receive the best execution were not harmed. Sinclair's youth, asserted inexperience, and prior clean record do not detract from the gravity of the violations found.[16] He "should have been aware of his obligation to give the benefit of the best price to the customer and of the impermissibility of obtaining reciprocal business . . . at the expense of a customer." [17] And he knew and attempted to conceal that he was flouting for personal profit his employer's rules, which were obviously designed to secure the best price for customers. Under all the circumstances, including the serious nature and extent of the misconduct shown and the scheme he devised and carried out to conceal it from his employer, we find that the sanction which the examiner imposed on Sinclair is inadequate in the public interest. We do not believe that the investing public should be exposed to further risks of fraudulent conduct by a respondent who has demonstrated such disregard of the basic duty of fair dealing required of those engaged in the securities business. Accordingly, we conclude that he should be barred from association with any broker-dealer without qualification.

[14] See *Atlantic Equities Company*, 43 S.E.C. 354, 366 (1967), *aff'd sub nom. Hansen* v. *S.E.C.*, 396 F.2d 694 (C.A.D.C. 1968). *Cf. F.T.C.* v. *Cement Institute*, 333 U.S. 683, 701 (1948), which held, applying the rule of necessity, that an agency was not disqualified from deciding an administrative proceeding to determine the legality of certain practices even though it had already formed an opinion as to such legality, where it was the only agency empowered to make that decision.

[15] See *Winkler* v. *S.E.C.*, 377 F.2d 517, 518 (C.A. 2, 1967); *Dlugash* v. *S.E.C.*, 377 F.2d 107 (C.A. 2, 1967); *Hiller* v. *S.E.C.*, 429 F.2d 856 (C.A. 2, 1970); *Martin A. Fleishman*, 43 S.E.C. 185, 190 (1966).

[16] See *Ross Securities, Inc.*, 41 S.E.C. 509, 516 (1963).

[17] *Thomas Brown III*, 43 S.E.C. 285, 287 (1967).

With respect to Hardy and Anderson, the hearing examiner made the following findings: About October 1963, Hoit entered into a secret arrangement with them to obtain over-the-counter business from Folger. Hoit agreed to pay them 25 percent of its gross profits on such business.[18] Hardy or Anderson would check the market as to a particular security,[19] quote a price to Hoit, and Hoit would accept the order if it could execute the order at a better price. Between October 1963 and February 1966, Hoit accepted 1,456 orders in securities which it did not quote in the sheets or in which it did not maintain a position.[20] Of those orders, over 85 percent were executed by Hoit with a market maker in the sheets within 20 minutes for a risk-free profit of 1/8 to 1/2. In over 54 percent, the execution was simultaneous or reasonably contemporaneous. An average of 12 brokers were listed in the current sheets for each of the securities involved in the 1,456 transactions. Hoit realized a gross profit in excess of $100,000 on those transactions.[21] Hardy and Anderson each received about $12,000 from Hoit on all the over-the-counter transactions it effected with Folger during the period, and the amounts received by them monthly exceeded their maximum monthly earnings as order clerks. The arrangement between Hoit and these respondents was kept secret from Folger and Folger's customers. These respondents also failed to record on the order tickets the time when customers' orders were transmitted for execution. The examiner concluded, among other things, that Hardy and Anderson willfully violated or aided and abetted violations of the antifraud provisions of Section 17(a) of the Securities Act and Sections 10(b) and 15(c)(1) of the Exchange Act and Rules 10b-5 and 15c1-2 thereunder, and the record-keeping provisions of Section 17(a) of the Exchange Act and Rule 17a-3 thereunder.

The only specific reasons cited by the examiner for granting leniency to Hardy and Anderson were that they were very young when they entered into the arrangement with Hoit, had no previous business experience, and received low salaries which may have acted as a temptation. Their misconduct,

[18] This arrangement succeeded a similar one Hardy and Anderson had for about a year with another broker-dealer who was going out of business and referred Hoit to them. These respondents each derived an income of approximately $150 to $200 per month from the earlier arrangement.

[19] Anderson testified that, although Folger's procedures required the checking of three market makers for the best price, he was seldom able to take the time to do so because of his workload.

[20] During the period, a total of 1,615 over-the-counter trades were referred to and effected by Hoit.

[21] Hoit's gross profit on the remaining 159 over-the-counter transactions directed to it during the period was $2,927.

however, extended over a longer period and was even more reprehensible than Sinclair's. We do not think that the reasons cited by the examiner provide a sufficient basis, with due regard to the public interest, for assessing sanctions upon them of less than an unqualified bar.[22]

Accordingly, IT IS ORDERED that Edward Sinclair, John Hardy, and Richard Clark Anderson be, and they hereby are, barred from being associated with any broker or dealer.

By the Commission (Commissioners SMITH, NEEDHAM and HERLONG), Commissioner OWENS not participating.

[22] The exceptions to the initial decision of the hearing examiner are overruled or sustained to the extent that they are inconsistent or in accord with our decision.

IN THE MATTER OF

MIDDLE SOUTH UTILITIES, INC.

File No. 3-2004. Promulgated March 30, 1971

Public Utility Holding Company Act of 1935—Section 19

ORDER

Middle South Utilities, Inc., a registered holding company, filed an application-declaration pursuant to the Public Utility Holding Company Act of 1935 with respect to a proposal to acquire the outstanding stock of Arkansas-Missouri Power Company in exchange for shares of the common stock of Middle South. Middle South has public utility subsidiaries which operate in Arkansas, Mississippi and Louisiana. Arkansas-Missouri is a non-associated electric and gas utility company which operates in Arkansas and Missouri.

A Notice of Filing and Order for Hearing in connection with Middle South's proposal was issued by the Commission on June 25, 1969 (Holding Company Act Release No. 16416), which ordered that a hearing be held on August 5, 1969, and directed that any person desiring to be heard or proposing to intervene in the proceeding should file, on or before August 1, 1969, a written request as provided in Rule 9 of the Commission's Rules of Practice. In response to that notice, the Public Service Commission of Missouri filed a petition to intervene. A public hearing was held on August 5, 1969, at which evidence was adduced with respect to the proposed acquisition, and at which no one appeared in opposition to Middle South's proposal.[1] At the close of the public hearing the parties waived an initial decision by the hearing examiner, and Middle South consented to participation by the Division of Corporate Regulation in the preparation of the Commission's findings and opinion.[2]

[1] The Missouri Public Service Commission, which had stated that its petition to intervene was for the purpose of receiving information regarding the proceeding, made no appearance at the public hearing nor did it make any subsequent submissions.

[2] Subsequent to the close of the hearing, by stipulations between Middle South and the Division, certain additional exhibits and a memorandum from Middle South were included in the public record.

On November 18, 1970, the Cities of Lafayette and Plaquemine, Louisiana ("Cities"), filed a Notice of Appearance and requested that the hearing on the Arkansas-Missouri acquisition be reopened. The Cities alleged that, in violation of the Federal antitrust laws, Louisiana Power & Light Company, an electric utility subsidiary company of Middle South, in combination with two other investor-owned utility companies in Louisiana, has undertaken to thwart construction of large-scale generation and transmission facilities by Louisiana electric cooperatives and the effectuation of a power-pool comprising the cooperatives and the Cities. The stated reason for the requested reopening was to present testimony with respect to such alleged antitrust violation, unless Middle South should agree to conditions which would result in the cessation of the allegedly unlawful activities and the rectification of the damage claimed to have been done,[3] and the Cities contended that such relief is appropriate under the public interest standards of Section 10(b)(1) of the Act.

On December 14, 1970 the Cities filed a memorandum in support of their position. Middle South filed a memorandum in response and a Motion to Dismiss the Cities' notice of appearance and intervention, to which the Cities filed a reply. The Division filed a statement opposing intervention by the Cities.[4] It and Middle South asserted that notice of appearance was filed by the Cities at too late a date. In addition, Middle South asserted that the Cities are not "interested" municipalities in this proceeding, and that the issues sought to be raised by them are irrelevant to and beyond the scope of the present proceeding and that the Cities are attempting to utilize the proceeding to advance their interests in unrelated negotiations.

As indicated above, notice of the public hearing was given some 17 months prior to the filing of the Cities' petition, and the public hearing was held some 15 months prior thereto. Rule 9(a) of this Commission's Rules of Practice permits inter-

[3] The Cities in separate actions also have requested that action on two declarations filed by Louisiana Power, one seeking authority to issue first mortgage bonds and the other to issue short-term notes, be withheld pending investigation or hearing with respect to the same allegations of activities in Louisiana in violation of the Federal antitrust laws. Those requests were denied, and Louisiana Power's declarations were permitted to become effective. Holding Company Act Releases Nos. 16881 (October 27, 1970) and 16955 (December 5, 1970).

[4] The Division stated that in view of the facts that the status of the Cities in these proceedings was in question and that the Cities had not waived any rights with respect to separation of functions provided by the Administrative Procedure Act, the Division, without admitting that it was precluded from doing so, nevertheless was not undertaking to assist the Commission in considering the motion to dismiss but merely filing its statement of views regarding it.

vention by an interested municipality or other political subdivision of a State upon the filing of a written notice of appearance. The rule, however, cannot be deemed to grant, nor does an orderly administration of proceedings permit, an extension of that privilege for such a long period of time beyond the time fixed in the public notice of hearing for interested persons to request participation. Apart from the questions raised as to the standing of the Cities as "interested" municipalities, their notice of appearance in this case was untimely filed, and the Motion to Dismiss such appearance will be granted.

The Commission's Findings, Opinion and Order with respect to Middle South's proposal to acquire stock of Arkansas-Missouri will be issued in due course.

Accordingly, IT IS ORDERED that the Notice of Appearance by the Cities and their request that either certain conditions be imposed or the hearing be reopened be, and they hereby are, denied.

By the Commission.

IN THE MATTER OF

MAJOR REALTY CORPORATION

File No. 3-2623. Promulgated April 8, 1971

Securities Exchange Act of 1934—Section 15(c)(4)

REPORTING COMPLIANCE PROCEEDING

Annual reports filed under Securities Exchange Act of 1934, *held*, materially misleading and deficient, where they improperly reflected agreement to sell land as representing sales income, thus resulting in overstatement of net income and understatement of deficit in retained earnings, and where description of mortgage note receivable in connection with the agreement failed to disclose all circumstances relating to right to rescind agreement.

APPEARANCES:

Richard H. Rowe, *John S. Bernas*, *Richard B. Nesson* and *Theodore A. Doremus, Jr.*, for the Division of Corporation Finance of the Commission.

Alan S. Kramer of Shea, Gallop, Climenko & Gould, and *Joel R. Wells, Jr.*, of Maguire, Voorhis and Wells, for Major Realty Corporation.

FINDINGS, OPINION AND ORDER

This is a proceeding instituted pursuant to Section 15(c)(4) of the Securities Exchange Act of 1934 ("Exchange Act"), to determine whether Major Realty Corporation ("registrant") failed to comply with Section 13 of the Exchange Act by filing annual reports on Form 10–K for the fiscal years ended May 31, 1968 and 1969 which included untrue statements of material facts and omitted to state material facts required to be stated therein. Registrant, a Delaware corporation with its principal offices in Orlando, Florida, registered its common stock pursuant to Section 12(g) of the Exchange Act on November 27, 1965. Registrant reported that it had $12,718,581 in total assets as of May 31, 1970 and 8,342 stockholders of record as of June 8, 1970.

Registrant submitted an offer of settlement, pursuant to which it entered into a stipulation of facts, waived a hearing and post-hearing procedures, and, solely for the purposes of this proceeding, consented to findings consistent with the allegations in the Statement of Matters filed by our Division of Corporation Finance that the annual reports were misleading and deficient. Registrant, among other things, also agreed to file correcting amendments to such reports and to provide all its shareholders prior to its next annual meeting with a copy of our Findings and Opinion herein.

Upon consideration of all the circumstances, including the recommendation of the Division, we determined to accept the offer of settlement.

We find that registrant's 1968 10-K report included untrue statements of material facts and omitted material information required to be stated therein or necessary to make the statements therein not misleading, with respect to the accounting treatment of an agreement regarding a parcel of land.

During the year ended May 31, 1968, registrant entered into a contract to sell the land which provided, among other terms, that registrant had the right to rescind the sale if the buyer failed to commence construction of a regional shopping mall by June 1, 1969, but that if prior to June 1, 1969, the buyer furnished evidence of a lease or letter of intent to lease from at least one major department store, the date for commencement of construction could be extended to a date not later than June 1, 1970.

Pursuant to the contract, the buyer assigned its obligations under the contract to a wholly-owned subsidiary to which title to the land was transferred in April 1968, and registrant received a $25,000 cash down payment and a promissory note of the subsidiary in the amount of $3,475,000 secured by a first mortgage lien on the property. The note bore interest at 6 percent per annum commencing February 1, 1970 and the principal was payable in three equal annual installments beginning February 1, 1971.

Registrant's consolidated statements of income and deficit for the fiscal year ended May 31, 1968 which were filed as part of its 1968 10-K report reflected a recognition of income derived from the land transaction in the amount of $3,152,170 and a reduction in its Retained Earnings deficit by the same amount, and the note in the amount of $3,475,000 was included in the Mortgage Notes Receivable assets account in its consolidated balance sheet as of May 31, 1968. In these respects registrant improperly treated the land transaction as a reportable sale and thereby overstated income from sales of property with a resultant overstatement of net income in its income statements, and an understatement of the deficit in Retained Earnings in both the income statements and its balance sheet, in view of the facts that:

1. registrant received a down-payment representing less than one percent of the purchase price;

2. registrant retained the right, under certain conditions, to rescind the sale subsequent to closing, and no interest or principal payments were to be made until such right to rescind was no longer extant; and

3. The buyer's subsidiary which had assumed the buyer's obligation with respect to the transaction had assets of only a nominal amount, and the note given registrant by such subsidiary was a non-recourse note.

Under these circumstances, the transaction must be accounted for in a manner which follows its substance rather than its legal form. Registrant had obtained nothing more from the buyer than a deposit in exchange for an option to purchase the property if it was able to fulfill certain conditions. The purchaser at the date of signing the agreement, and for a long period thereafter, had so little economic interest in the property that the transaction could not be deemed a sale for accounting purposes.

The Commission in Accounting Series Release No. 95, dated December 28, 1962, stated that, "In some situations coming before us it appears from the attendant circumstances that the sale of property is a mere fiction designed to create the illusion of profits or value as a basis for sale of securities. Moreover, even in bona fide transactions the degree of uncertainty as to ultimate realization of profit may be so great that business prudence, as well as generally accepted accounting principles, would preclude the recognition of gain at the time of sale." The publication of this release should have been notice to registrant that the transaction should not have been recorded as a sale and that no profit should have been recorded on the transaction.

We also find that registrant's 1969 10-K report included untrue statements of material fact and omitted to state material facts required to be stated therein. As a result of the improper treatment of the land transaction in the 1968 report, the balance sheet in the 1969 report continued the understatement of the deficit in Retained Earnings.[1] The description of

[1] That balance sheet for the fiscal year ended May 31, 1969, reflected $5,895,437 in Mortgage Notes Receivable and a $3,901,628 deficit in Retained Earnings.

the mortgage note receivable with respect to the land transaction, was materially misleading in that it omitted to state that the underlying sale contract provided that registrant may elect to rescind the transaction if the buyer failed to start construction by June 1, 1969, that such date could be extended to June 1, 1970 if prior to June 1, 1969 the buyer furnished evidence of a lease or a letter of intent to lease from one major department store, and that the buyer failed to furnish such evidence and was not granted an extension to June 1, 1970.[2] On or about June 30, 1969, three months prior to filing the 1969 10-K report, in response to a request by the buyer for a 12 month extension of the terms of the contract relating to the start of construction, registrant notified the buyer of its willingness to grant an extension only until October 1, 1969, and further stated that registrant had elected to exercise its right to rescission under the contract unless the buyer agreed in writing by August 15, 1969 to accept the extension. No written agreement was ever given by the buyer.[3]

In view of the foregoing, we deem it appropriate in the public interest to accept the offer of settlement and to impose the conditions agreed to by registrant.

Accordingly, IT IS ORDERED, pursuant to the undertakings in registrant's stipulation, that registrant file correcting amendments to its reports and that it send copies of these Findings, Opinion and Order to all of its shareholders.

By the Commission (Commissioners OWENS, SMITH and NEEDHAM), Commissioner HERLONG not participating.

[2] The balance sheet incorrectly recited that mortgage notes receivables included

> "a note for $3,475,000 arising from the sale of land from which the Company recognized $3,152,170 in income during the year ended May 31, 1968. The Company may rescind the sale if the buyer fails to commence construction for a regional shopping mall on or before June 1, 1970. As of the date of this report, no construction has started."

[3] Registrant has reported that during the year ended May 31, 1970, it rescinded the sale and returned the $25,000 cash down payment and the promissory note, and that the buyer reconveyed the land to registrant.

IN THE MATTER OF

BARRACO AND COMPANY

and

PAUL BARRACO

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

File No. 3-2423. Promulgated April 16, 1971

Securities Exchange Act of 1934—Section 15A(g) and 15A(h)

REGISTERED SECURITIES ASSOCIATION—REVIEW OF DISCIPLINARY PROCEEDINGS

Violations of Rules of Fair Practice

Failure to Comply with Net Capital Requirements

Failure to File Subordination Agreements

Improper Extension of Credit

Failure to Maintain Written Supervisory Procedures

Dealing with Non-Member Broker-Dealers on Preferential Terms

Failure to Maintain Books and Records

In proceedings for review of action of registered securities association expelling member and revoking registration of member's president as registered representative, association's findings of violations of its rules based on failure to comply with Commission's net capital rule, to file subordination agreements with association, and to maintain written supervisory procedures and certain records, and on extension of credit in violation of Regulation T and dealing with non-member broker-dealers on preferential terms, *sustained*, but sanction imposed on president *modified* to suspension, in view of facts that gravamen of findings related to managerial matters in which president was inexperienced and had sought expert assistance, and several of association's findings of violation set aside.

APPEARANCES:

Norman S. Johnson, of Gardiner & Johnson, for applicants.

Lloyd J. Derrickson, *Frank J. Wilson*, and *Andrew McR. Barnes*, for the National Association of Securities Dealers, Inc.

FINDINGS, OPINION AND ORDER

Barraco and Co., a member of the National Association of Securities Dealers, Inc. ("NASD"), and Paul Barraco, its president, seek review, pursuant to Section 15A(g) of the Securities Exchange Act of 1934 ("Act"), of disciplinary action taken against them by the Association. The NASD, on the basis of findings that applicants violated certain of its Rules of Fair Practice, expelled the firm from NASD membership, revoked the registration of Barraco as a registered representative, and assessed costs. Applicants and the NASD filed briefs with us. On the basis of our review of the record, we make the following findings.

VIOLATIONS OF RULES OF FAIR PRACTICE

1.(a) The NASD found a violation of Section 1 of Article III of the NASD's Rules of Fair Practice,[1] in that the firm's net capital as of January 31, 1969, did not comply with our net capital rule.[2] The net capital deficiency existed because two loans totaling $44,500 were includible in indebtedness since copies of subordinated loan agreements with respect to such loans, dated January 1, 1969, were not filed with us.[3]

Applicants do not deny that the subordination agreements had not been filed with us as of January 31, 1969, and do not deny that, reflecting the two loans in the computation of net capital, there was a deficiency under our rule. They argue, however, that a net capital infraction does not constitute a violation of any NASD rule, and they further claim that the firm's actual financial position was not deficient since the net capital deficiency arose only because of "technical reasons." [4]

Applicants' arguments are without merit. We have approved the NASD's practice of considering violations of the Act and the rules thereunder to be violations of Section 1.[5] Moreover, we do not agree that failure to comply with any provisions of our net capital rule, which is designed to assure the financial

[1] Section 1 requires observance of "high standards of commercial honor and just and equitable principles of trade."

[2] Rule 15c3-1 under Section 15(c)(3) of the Act.

[3] The NASD, using figures submitted by the firm to the NASD's national office, found that the ratio of the firm's aggregate indebtedness to its net capital, as computed under our rule, was 26.71 to 1. However, there is another computation in the record as of the date in question, made by the staff of the NASD's District Committee from figures submitted to it, which shows a ratio of 20.5 to 1. The record does not otherwise explain this discrepancy.

[4] Contrary to applicants' further contention, the NASD's complaint explicitly charged a violation of Section 1 of Article III of the NASD's Rules based on a failure to comply with our net capital rule.

[5] *Joseph Blumenthal*, 41 S.E.C. 133, 136 (1962); *Valley Forge Securities Co., Inc.*, 41 S.E.C. 486, 488 (1963); *Cf. Bennett-Manning Company*, 40 S.E.C. 879, 882 (1961).

responsibility of broker-dealers, can be disregarded as merely "technical." [6] In keeping with the objective of that rule, liabilities which are subordinated to the claims of general creditors pursuant to a "satisfactory subordination agreement" are excluded from the computation of a firm's "aggregate indebtedness" and net capital.[7] A "satisfactory subordination agreement" as defined in the rule must include certain provisions, and copies thereof with certain accompanying documents and specified information must be filed with the appropriate Regional Office of this Commission.[8] Until and unless such filings are made, it cannot be determined whether the agreement satisfies the requirements of the rule and therefore provides the requisite creditor protection. Since the subordination agreements were not filed as of January 31, 1969, the liabilities in question were properly included in the computation of the firm's aggregate indebtedness and net capital position, and a deficiency resulted.

Accordingly, we affirm the NASD's finding of violation with respect to compliance with the net capital rule.

(b) The NASD found further violations of Article III, Section 1, in that the firm failed to file copies of the above subordinated loan agreements with us, and failed to file with the NASD copies of such agreements and of five other subordination agreements covering loans to the firm totaling about $57,000. The firm admittedly failed to file copies of subordination agreements with the NASD, as required by a resolution of the Association's Board of Governors.[9] We do not, however, find Barraco responsible for such failure under the circumstances shown by the record. Barraco had instructed the firm's secretary and treasurer to file copies of subordination agreements, and that officer, who is an attorney, did not file copies with the NASD because he was unfamiliar with the NASD's requirement. The record does not show that Barraco knew or should have known that the officer had failed to carry out the responsibility which had been assigned to him.[10]

We also cannot find that the failure to file copies of the January 1, 1969 agreements with us constituted a violation. A failure to file subordination agreements with us is not itself a

[6] See *Blaise D'Antoni & Associates, Inc.* v. *S.E.C.*, 289 F.2d 276, 277 (C.A. 5, 1961) where the court stated, "The net capital rule is one of the most important weapons in the Commission's arsenal to protect investors."

[7] Rule 15c3-1(c)(1)(I) and (c)(2)(G).

[8] Rule 15c3-1(c)(7).

[9] NASD Manual §4111, p. 4046.

[10] *Cf. H. C. Keister & Company*, 43 S.E.C. 164, 170–71 (1966).

violation of any section of the Act or the rules thereunder, and there is therefore no basis for finding it a violation of the NASD Rules.

Accordingly, we affirm the NASD's finding of a violation by the firm resulting from its failure to file subordination agreements with the NASD, and set aside the other findings of filing violations.

2. The NASD found that the firm, from December 1968 to February 1969, extended credit in violation of Regulation T of the Federal Reserve Board by failing to cancel or liquidate 48 cash purchases by customers when payment was not received within the prescribed 7-day period.

Applicants admitted some of the violations, and, as to others, claimed that the firm's books, on the basis of which the NASD made its findings, were in error. However, no documentation was submitted in support of such claim, and, under the circumstances, the NASD properly relied on the firm's books.[11] We therefore affirm the NASD's findings that applicants also violated Section 1 of Article III of the NASD's Rules in this respect.

3. The NASD found that applicants, in violation of Sections 1 and 27 [12] of Article III, failed to maintain written supervisory procedures and failed to exercise proper supervision over customers' accounts.

Applicants admittedly had not prepared written supervisory procedures at the time of the NASD's examination, and the fact that they were in the process of doing so cannot excuse their failure to comply with the NASD's requirements. We accordingly sustain the NASD's findings of violation in this respect.

With respect to applicants' supervision of customer accounts, the NASD introduced into evidence transcripts of various of such accounts, including those of certain persons against whom we had obtained injunctions against violations of the registration provisions of the Securities Act of 1933 or with respect to whom we had taken disciplinary action. The NASD found that the firm failed to maintain a ledger showing a complete record of each customer's transactions, and an overall position record for each security, and it concluded that

[11] *Guardian Investment Corporation*, 41 S.E.C. 850, 851–2 (1964); *Madison Management Corp.*, 42 S.E.C. 390, 393 (1964).

[12] Section 27(a) requires the establishment, maintenance and enforcement of written procedures which will enable proper supervision of a member's representatives and associated persons. Section 27(d) requires periodic examination of customer accounts to detect and prevent irregularities or abuses.

"Barraco's record-keeping was so deficient that he in no way could have recognized improper conduct on the part of such customers had they attempted it." It also concluded that in view of the firm's volume it was impossible for Barraco, who was the only active principal responsible for review but who also acted as trader and salesman, to exercise proper supervision of customers' accounts. The Association, however, made no charge or finding that any irregularities had in fact occurred in the accounts.

The NASD noted that the firm kept bound monthly compilations of the statements of account which it sent to all of its customers each month detailing their activity for that period, and maintained a daily computer print-out showing the positions of all securities. Barraco testified that he made a daily check of all trades in customer accounts, all of which were "more or less" his although he employed one or two salesmen during the period in question; that he reviewed all customers' monthly statements to see, among other things, how much trading there was in a particular stock or by a particular customer; and that he was aware that certain of his customers had had difficulties with the NASD and this Commission and therefore watched their accounts very closely.

We agree with the NASD that review of customers' activity would be more feasible if all monthly statements for a particular customer were kept together, so that his account could be reviewed without the necessity of inspecting monthly statements dispersed in several bound volumes. We cannot, however, conclude on the basis of this record that applicants were unable to make an appropriate review of the activity in customers' accounts, or that the review which they made was inadequate. Accordingly, we set aside the NASD's findings of violation of Sections 1 and 27(d) with respect to applicants' review of such accounts.

4. The NASD found that applicants violated Sections 1 and 25 of Article III by dealing with three non-member broker-dealers on terms different than those accorded the general public.[13] Applicants assert that their violations were unintentional and that they were erroneously advised by a member of the NASD staff that one of the three brokers was an Association member. However, applicants dealt with the broker in question on preferential terms prior to receiving any advice

[13] Section 25 prohibits a member from dealing with any non-member broker or dealer except at the same prices, commissions, fees, terms or conditions as are by such member accorded to the general public.

from the NASD, and the fact that their violations may have been unintentional cannot excuse their failure to comply with the requirements of Section 25. We therefore affirm the Association's findings of violation in this respect.

5. The NASD found that applicants failed to maintain properly various books and records:

(a) Rule 17a–3(a)(4)(D) promulgated by us under the Act requires broker-dealers to maintain a record of "monies borrowed." The firm did not show as monies borrowed in its records certain short term loans which it obtained from four individuals including its secretary-treasurer and its accountant. Instead, such loans were merely reflected as credits to those individuals' customer accounts and, upon payment of the loans, offsetting debits were entered in those accounts. The facts that applicants' accountant advised them to handle the loans in this manner and that they discontinued this practice upon being advised by the NASD to do so, while they may be considered in mitigation, do not negate the Association's findings that applicants failed to comply with the record-keeping rule and thereby violated Section 1 of Article III, and those findings are affirmed.

(b) Section 21(c) of Article III of the NASD's Rules requires a member to keep and preserve a separate file or separate record of all written customer complaints. Barraco testified that although no separate file or record was kept of all complaints, each complaint was preserved in the individual customer's file. This clearly did not comply with the NASD's requirement, and we affirm the Association's finding that in this respect applicants violated Sections 1 and 21(c).

(c) The NASD found that applicants violated Sections 1 and 21(b) of Article III of the NASD's Rules because a number of the firm's accounts, at least one of which was a corporation, were listed in group or other names which did not disclose the names of all the individual beneficial owners. Applicants assert that they made an effort to list all known beneficial owners of an account. Section 21(b) provides that each member shall maintain accounts of customers "in such form and manner" as to show, among other things, the customer's name and address. The only definition of "customer" provided by the Rules is that the term "shall not include a broker or dealer".[14]

[14] Article II, Section 1(f).

Our Rule 17a–3(a)(9) under the Act requires every broker-dealer to maintain a record for each cash and margin account containing the name and address of the beneficial owner of the account, provided, however, that "in the case of a joint account or an account of a corporation, such records are required only in respect of the person or persons authorized to transact business for such account."

The NASD District Committee, whose decision was affirmed by the NASD Board of Governors, recognized that "Section 21(b) does not specifically refer to group accounts" but concluded that it was "essential . . . to have information available as to the make-up of any group."

We agree with the NASD that it may be desirable for a broker to obtain information with respect to all beneficial owners of investment club and other group accounts. However, we do not consider that Section 21(b) spells out such a requirement with sufficient clarity to justify findings of violation by applicants for failing to observe it. Such findings are accordingly set aside.

(d) Our Rule 17a–3(a)(5) under the Act requires, among other things, that broker-dealers maintain a record "reflecting separately for each security" all "long" or "short" positions carried for the account of the broker-dealer or his customers. As indicated above, and as found by the NASD, the firm maintained a position record consisting of daily computer print-outs, each print-out setting forth separately for each security the required position information for one day. The NASD concluded that applicants failed to comply with the Rule since, although "by going through the record, day by day, one could see the overall activity in each particular security," it would be "extremely cumbersome" to determine changes in a security's position over a period of time.

While we agree with the NASD that it would be preferable for a broker-dealer to maintain a separate ledger or other record for each security, we are unable to find that the firm's position record did not comply with the requirements of our Rule.[15] We therefore set aside the NASD's finding that applicants violated Sections 1 and 21(a), which latter Section requires a member to keep and preserve records in conformity with all applicable laws and rules.[16]

PUBLIC INTEREST

Applicants urge that the sanctions imposed on them by the NASD are excessive. They assert, among other things, that the NASD examination which resulted in the present proceeding was the first and only routine examination of the firm by the Association; that the firm at the time was small and relatively

[15] The NASD also found that the firm's position record did not show the location of all securities as required by the Rule. However, on the record before us, we are unable to sustain that finding.

[16] The record also does not support, and we set aside, the NASD's finding that applicants violated Section 1 of Article III by failing to maintain a separate file for advertising and sales literature, as required by the NASD's Advertising Interpretation.

new in the business; that Barraco, who had no previous managerial experience, was the only active principal, sought legal and accounting advice and assistance, and undertook to remedy the deficiencies found by the Association; that the violations of Regulation T were due to a newly installed computer and inefficient employees; that the method of accounting for short term loans, which was changed when the matter was brought to Barraco's attention, had been instituted on the advice of the firm's accountant; and that the fact that certain of their customers had previously been in difficulties with this Commission or the NASD improperly colored the NASD's findings.

The NASD was of the view that the numerous violations indicated that the member's procedures with respect to internal control, record-keeping, supervision and review of accounts were entirely inadequate, and it noted that subsequent to the institution of the proceedings, the firm filed a voluntary petition under Chapter 11 of the Bankruptcy Act.[17]

We have considered all the factors relating to the sanctions imposed by the NASD. Under all the circumstances, noting particularly that the gravamen of the findings relate to managerial matters as to which Barraco was inexperienced and made efforts to obtain expert advice and assistance, and also taking into account the fact that several findings of violations have been set aside, we conclude that, while expulsion of the firm from NASD membership is appropriate, revocation of Barraco's registration is excessive, having due regard to the public interest. We conclude that it would be appropriate in the public interest to suspend Barraco's registration for a period of 30 days, and to provide that for a period of one year he may not become registered with a member firm as a principal exercising managerial functions.

Accordingly, IT IS ORDERED that the action of the National Association of Securities Dealers, Inc. expelling Barraco and Co. from membership in the Association, revoking the registration of Paul Barraco as a registered representative, and imposing costs be, and it hereby is, modified to provide

[17] In addition, it appears that pursuant to its consent in injunctive and administrative proceedings instituted against the firm by us, in which it did not admit the allegations against it, the firm was permanently enjoined from violations of the registration provisions of the Securities Act of 1933 (Civil Action File No. C 44–69, U.S.D.C., D. Utah, September 2, 1969), and its broker-dealer registration was suspended for 30 days (Securities Exchange Act Release No. 8704, September 24, 1969). Subsequently, again pursuant to the firm's consent without admitting the allegations against it, the firm was permanently enjoined from violations of the net capital and bookkeeping provisions of the Exchange Act (Civil Action File No. C 368–69, U.S.D.C., D. Utah, November 19, 1969).

that Barraco's registration be suspended for a period of 30 days and that for a period of one year after the effective date of such suspension Barraco shall not be registered with a member firm as a principal, and that the action of the Association in all other respects be, and it hereby is, affirmed. The suspension of Barraco shall be effective as of the opening of business on April 26, 1971.

By the Commission (Commissioners OWENS, SMITH, NEEDHAM and HERLONG).

In the Matter of

MIDDLE SOUTH UTILITIES, INC.

File No. 3-2004. Promulgated May 5, 1971

Public Utility Holding Company Act of 1935—Sections 6, 7, 9 and 10.

ACQUISITION BY REGISTERED HOLDING COMPANY OF SECURITIES OF NON-AFFILIATE PUBLIC UTILITY COMPANY

Application-declaration by registered holding company proposing acquisition of common and preferred stocks of non-affiliate gas and electric utility company (to be followed by disposition of non-affiliate's gas and non-utility properties), *granted and permitted to become effective*, the Commission finding that acquisition would tend towards economical and efficient development of integrated electric system, that consideration to be paid for securities is fair and reasonable, that acquisition will not result in concentration of control of kind or to extent detrimental to public interest or interest of investors or consumers, and that other applicable standards of Public Utility Holding Company Act of 1935 are satisfied.

APPEARANCES:

Daniel James and Anthony W. Graziano of Cahill, Gordon, Sonnett, Reindel & Ohl, for Middle South Utilities, Inc.

Aaron Levy, R. Moshe Simon and H. Kennedy Linge, for the Division of Corporate Regulation of the Commission.

FINDINGS AND OPINION OF THE COMMISSION

This is a proceeding on an application-declaration filed by Middle South Utilities, Inc. ("Middle South"), a registered holding company, pursuant to Sections 6, 7, 9 and 10 of the Public Utility Holding Company Act of 1935 ("Act") and Rule 50 promulgated thereunder. Middle South proposes to exchange its shares of common stock for each outstanding share of common stock and preferred stock of Arkansas-Missouri Power Company ("Ark-Mo"), a non-associate electric and gas utility company. After appropriate notice,[1] a public hearing

[1] Holding Company Act Release No. 16116 (June 25, 1969).

was held, at which evidence was adduced with respect to the proposed acquisition.[2] Post-hearing procedures were waived.

DESCRIPTION OF THE COMPANIES INVOLVED

Middle South owns all of the outstanding shares of common stock of four public-utility companies which distribute electric energy to approximately 1,100,000 customers in Arkansas, Mississippi and Louisiana. Its subsidiary company, Arkansas Power & Light Company ("AP&L"), provides electric service in the eastern part of Arkansas. The remaining subsidiary companies are Louisiana Power & Light Company and Mississippi Power & Light Company, which provide electric service in Louisiana and Mississippi, respectively, and New Orleans Public Service Company, which in addition to providing electric service in the City of New Orleans, distributes natural gas at retail and operates a passenger transit system in that City.

As of April 30, 1970, the Middle South system had consolidated assets, less accumulated reserves, of $1,649,640,092 and for the year then ended, consolidated gross operating revenues of $425,866,666 and consolidated net income of $55,073,466 Middle South's common stock, $5 par value, of which there were 38,457,334 shares outstanding as of the same date, is listed and traded on the New York Stock Exchange. As of April 30, 1970, AP&L had consolidated assets, less accumulated reserves, of $550,783,323.

Ark-Mo distributes electricity and natural gas at retail in northeast Arkansas and an adjoining area in southeast Missouri. Ark-Mo's wholly-owned subsidiary company, Associated Natural Gas Company ("Associated"), is engaged in the distribution of natural gas at retail in other areas of Missouri. Ark-Mo and Associated, combined, provide electric service to approximately 49,500 customers and natural gas at retail to approximately 51,400 customers. Ark-Mo owns relatively little generating capacity. Its two hydro-electric units, one installed in 1900 and the other in 1910, have an aggregate capacity of 1.4 mw, and serve primarily for standby and peak-shaving purposes. Its principal unit, installed in 1950, has a rated capacity

[2] The Public Service Commission of Missouri petitioned to intervene in the matter, but made no appearance at the public hearing. A stockholder of Ark-Mo, in a letter expressing his view, indicated that the exchange is unfair to Ark-Mo. On November 18, 1970, the Cities of Lafayette and Plaquemine, Louisiana ("Cities"), filed a Notice of Appearance and requested that, unless Middle South consented to the imposition of certain conditions, the hearing be reopened. Middle South filed a motion to dismiss such petition; and our Division of Corporate Regulation supported Middle South's motion. On March 30, 1971 (44 S.E.C. 530), we issued an order granting the Motion to Dismiss and denying the Cities' request on the ground that it was not timely filed.

of 33 mw. In 1969 Ark-Mo generated only 4.7 percent of its total energy sold. The bulk of its requirements are purchased from other companies, principally AP&L.

As of April 30, 1970, Ark-Mo had consolidated assets, less accumulated reserves, of $56,967,343, and its consolidated gross operating revenues for the year then ended were $29,487,650 of which $19,275,843 were derived from the electric business and $10,211,807 from the gas business. Consolidated net income for the year 1969 was $1,999,739. Ark-Mo's common stock, $2.50 par value, of which 2,291,988 shares were outstanding as of April 30, 1970, is traded over-the-counter.

THE PROPOSED TRANSACTIONS

Middle South's offer to exchange 0.7 of a share of its common stock for each share of Ark-Mo common stock will be made over an initial period of approximately 30 days, which may be extended by Middle South for up to two addtional 30-day periods, with any further extension subject to approval by us. Acceptance by the holders of not less than 80 percent of the outstanding shares of Ark-Mo common stock is required for the exchange offer to become effective. No fractional shares of Middle South common stock will be issued, and the common stockholders of Ark-Mo will be entitled to purchase additional fractional interests required to make up a full share or to sell the fractional interest to which he would otherwise be entitled.

Middle South further proposes to acquire all the 40,900 shares of Ark-Mo's 4.65 percent cumulative preferred stock outstanding, $100 par value per share, on the basis of an exchange of 4$^1/_8$ shares of Middle South common stock for each share of Ark-Mo preferred stock. Ten financial institutions, which own all such shares of preferred stock, have agreed to the exchange, if the holders of the requisite number of shares of Ark-Mo's common stock accept the offer to be made to such holders.

APPLICABLE STATUTORY STANDARDS

Integration Aspects of the Proposed Acquisition

Under Section 10(c)(2) of the Act, we may not approve Middle South's proposed acquisition of Ark-Mo common stock unless we find that it ". . . will serve the public interest by tending towards the economical and efficient development of an integrated public-utility system", as defined in Section 2(a)(29)(A).[3]

As of December 31, 1969, Middle South's subsidiary companies owned and operated 7,504 miles of transmission lines (of which 6,792 miles are 161 kv capacity and 712 miles are 500 kv) and 53,252 miles of distribution lines. As of September 30, 1969, Ark-Mo owned and operated approximately 1,090 miles of transmission lines, of which about 253 miles are 161 kv, and approximately 219 miles of distribution lines serving 85 communities.

Ark-Mo is physically interconnected with the Middle South system, through AP&L, at three locations and an additional interconnection of 161 kv is currently under construction. AP&L will continue to provide a substantial amount of Ark-Mo's energy requirements. Ark-Mo has contracted to purchase annually, commencing in 1974, approximately 700,800 mwh from the City of New Madrid, Missouri, which is constructing a power plant with a design capacity of 600 mw, primarily to serve an aluminum-reduction plant under construction. Even after deliveries of electric energy from the New Madrid plant commence, however, AP&L will supply between 30 percent–40 percent of Ark-Mo's energy requirements.

The acquisition of Ark-Mo by Middle South will result in only a relatively small increase in the number of electric customers served by Middle South (4.5 percent) and in total energy sales (4.4 percent). Considering the overall size of Middle South, the relative size of the acquired company and the area or region affected the Middle South system as thus constituted will meet the standards of Section 2(a)(29)(A), and we also make the requisite affirmative finding under Section 10(c)(2) of the Act.

Section 10(c)(2) precludes the acquisition by Middle South of Ark-Mo's retail gas properties as well as of the latter's interest in Associated.[4] Ark-Mo also owns 100 percent of Ark-Mo Ice Company, a small business with $50,000 of assets as of April 30, 1970, and an operating deficit of $9,000 for the twelve months then ended. Middle South has stated that it will dispose of

[3] Section 2(a)(29) defines "integrated public utility system" to mean:

"(A) As applied to electric utility companies, a system consisting of one or more units of generating plants and/or transmission lines and/or distribution facilities, whose utility assets, whether owned by one or more electric utility companies, are physically interconnected or capable of physical interconnection and which under normal conditions may be economically operated as a single interconnected coordinated system confined in its operations to a single area or region, in one or more States, not so large as to impair (considering the state of the art and the area or region affected) the advantages of localized management, efficient operation, and the effectiveness of regulation."

[4] See, *Illinois Power Company*, 44 S.E.C. 139 (1970).

these properties after the tender offer has been consummated. In addition, as noted above, Middle South owns a subsidiary company which has provided both electric and gas services and operated a transit system in New Orleans for a period of years extending prior to the passage of the Act. In 1953 the Commission considered the unresolved problems of the Middle South system under Section 11(b)(1) and, with respect to New Orleans, stated that:

> "[i]n view of the expressed policy of the city with respect to its strong desire for continued unified operations and in view of the New Orleans franchise situation, we do not propose at this time to take any action with respect to the gas and transportation properties of New Orleans under the standards of Section 11 (b)(1) of the Act."[5]

In view of those factors, we do not believe that the issues relating to the situation in New Orleans should be determined in this proceeding. We shall consider this problem in an appropriate proceeding as soon as practicable.

CONCENTRATION OF CONTROL ASPECTS OF THE PROPOSED ACQUISITION

Under Section 10(b)(1) of the Act, we cannot approve an acquisition which "will tend towards interlocking relations or the concentation of control of public-utility companies, of a kind or to an extent detrimental to the public interest or the interest of investors or consumers." This provision also requires us to consider the proposed acquisition in the light of Federal antitrust policies.[6]

As indicated above, in terms of the overall size of Middle South, the addition of Ark-Mo's electric properties would represent at most a minimal increase in the size of the Middle South system and would not affect significantly either its relative position in Arkansas or in the general region in which it serves. Accordingly we make no adverse findings under Section 10(b)(1).

THE REASONABLENESS OF THE CONSIDERATION

Under Section 10(b)(2) of the Act, we may not approve the proposed acquisition if the terms of the exchange offer are "not reasonable or [do] not bear a fair relation to the sums invested in or the earning capacity of the underlying utility

[5] *Middle South Utilities, Inc.*, 35 S.E.C. 1, 15. The electric, gas and transportation properties are operated by a single company. Its rate base and allowable rate of return are determined on a combined basis for all three services.

[6] *Municipal Electric Association of Massachusetts* v. *S.E.C.*, 413 F.2d 1052 (C.A. D.C., 1969); *Northern Natural Gas Company* v. *F.P.C.*, 399 F.2d 953 (C.A. D.C., 1968).

assets." Among the factors to be considered are the respective earnings, dividends, book values, market values and capitalization ratios applicable to the Middle South common stock and the Ark-Mo common and preferred stocks.

The following table presents comparative data for the Ark-Mo and Middle South common stocks.

TABLE I

	Ark-Mo Per Share	Middle South Per 0.7 Share*
Earnings:		
1966	$0.74	$0.84
1967	0.71	0.87
1968	0.76	0.91
1969	0.76	1.04
Twelve months ended 4/30/70	0.79	1.07
1970 (estimated)	0.84	1.09
1971 (estimated)	0.91	1.17
Dividends:		
1966	0.50	0.49
1967	0.52	0.54
1968	0.52	0.58
1969	0.55	0.62
Twelve months ended 4/30/70	0.56	0.64
Book Values:		
April 30, 1970	6.62	8.58
Market Prices:		
Six month period ended 12/31/68		
High	$12^{3}/_{4}$	$18^{3}/_{4}$
Low	$10^{3}/_{4}$	$15^{1}/_{4}$
Average	12	$16^{3}/_{4}$
Six month period ended 6/30/69		
High	$13^{3}/_{4}$	$18^{1}/_{8}$
Low	$11^{1}{}_{8}$	$14^{5}/_{8}$
Average	$12^{1}/_{2}$	$16^{3}/_{8}$

*Pro forma, giving effect to the proposed exchange of 0.7 of a share and $4^{1}/_{8}$ shares, respectively, of Middle South common stock for each Ark-Mo common and preferred share. Earnings per share for Middle South were computed on the basis of average number of shares outstanding.

Consummation of the proposed exchange of 0.7 shares of Middle South common stock for each share of Ark-Mo common stock would result in the issuance by Middle South of approximately 1,604,370 shares of its common stock if all of Ark-Mo's common stock were tendered. The proposed exchange of $4^{1}/_{8}$ shares of Middle South common stock for each share of Ark-Mo preferred stock would require the issuance of an additional 168,713 shares of Middle South common stock. As of April 30, 1970, Middle South had 38,457,334 shares of common stock outstanding, 3,100,000 of which had been sold on April 22, 1970.

It is clear from the above table that, on the basis of earnings, dividends, book values, and market prices, the proposed exchange offer is fair to the Ark-Mo common stockholders. In terms of comparative market prices we have considered market prices of Ark-Mo only prior to the announcement of the exchange offer at the end of February 1969.[7] We note, however, that average prices of Ark-Mo common stock for the six months ended December 31, 1968 and for the following six months do not differ significantly.

Duff & Phelps, Inc. was engaged by Middle South and Ark-Mo to assist in determining fair exchange ratios for the preferred and common stock of Ark-Mo. In a report submitted by it, it recommended an exchange offer within the range of 0.65 to 0.8 of a share of Middle South common stock for each share of Ark-Mo common stock. At the hearing, its representative, after having reviewed the actual earnings for 1968 and estimated earnings presented by Middle South and Ark-Mo for the years 1969 through 1971, qualified his prior opinion by stating that he would recommend an exchange ratio closer to the lower end of the range.

The exchange of Ark-Mo's 4.67 percent $100 preferred stock for $4^{1}/_{8}$ shares of Middle South common is fair to the holders of Ark-Mo's preferred stock. The preferred stock was sold by Ark-Mo at the par value of $100 per share. Pro forma earnings for the year ended April 30, 1970 for the $4^{1}/_{8}$ shares of Middle South common stock offered in exchange were $6.31 and dividends were $3.96. There are no market prices for the Ark-Mo preferred stock and, in the light of prevailing interest rates, it can be expected that the preferred stock would sell substantially below par. The average of market price of Middle South common stock for the six months ended June 30, 1970 was $21^{3}/_{4}$ per share, and on this basis the $4^{1}/_{8}$ shares would have a value of 89.72.[8]

The exchange offer is not unfair to the common stockholder of Middle South. If the exchange offer had been consummated as of April 30, 1970, earnings per share for the year then ended have been reduced from $1.55 to $1.53. This is a minimal dilution; it does not appear to affect Middle South's current dividend of $0.92 per share; and the indicated dilution does not reflect projected savings to Ark-Mo as a result of the acquisition.

In view of the above, and considering that the exchange

[7] See, *Penzoil company*, et al., 43 S.E.C. 709, 736–37 (1968), and cases cited therein.

[8] The average market price of Middle South's common stock in the first quarter of 1969 was about $23^{1}/_{2}$, so that the average market price for the $4^{1}/_{8}$ shares at the time of the agreement was about 97.

ratios were determined at arm's-length bargaining, we make no adverse findings under Section 10(b)(2) of the Act.

OTHER MATTERS

We also find that the proposed acquisition by Middle South of Ark-Mo common stock meets other applicable standards of Section 10 of the Act and that no adverse findings are necessary. The issuance of common stock by Middle South meets the standards of Section 7 of the Act, and the proposed acquisition insofar as necessary has been approved by the Public Service Commission of Missouri. The effect of the proposed acquisition on the Middle South capital structure is insignificant, as shown on Table II appearing below.

As at April 30, 1970

TABLE II

(000 omitted)

	Middle South Consolidated		Ark-Mo		Pro Forma Combined	
	Amount	Percent	Amount	Percent	Amount	Percent
Long-term debt	$ 766,778	55.7	$23,361	54.7	$ 790,139	55.7
Preferred	135,848	9.9	4,090	9.5	135,848	9.6
Common stock & surplus:						
Common stock	192,287	14.0	5,730	13.4	201,153	14.2
Capital surplus	87,284	6.3	3,533	8.3	97,798	6.9
Earned surplus	194,376	14.1	6,026	14.1	194,376	13.6
Total Common Equity	473,947	34.4	15,289	35.8	493,327	34.7
Total Capitalization	$1,376,574	100.0	$42,740	100.0	$1,419,314	100.0

If not all Ark-Mo shares are tendered, there will remain outstanding a publicly held minority interest in Ark-Mo, contrary to Sections 10(c)(1) and 11(b)(2).[9] Middle South has agreed to eliminate any such interest by submitting a plan pursuant to Section 11(e) of the Act. Middle South also agreed to dispose of direct and indirect interests in the Ark-Mo gas properties and Ark-Mo Ice Company pursuant to such a plan. It will also retire the outstanding Ark-Mo preferred stock it will acquire. Jurisdiction will be reserved with respect to all of the foregoing as well as with respect to the fees and expenses incurred in connection with the proposed acquisition. Under Section 10(e) of the Act, we may impose such conditions as we "find neces-

[9] *Northeast Utilities*, 43 S.E.C. 462, 469 (1967), (August 18, 1967) and cases therein cited.

sary or appropriate in the public interest or for the protection of investors or consumers." In light of the foregoing discussion, we shall approve the proposed acquisition subject to the undertakings by Middle South and Ark-Mo we have noted above.

The respective common stocks proposed to be issued have par values and are being issued for the purpose of effecting a merger, consolidation, or other reorganization, in satisfaction of the standards of Section 7 of the Act. It also appears that the proposed accounting treatment of the acquisition is appropriate.[10] Middle South proposes to record its investment in the common stock of Ark-Mo at an amount equal to the underlying book value of such stock on the effective date of the merger. Middle South will credit its capital stock account in an amount equal to the aggregate par value of the shares of stock it will issue and it will credit its capital surplus account in an amount equal to the excess of such underlying book value over the par value of the stock to be issued.

Middle South has requested an exception from the competitive bidding requirements of Rule 50 promulgated under the Act. Rule 50(a)(5)(C) permits an exception if the Commission finds that compliance with the competitive bidding requirements under the rule is not "necessary or appropriate in the public interest or for the protection of investors or consumers to assure the maintenance of competitive conditions, the receipt of adequate consideration or the reasonableness of any fees or commissions . . . ." We find the requested exception thereunder should be granted.

Middle South has filed with us proposed solicitation material to be sent to the common stockholders of Ark-Mo in connection with the proposed exchange offer. The financial statements will be updated to reflect latest available operating statistics. Our order herein will also require Middle South to send a copy of these Findings and Opinion and related Order to each common stockholder of record of Ark-Mo. Our approval of the exchange offer is not a recommendation that the common stockholders of Ark-Mo either accept or reject the exchange offer. Each such stockholder must decide for himself, after careful and independent consideration of the facts, whether to deposit his shares for exchange.

CONCLUSION

Based upon the foregoing, we find that the proposed transactions meet the requirements of the Act, and we shall issue an

[10] See, *National Fuel Gas Company*, 44 S.E.C. 115 (1969) and *Northeast Utilities*, 43 S.E.C. 462 (1967).

order granting the application and permitting the application-declaration to become effective forthwith, subject to the conditions noted herein and to the conditions contained in Rule 24 under the Act.

By the Commission (Chairman CASEY and Commissioners OWENS, SMITH, NEEDHAM and HERLONG).

In the Matter of

BLIMPIE CORPORATION OF AMERICA

File No. 3-2887. Promulgated May 6, 1971

Securities Act of 1933—Section 8(d)

FINDINGS AND STOP ORDER

In these proceedings instituted under Section 8(d) of the Securities Act of 1933 to determine whether a stop order should issue suspending the effectiveness of a registration statement filed by Blimpie Corporation of America ("registrant") on February 23, 1968 and thereafter amended, which has not become effective, registrant failed to appear at hearings of which it had been duly notified. Under Rule 6(e) of the Commission's Rules of Practice, registrant is therefore deemed to be in default and the proceedings may be determined as to it upon consideration of the order for proceedings, the allegations of which may be deemed to be true.

On the basis of the order instituting these proceedings and the allegations in the Statement of Matters of the Division of Corporation Finance of the Commission, which were incorporated by reference in such order, and evidence introduced by the Division at the hearings, the following findings are made.

Prior to the institution of these proceedings, the Commission ordered an examination and private investigation pursuant to Sections 8(e) and 20(a) of the Securities Act and Section 21(a) of the Securities Exchange Act of 1934 to determine, among other things, whether the registration statement filed by registrant contained untrue statements of material facts or omitted to state material facts required to be stated therein or necessary to make the statements therein not misleading with respect to the identity of persons in control of registrant, the background of its board of directors, and transactions by and between its officers and directors. In the course of such examination and investigation, the Division subpoenaed the four persons listed in the registration statement as registrant's officers, directors and sole stockholders to appear and testify concerning such matters. However, when these persons appeared, they refused, on grounds of privilege, to testify with respect thereto. Such refusal constituted a failure by registrant to cooperate in the examination (*Cf. Decorative Interiors, Inc.*, 41 S.E.C. 811 (1964)), and, as provided by Section 8(e) of the Securities Act, constitutes a ground for the issuance of a stop order.

In view of registrant's failure to cooperate, a stop order should issue suspending the effectiveness of the registration statement.

Accordingly, IT IS ORDERED that the effectiveness of the registration statement filed by Blimpie Corporation of America be, and it hereby is, suspended.

For the Commission, by the Office of Opinions and Review, pursuant to delegated authority.

In the Matter of

IVY FUND, INC.

STUDLEY, SHUPERT AND CO., INC. OF BOSTON

File No. 3-2175. Promulgated May 6, 1971

Investment Company Act of 1940—Section 17

TRANSACTION BETWEEN AFFILIATED PERSONS

Grant of License by Investment Company to Adviser With Respect to Use of Name

Where investment company and its adviser applied, pursuant to Section 17(b) of Investment Company Act of 1940, for exemption from Section 17(a) of Act with respect to proposed grant to adviser, for specified cash consideration, of license to use investment company's name in adviser's name and to confer similar name on other investment companies for which adviser presently or in future acted as adviser, *held*, applicants failed to meet burden of proving reasonableness and fairness of consideration to be paid for license, and application *denied*.

APPEARANCES:

Robert M. Gargill, of Choate, Hall & Stewart, for applicants.

Stanley B. Judd, for the Division of Corporate Regulation of the Commission.

FINDINGS, OPINION AND ORDER

Ivy Fund, Inc. ("Fund"), a registered open-end investment company, and Studley, Shupert and Co., Inc. of Boston ("Adviser"), Fund's investment adviser and business manager, filed a joint application pursuant to Section 17(b) of the Investment Company Act of 1940 ("Act") for an order exempting from the provisions of Section 17(a) of the Act the proposed grant by Fund to Adviser of a license, more fully described below, to use the word "Ivy" in a proposed new name for Adviser and the names of other investment companies advised by it, in consideration of a payment of $2,000 by Adviser to Fund. After appropriate notice,[1] hearings were held and the hearing exam-

[1] *Ivy Fund, Inc.*, Investment Company Act Release No. 5971 (February 6, 1970).

iner submitted an initial decision in which he concluded that the application should be granted. Our Division of Corporate Regulation filed a petition for review, which we granted, with respect to the examiner's finding that the proposed consideration was reasonable and fair, and briefs were filed by the Division and applicants.[2] Our findings are based upon an independent review of the record.

Under the terms of the proposed transaction, which was approved by Fund's board of directors and shareholders, subject to our grant of an exemption Fund would grant to Adviser (1) a license to use the word "Ivy" in a new name for Adviser and in the name of any wholly or majority owned subsidiary of Adviser, and (2) the right to confer, by sub-license or otherwise, the privilege of using a name similar to the name of Fund on any other investment company for which Adviser now or hereafter acts as investment adviser. The agreement further provides that such license and right would be terminable at the option of Fund in the event that Adviser ceases to be an investment adviser of Fund, and that the privilege of any other investment company to use a name similar to Fund's name would be terminable at the option of Fund in the event that Adviser ceases to be an investment adviser of Fund or of such other investment company.

As pertinent here, Section 17(a) of the Act prohibits an affiliated person of a registered investment company from purchasing any property from such company. An investment adviser of an investment company is an "affiliated person" of such company under Section 2(a)(3) of the Act and Fund's name constitute "property".[3] Section 17(b) of the Act provides, in relevant part, for the granting of an exemption from such prohibition if evidence establishes that the terms of the proposed transaction, including the consideration to be paid or received, are reasonable and fair and do not involve overreaching on the part of any person concerned.[4] The burden of proving the availability of an exemption is upon the applicants.[5] In our opinion, applicants here have failed to meet that burden.

Fund was organized in 1960 under a different name and its

[2] Three shareholders of Fund submitted letters objecting to the proposed transaction.

[3] See *Taussig* v. *Wellington Fund, Inc.*, 313 F.2d 472 (C.A. 3, 1963).

[4] No issue has been raised on review, and we find no basis for any adverse findings, respecting compliance of the proposed transaction with the other standards of Section 17(b), requiring consistency of such transaction with the policy of the investment company concerned and the general purposes of the Act.

[5] See, *e.g.*, *Fifth Avenue Coach Lines, Inc.*, 43 S.E.C. 635, 637 (1967).

shares were initially sold with a sales load. In 1966, it became a "no-load" fund and in March 1967, at the suggestion of Adviser, it adopted its present name. No advertising or salesmen are used in connection with the sale of Fund's shares. Nevertheless, Fund experienced a very large growth in the period following 1966. The number of shareholders increased from 295 as of the end of that year to 17,145 by the end of 1968 and increased further to 28,190 by the end of 1969; total shares outstanding increased from 131,390 to 5.1 million between the end of 1966 and the end of 1968 and reached 7.9 million by the end of the following year; and total net assets rose from about $678,000 to $63.5 million by the end of 1968 and were $65.5 million as of December 31, 1969. Shares sold during this period rose from about 127,000 in 1967 to 5.1 million each in 1968 and 1969, while shares redeemed totalled about 15,000, 290,000 and 2.3 million, respectively. Net asset value per share increased from $5.16 at December 31, 1966 to $12.36 by the end of 1968, before decreasing to $8.27 by the end of 1969.[6]

Adviser states that it desires the proposed license for a number of reasons. It seeks to adopt a new name including the word "Ivy" so as to identify itself with Fund and its investment performance and to differentiate itself from Studley, Shupert and Co., Inc. of Philadelphia, a previously related company which is also in the investment management business, as well as from the ownership and management of Adviser prior to 1966. In addition, at the time in early 1969 when the licensing agreement was reached, Adviser wanted to secure the "Ivy" name for two new investment companies then being established and for which Adviser was to be investment adviser. One of these was to be a closed-end investment company named "Ivy Capital Corp." which at that time had already filed registration statements with us under that name. However, that company subsequently changed its name to "Inventure Capital Corp." and made a public offering and continued operations under such name. A change back to its original name is not now contemplated, although it would be within the terms of the proposed license. The second company, which was to be called "Ivy Convertible Securities Fund", was envisaged as an open-end no-load fund investing primarily in convertible securities. It was anticipated at the time that Fund's net assets would soon reach approximately $100 million, at which point it would discontinue the offering of its

[6] The figures for shares outstanding, sold and redeemed and net asset value per share have been adjusted to reflect a 5 for 2 stock split effected in 1969.

shares to other than its existing shareholders, and that the new fund would take Fund's place as a vehicle for public offering. Subsequent developments, however, defeated the expectation regarding the growth of Fund's assets,[7] and the other company, while in existence as a corporation, is still inactive.[8]

The Division contends that applicants have failed to prove that $2,000 is fair and reasonable consideration for the license and that in fact such figure was selected on an arbitrary basis. It urges that the license can be valued only by estimating the worth both of its benefits to Adviser and of the detriments to Fund; that any estimate of the former element must include an estimate of the value of the right to confer the "Ivy" name on other funds; and that there is no evidence that Fund's board of directors attempted to make such estimate. It contends that such an estimate would have required an attempt to estimate sales of shares of funds which Adviser was then in the process of creating and the proportion of such sales, and derivative revenues to Adviser, attributable to the use of the "Ivy" name by such funds.

Applicants, on the other hand, urge that the record supports the examiner's findings that Fund's board of directors, a majority of whom were independent of Adviser, made a value judgment in good faith based on the pertinent and relevant information, including its judgment as to the value of the license to Adviser. They also contend that the method of valuation suggested by the Division is not realistic and provides no reliable help in the valuation process.

The record shows that at the board meeting at which the grant of a license was first considered, Adviser suggested a payment of $500, but action was deferred. The minutes of that meeting indicate that consideration was given to the facts that Fund had spent no money on advertising or promoting its name, that the name had originated with Adviser, that it was anticipated that sales of Fund shares would soon be discontinued, that it would be "difficult to prove any damages" to Fund's shareholders as a result of the license, and that it was planned to use the "Ivy" name in connection with the two investment companies being established by Adviser. The con-

[7] Net assets had increased from $2.3 million at December 31, 1967 to $63.5 million at December 31, 1968, but, as previously noted, only increased to $65.5 million over the next year.

[8] Aside from the question whether other parties in interest would agree to name changes, Adviser committed itself not to confer a name similar to Fund's on Commonwealth Fund Indenture of Trust Plans and Competitive Capital Fund for which it also serves as investment adviser and one of several advisers, respectively.

sideration was resumed at the next meeting, in the course of which one of the independent directors suggested the $2,000 figure. The minutes of that meeting recite that there was a discussion of "all of the various factors," and the testimony of the two witnesses who appeared on behalf of applicants, one of whom is the secretary of Fund and the other a director of Fund who is also executive vice-president of Adviser, indicates that there were extended discussions at the two meetings encompassing such matters as the past sales and investment performance of Fund, the fact that the license would be revocable, and possible advantages which might inure to Adviser and to Fund by virtue of the licensing agreement.

We must agree with the Division's position that as far as the record shows the $2,000 figure was selected essentially on an arbitrary basis. While it appears that Fund's board of directors discussed various factors relevant to the amount which would represent fair consideration for the license, the record does not show that the board, which acted without the benefit of independent expert assistance, made any effort to place dollar values on any of such factors. We note in this connection the testimony of the director that the originally suggested price of $500 represented "an attempt not to just name a nominal $1 or . . . a silly amount," but a figure which the shareholders and this Commission would recognize as meaningful, that one of the directors not affiliated with Adviser felt $500 would look too low to the shareholders and that the figure of $2,000 would have "some substance in it," since "thousands looked bigger than hundreds," and that such figure represented a compromise.

If we are to be able to make the necessary statutory findings, a method of valuation must be selected which removes the determination from the area of guess-work. The fact that Fund's directors did not have available any specific precedent which could serve as a basis for comparison in the circumstances did not relieve them of the burden to develop a valuation basis for the proposed sale of Fund's asset. It seems likely that guidance could have been obtained from a consideration of analogous situations such as, for example, the sale or licensing of trade names. Moreover, without such guidance the various uncertainties as to the use which Adviser would make of the license, particularly the extent to which it could make use of the "Ivy" name in connection with other investment companies, precluded a reasonable determination by the board of directors of an appropriate consideration for all such usés.

Such uncertainties could have been narrowed by appropriate limitations in the licensing greement or a formula provision for additional payments.

In light of our conclusion that applicants have not sustained the burden of proving the reasonableness and fairness of the consideration to be paid for the license, we must deny the application.

Accordingly, IT IS ORDERED that the application for exemption under Section 17(b) of the Investment Company Act of 1940 filed by Ivy Fund, Inc. and Studley, Shupert & Co., Inc. of Boston be, and it hereby is, denied.

By the Commission (Commissioners OWENS, SMITH, NEEDHAM and HERLONG). Commissioner NEEDHAM filed a separate concurrence. Chairman CASEY did not participate.

Commissioner NEEDHAM, concurring:

I completely concur in the decision of my colleagues. However, without reflecting on the conduct of the parties now before us, I also deem it appropriate to indicate my concern with what in my view is a largely unnecessary recourse in many instances to lengthy formal procedures. In my view, such recourse serves to divert the Commission's attention and resources from more important responsibilities.

The Commission was created for the purpose of providing maximum protection for investors and thereby foster confidence in the securities markets which will promote growth of American business and trade. It was envisaged that the Commission, as the agency charged with the administration of the securities acts, would be able to bring expertise and flexibility to bear on the problems of an extremely complex and constantly changing area and to obviate the need for frequent Congressional action or resort to the judicial branch of the government. Clarification of the scope and intent of the necessarily broad provisions of the various statutory provisions with whose administration it is charged, including the provisions of the Investment Company Act, has to a considerable extent been accomplished, in large part through the rule-making process and through the issuance of statements of policy and interpretations, as well as by the adjudicatory process. In areas where the Commission's policy or position has thus been established, it has provided for simplified procedures and delegations of authority to its staff to facilitate the resolution and disposition of particular matters presented for action. Such steps have directly benefitted the business community by permitting more expeditious effectuation of those business decisions which are consistent with applicable standards. At the same time, the Commission has been enabled to devote more attention to major matters of policy and planning as well as to resolve issues which come to it de novo or involve questions of first impression.

What concerns me is what I see as a general trend toward an increasing incidence of undesirable controversy and away from the reasonable accommodation between business activity and the public interest which Congress contemplated. Reversal of this trend will require an increased sense of responsibility on the part of the business sector, combined, as to matters within our responsibilities, with a greater readiness by this Commission and its staff to facilitate and expedite the implementation of reasonable business decisions. In a context such as that before us, management must take all reasonable steps to reach decisions which take into account relevant public interest considerations. At the same time, our staff must be ready, to the extent that its heavy responsibilities permit, to provide assistance to those seeking it in good faith and to facilitate resolution of issues in a way comporting with the Congressional objectives.

In the Matter of

M.V. GRAY INVESTMENTS, INC.

MAXEL V. GRAY

File No. 3-1811. Promulgated May 20, 1971

Securities Exchange Act of 1934—Sections 15(b) and 15A

BROKER-DEALER PROCEEDINGS

Grounds for Remedial Sanctions

Sale and Delivery of Unregistered Securities

Misrepresentations in Sale of Securities

Failure to Comply with Record-Keeping Requirements

Failure to Comply with Net Capital Requirements

Improper Extension of Credit

Failure to Promptly Amend Application for Registration

Where person associated with registered broker-dealer firm sold and delivered unregistered securities and made misrepresentations in their sale, and firm, aided and abetted by such person, failed to comply with record-keeping and net capital requirements, improperly extended credit to customers, and failed promptly to amend application for registration, in willful violation of Securities Act of 1933 and Securities Exchange Act of 1934, *held*, in public interest to revoke broker-dealer's registration and expel it from membership in registered securities association and to bar associated person from association with any broker-dealer with provision for permitting supervised association after specified period upon appropriate showing.

Appearances:

Allen Schwartz and *David D. Joswick*, of Miller, Canfield, Paddock and Stone; *Loren Gray*, of Gray and Thompson; and *Carl L. Shipley* and *Moreland G. Smith, Jr.*, of Shipley, Akerman, Pickett, Stein & Kaps, for M.V. Gray Investments, Inc. and Maxel V. Gray.

Mark A. Loush and *Hugh H. Makens*, for the Division of Trading and Markets of the Commission.

FINDINGS AND OPINION OF THE COMMISSION

Following hearings in these private proceedings pursuant to Sections 15(b) and 15A of the Securities Exchange Act of 1934

("Exchange Act"), the hearing examiner issued an initial decision in which he concluded that the registration as a broker and dealer of M. V. Gray Investments, Inc. ("registrant") should be revoked, and that registrant should be expelled from membership in the National Association of Securities Dealers, Inc. He further concluded that Maxel V. Gray, who was president and principal stockholder of registrant, should be barred from association with any broker or dealer, with the proviso that after one year he may become so associated upon an appropriate showing that he will be adequately supervised. We granted petitions for review of the initial decision filed by respondents in which exception was taken to various findings and conclusions of the examiner, and by our Division of Trading and Markets ("Division") which excepted to a finding by the examiner that an allegation relating to failure of supervision was defective. Respondents and the Division filed briefs, and we heard oral argument. On the basis of an independent review of the record and for the reasons set forth herein and in the initial decision, we make the following findings.

Registrant became registered with us in 1964 and engaged in business in the State of Michigan primarily in the sale of mutual fund securities.

TRANSACTIONS IN UNREGISTERED SECURITIES

The record establishes that in October and December 1967, Gray willfully violated the registration provisions of Section 5(a) of the Securities Act of 1933 in the sale and delivery of Class B common stock of American Monitor Corporation ("Monitor"), an Indiana corporation, when no registration statement was in effect under that Act with respect to such securities.

Around August 1967 Gray agreed with three officers of Monitor, who owned 26,100 of its 30,000 authorized Class B shares,[1] to buy 400 of their shares at $100 a share and up to 1,600 more of such shares at the same price if the officers determined that it was necessary for them to supply additional capital to Monitor by purchasing more shares from it. It was understood that at least some of the additional shares to be disposed of by the officers would be sold to a number of Gray's customers. By early October Gray had purchased 200 shares and registrant 100, and, following notification of Monitor's

[1] The company also had 1,000 shares of Class A stock outstanding which were owned by the three officers and which contained restrictions on transferability but otherwise had the same rights as the Class B stock.

officers' desire to sell additional shares, in October Gray sold 405 shares to over 20 employees of registrant at $100 and 1,015 shares to over 45 other persons at $120 per share. As sales were effected the Monitor officers in turn purchased from Monitor an equivalent number of new shares at $100 per share. In December 1967 Gray sold, out of the 200 shares previously purchased by him, 91 shares to 14 persons at $175 per share.

Respondents assert that Gray did not commit any willful violation because he relied on the advice of counsel for Monitor, obtained at his request, which was that it was permissible for the Monitor officers to sell their personally-owned shares to him as an individual and for him to resell such shares, and that he purchased his 200 shares for investment and sold some of them only because he needed immediate cash for fertilizer for a crop he owned and was pressed by friends who wanted to purchase Monitor shares.

We find that Gray sold shares for an "issuer"[2] in connection with a distribution, or sold shares purchased from an issuer with a view to distribution; accordingly, he was an "underwriter" as defined in Section 2(11) of the Securities Act. A distribution of securities comprises "the entire process by which in the course of a public offering the block of securities is dispersed and ultimately comes to rest in the hands of the investing public." [3] A willful violation is established since the record shows that Gray knew he was selling and delivering unregistered securities.[4] We note that, while Gray was told of the legal advice given the Monitor officers, he did not himself consult that or other counsel for advice although the facts known to him at the least called for further and more direct inquiry. Under the circumstances he was not entitled to rely on the self-serving statements of the Monitor officers and their recital of their counsel's opinion as to the legality of the transactions.[5] We also cannot accept Gray's assertion that he bought the 200 shares, which he acquired by early October, for investment rather than distribution. The resale of some of those shares a few months later at a profit of $75 per share is inconsistent with such assertion, and his stated reasons for the

[2] Section 2(11) defines the term "issuer" to include in addition to an issuer, a person controlling the issuer.

[3] *Lewisohn Copper Corp.*, 38 S.E.C. 226, 234 (1958).

[4] It is well established that a finding of willfulness does not require an intent to violate the law; it is sufficient that the person charged with the duty intentionally commits the act which constitutes the violation. See *Tager* v. *S.E.C.*, 344 F.2d 5, 8 (C.A. 2, 1965), and cases there cited.

[5] See *S.E.C.* v. *Culpepper*, 270 F.2d 241, 251 (C.A. 2, 1959); *A. G. Bellin Securities Corp.*, 39 S.E.C. 178, 184 (1959).

resales are not sufficient under the circumstances to justify resale of "investment" stock.[6]

MISREPRESENTATIONS IN OFFER AND SALE OF SECURITIES

The record establishes that Gray willfully violated the antifraud provisions of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b–5 thereunder in connection with his sales of Monitor stock in October and December 1967.

Monitor was organized in June 1966 and is engaged in the business of developing and manufacturing diagnostic chemicals for hospital and laboratory use. In August 1967 it had five or six employees, including the three officers, was marketing only two products at least one of which was similar to one made by a number of competitors, and although several products were in development, it had no patents. Its financial reports reflected sales of $8,200 through December 1966 and $26,200 from January through April 1967, net sales of $57,241 and $27,190, respectively, for the fiscal year ending June 30, 1967 and for three months ending September 30, 1967 and net losses for those two respective periods of $10,278 and $19,722.[7]

Gray told customers that he thought the Monitor stock would be a good investment which would probably eventually make money for the customer, that Monitor was probably breaking even, and that he thought the company would "go places" and its stock would go up in price over a period of time and had good growth possibilities if kept from 3 to 5 years. Gray had no reasonable basis for his optimistic representations and predictions, and he knew in August 1967, but did not tell customers to whom he recommended the stock, that Monitor had been losing money. In addition, in the case of one customer with whom Gray had a relationship of trust and confidence, he realized profits which were not disclosed to her of $4,000 on the sale to her of 200 shares in a riskless transaction.[8]

[6] Respondents have also suggested that a private offering exemption provided by Section 4(2) of the Securities Act may have been available. However, apart from the fact that Section 4(2) by its terms exempts only "transactions by an issuer," the record does not show that the persons who purchased the Monitor stock had access to the kind of information which would be disclosed in a registration statement so as to meet the exemptive test enunciated by the United States Supreme Court. *S.E.C.* v. *Ralston Purina Co.*, 346 U.S. 119, 127 (1953).

[7] By April 1967 the Monitor officers had acquired 18,000 shares of Class B stock for $6,000 in cash, or about 33 cents per share, and an additional 8,100 shares of such stock in lieu of past due salaries. The book value was about 86 cents per share.

For the year ended June 30, 1968, Monitor had net sales of $231,045 and a net loss of $105,690.

[8] We note that, contrary to respondents' contention that a relationship of trust and confidence did not exist, the customer, a widow, testified that Gray was her "confidante" and lawyer, sold her cars and, with one exception, advised her in all her undertakings, and that she generally followed his investment recommendations and could not recall any specific instance of not doing so.

The making of predictions and representations, whether couched in terms of opinion or fact, which are without reasonable basis is violative of the antifraud provisions of the securities acts.[9] Gray is not aided by stressing that he told customers that an investment in Monitor stock was speculative; such statement did not constitute a sufficient disclosure of Monitor's adverse financial condition.

FAILURE TO COMPLY WITH RECORD-KEEPING REQUIREMENTS

The record supports the examiner's finding that registrant, willfully aided and abetted by Gray, willfully violated the record-keeping requirements of Section 17(a) of the Exchange Act and Rule 17a–3 thereunder in failing to accurately make and keep current certain required books and records.

An inspection of registrant's records by our staff between November 18 and 25, 1968 disclosed that the general ledger and the money balances in customers' ledger accounts had not been posted since August 31, 1968 and that receipts and deliveries of securities in the customers' ledger accounts had not been posted since December 1967, and that registrant did not maintain a record of collateral in connection with outstanding bank loans as of September 30, 1968, securities position records since February 1968, and securities-in-transfer records. In addition, registrant did not prepare monthly records of aggregate indebtedness and net capital from December 31, 1967 through December 31, 1968 and monthly trial balances for most of such period.[10]

Respondents assert that Jerry Vollmer, the employee who maintained registrant's records from December 1967 to December 1968, concealed the true status of the records and told Gray that necessary records were being maintained and were virtually current; that Gray, who had defective vision and knew no accounting, was limited in his ability to check on Vollmer; and that a record of pledged securities was maintained since registrant's auditors supplied such a list to our staff in November 1968. They also argue that the examiner's findings that Gray knew of record-keeping deficiencies must be set aside

[9] *Alexander Reid & Co., Inc.*, 41 S.E.C. 372, 375 (1963).

[10] The State of Michigan summarily suspended the registrations of registrant and Gray during the period from December 6, 1968 to January 30, 1969, because of charges which included alleged deficiencies of registrant's books and records and misleading statements in sales of unregistered Monitor shares. The condition of registrant's records was such that, even though registrant's business had been suspended during that period, an accountant and three other persons worked about 60 hours a week for about one month in an effort to rehabilitate them, with two other persons being engaged in such endeavor on various occasions.

because those findings were based on the testimony of Vollmer who they assert was a hostile witness and a "perjurer."

The record shows that Gray had been alerted to and was told about deficiencies in registrant's books and records. In connection with a previous inspection by our staff of registrant's books in December 1966, Gray received a letter indicating deficiencies in various records including the customer ledger accounts and the collateral and position records which we have found deficient in these proceedings, reciting the specific record-keeping provision covering each of those situations, and stressing the importance of compliance with our record-keeping requirements. About February 1968 he was informed by Vollmer that receipts and deliveries of securities were not being posted in customers' ledger accounts and that he did not have the time to post such records himself. An officer of registrant also told Gray that registrant did not prepare a monthly trial balance, and Gray knew it did not prepare computations of net capital. Gray thus had knowledge of the deficient status of certain of the records in question and must be held responsible for the violations that occurred. He cannot be exonerated because of his vision defect or a lack of a background in accounting, or by the fact that Vollmer incorrectly told him that registrant need no longer keep separate securities position cards because such data was contained in other records. Even if such data, or the data as to pledged securities, could be derived from other records, it would be no defense to the failure to maintain required records in the prescribed form.[11]

With respect to the testimony of Vollmer, the hearing examiner who observed the demeanor of all the witnesses, credited such testimony and rejected the testimony of Gray in certain respects, and we find no basis for disturbing his assessment. Respondents' assertion that Vollmer was a "perjurer" whose testimony must be disregarded is based not on his testimony in this proceeding, but on the fact that a balance sheet for registrant as of May 31, 1968, which Vollmer prepared pursuant to Gray's instructions and signed, although not under oath, and which was filed with the Michigan Securities Bureau, incorrectly showed cash in bank of $17,747 instead of an overdraft of $7,253.[12] Since Vollmer did not sign the financial

[11] *Cf. Associated Securities Corporation*, 40 S.E.C. 10, 18 (1960).

[12] Vollmer testified Gray told him to treat a loan by registrant to Gray of $25,000 which had not been repaid as an "in transit item" on the balance sheet, and Vollmer thereupon entered that amount under cash in bank.

statement under oath, it is not precise to characterize him as a "perjurer." In any case, it may be noted that even the testimony of a perjurer need not be disregarded, even where it is proved or conceded that part of the testimony itself is false, although the perjury and partial falsity are factors to be taken into account in assessing the weight to be given to his testimony.[13] In addition, while Vollmer might be viewed as hostile to respondents because he had been dissatisfied with his position at registrant and was discharged, we do not think that this or any other factors presented to us are sufficient to discredit him as a witness or render his testimony unacceptable.[14]

Failure to Comply with Net-Capital Requirements

We find, as did the examiner, that registrant, willfully aided and abetted by Gray, willfully violated the net capital requirements of Section 15(c)(3) of the Exchange Act and Rule 15c3–1 thereunder. Registrant had net capital deficiencies, as computed under Rule 15c3–1, of $22,725, $43,692, $38,670, $102,655 and $9,469, respectively, on April 30, May 31, June 30, September 30 and October 31, 1968.

Respondents argue that investors were not subject to risk of loss because registrant remained liquid and could have met the net capital requirements by selling its securities had Gray known of the deficiencies. They also assert that the violations were caused by Vollmer's failure to keep applicable records and provide Gray with figures.

The net-capital Rule was designed to assure the financial responsibility of broker-dealers, and the exposure of customers to the risk posed by violations of the Rule is in itself the abuse at which the Rule is aimed.[15] By effecting transactions when its net capital position was not in compliance with our requirements, registrant willfully violated those requirements.[16] Moreover, Gray had received an earlier warning from our staff following its inspection in December 1966, referred to above, indicating that registrant had a net capital deficiency as of November 30, 1966, and emphasizing the continuing obligation

[13] *Cf. Shelton* v. *United States*, 169 F.2d 665 (C.A.D.C., 1948), *cert. denied* 335 U.S. 834. See 3 Wigmore, *Evidence*, p. 674 *et seq.* (3rd ed. 1940). This view would apply *a fortiori* in administrative proceedings, where rules of evidence are more liberal. See 2 Davis, *Administrative Law Treatise*, pp. 276, 303–4 (1958). *Cf. Charles P. Lawrence*, 43 S.E.C. 607 (1967).

[14] The record does not support respondents' claim that Vollmer deliberately and secretly maintained registrant's records improperly.

[15] See *Blaise D'Antoni & Associates, Inc.*, v. *S.E.C.*, 289 F.2d 276, 277 (C.A. 5, 1961); *Metropolitan Securities, Inc.*, 41 S.E.C. 365, 368 (1963); *Bennett-Manning Company*, 40 S.E.C. 879, 882 (1961).

[16] *Churchill Securities Corp.*, 38 S.E.C. 856, 859 (1959).

of compliance with our net-capital Rule. In addition, he was informed by Vollmer a number of times that registrant did not have adequate net capital or had a net capital problem, and in July 1968 the Michigan Securities Bureau advised him that registrant was not in compliance with Michigan's net capital requirements as of May 31, 1968. Under the circumstances Gray should have been particularly sensitive to the need for achieving compliance with our net capital Rule. However, he did not even inquire whether Vollmer was making net capital computations and, indeed, knew that such computations were not being made during 1968, although he had advised our staff in February 1967 that net capital was computed at regular intervals according to instructions given by our inspector.

Improper Extension of Credit

We also find that registrant, willfully aided and abetted by Gray, willfully violated the credit-extension provisions of Section 7(c) of the Exchange Act and Regulation T promulgated by the Board of Governors of the Federal Reserve System. Registrant in 184 instances in 1968 failed promptly to cancel or liquidate purchases effected in cash accounts of customers who did not make full payment within seven business days, with payment in 155 instances ranging up to 29 days late, in 21 instances from 30 to 59 days late, and in 8 cases 60 or more days late.

Failure to Amend Application

Registrant, willfully aided and abetted by Gray, willfully violated Section 15(b) of the Exchange Act and Rule 15b3–1 thereunder, in that it failed promptly to amend its application for registration as a broker-dealer to reflect changes in its officers. Such changes, including the designation of Vollmer as treasurer, were made in February 1968 but were not reported in any amendment filed with us until January 1969.

Failure to Supervise

The order for proceedings charged that respondents failed to supervise the persons under their supervision with a view to preventing the violations by registrant aided and abetted by Gray that were specified in such order. The hearing examiner, while noting that the record established a failure of supervision with a view to preventing those violations, held that the charge in the order for proceedings was defective because of the failure to allege any violation by the personnel subject to respondents' supervision.

Under Section 15(b)(5)(E) of the Exchange Act, a remedial sanction may be imposed if a broker-dealer or associated person "has failed reasonably to supervise, with a view to preventing violations . . ., another person who commits such a violation, if such other person is subject to his supervision." We do not construe that provision to require that a violation by another person subject to supervision be specifically alleged in order to reach the responsible supervisor. We are of the opinion that the charge respecting failure of supervision was not defective and fully apprised respondents of the issues raised, and that the record supports the charge. In view, however, of the findings we have made that registrant willfully aided and abetted by Gray willfully violated the underlying provisions in question, we do not base any conclusions as to the appropriate sanctions upon a finding of failure of supervision to prevent such violations.

OTHER MATTER–

We find no merit in various additional contentions advanced by respondents.

Respondents are not aided by pointing to Section 9(b) of the Administrative Procedure Act, 5 U.S.C.   558(c), under which a registration may not be suspended or revoked unless an opportunity to achieve compliance with lawful requirements is afforded before the institution of proceedings. These proceedings clearly fall within the Section's express exception with respect to cases of willfulness or those in which the public interest requires that opportunity for compliance not be given. Nor can we agree with respondents' argument that in view of the sanctions that may be imposed these proceedings are in the nature of a criminal proceeding and require the imposition of stricter evidentiary standards than ordinary remedial proceedings. In proceedings under the Exchange Act such as these, which are remedial in nature, allegations of willful violations of the securities acts need be proven only by a preponderance of the evidence.[17] This has been the standard of proof consistently used in broker-dealer administrative proceedings, and it satisfies the requirements of Section 7(c) of the Administrative Procedure Act, 5 U.S.C.   556(d), that administrative agency action be supported by "the reliable, probative, and substantial evidence."[18]

[17] *Norman Pollisky*, 43 S.E.C. 852, 861 (1968); *Underhill Securities Corporation*, 42 S.E.C. 689, 695 (1965).

[18] *Norman Pollisky*, *supra*.

Finally, we reject the contention that the examiner's finding that Gray predicted that the investor would eventually make money on the Monitor stock was based on new charges raised in the Division's proposed findings filed after the hearings and were therefore improper. In our opinion that finding was properly based on the allegations in the order for proceedings, as amended, that Gray willfully violated designated antifraud provisions of the securities acts in that, among other things, he sold the Monitor stock, which was speculative, in disregard of certain important information relating to the issuer and made false and misleading statements concerning its financial condition and operating losses. We think it clear that such allegations were sufficient to apprise respondents of the nature of the misconduct charged.

Public Interest

Respondents urge that the sanctions imposed by the examiner are too harsh. They stress, among other things, Gray's visual handicap, that registrant's books and records were brought up to date, and that registrant has retained a prominent certified public accounting firm and adopted procedures designed to prevent future deficiencies. They also assert that Gray was inexperienced in public distributions and relied upon the advice of counsel, and that after new counsel for Monitor advised him that his Monitor sales might have been improper he and Monitor took the matter to the Michigan Securities Bureau and he offered to guarantee rescission of all the sales that had been made.[19]

The assessment of what sanctions are appropriately imposed upon those who have been found to have violated the securities acts entails an examination and balancing of various considerations. Those acts embody a comprehensive regulatory scheme designed to protect the public interest in maintaining the integrity of the securities markets. As an integral part of such scheme, Section 15 of the Exchange Act authorizes the exclusion from the securities business or restriction of the securities activities of broker-dealers and associated persons

[19] In January 1969 Gray submitted an undertaking to the Michigan Securities Bureau to rescind the transactions he effected in Monitor stock upon request of the purchasers, and notices were sent out by the Bureau advising purchasers that violations appear to have been committed in connection with their transactions and of their rights of rescission under Michigan law if such violations were established.

who have acted contrary to the statutory standards and requirements if we find such sanction is in the public interest. It reflects Congress' recognition that such sanctions may be necessary for the effective maintenance of those standards and requirements. They serve to restrain the particular respondents as well as others in the securities industry from committing future violations, and thereby fulfill the remedial objective of our administrative proceedings. Where upon consideration of the nature and extent of the violations and the surrounding circumstances a limited exclusion or restriction of a respondent is deemed sufficient, its duration and scope are properly fixed with a view to adequately impressing upon him through its impact the necessity of avoiding a repetition of his specific misconduct and the need for scrupulous propriety in all aspects of his securities activities in the future. We have attempted to exercise the discretionary power reposed in us to select in each case the measure of sanction that will accord investors protection, through not only the restraint imposed on the particular respondent but also the example set for others, without visiting upon the wrongdoer adverse consequences not required in achieving that protection.

We have appraised respondents' misconduct in this case together with the mitigative factors asserted by them in light of the requirements of the public interest and the interest of investors. The serious and pervasive violations disclosed by the record demonstrated an inability or unwillingness on the part of registrant and Gray, who was its president and controlling stockholder, to operate a securities business in conformance with applicable requirements. Among other things, we note that registrant's new office procedures were adopted only after the institution of these proceedings. Gray's visual impairment cannot mitigate the violations we have found of our record-keeping and net capital requirements in view of his knowledge of problems in those areas and the prior warning given him by our staff concerning such requirements, and he himself made misrepresentations in his sales of the unregistered Monitor securities. We conclude that it is in the public interest to revoke registrant's registration as a broker and dealer and expel it from membership in the National Association of Securities Dealers, Inc.

With respect to Gray, we consider that it is appropriate, as did the examiner, to bar him from association with any broker or dealer, but under all the circumstances we are of the opinion that it would be consistent with the public interest to provide that he may become employed in a supervised capacity after six months, upon a showing of adequate supervision.[20]

An appropriate order will issue.

By the Commission (Commissioners OWENS, SMITH, NEEDHAM and HERLONG; Chairman CASEY not participating).

[20] In a submission filed on May 5, 1971, while these Findings and Opinion were in the process of being issued, respondents recited, among other things, that registrant is now operated by Gray's son and others who were not employed by it at the time of the activities in question and that Gray himself would not engage in the securities business except with our approval, and urged that only a sanction of censure should be imposed on registrant. We reject this belated suggestion. We do not consider that the facts asserted are sufficient to warrant any change in the conclusions with respect to the appropriate sanctions that we have reached on the basis of our review of the record and for the reasons set forth above. We also note that the fact, to which respondents also call attention, that Vollmer died after the close of the record is clearly irrelevant.

The exceptions to the initial decision of the hearing examiner are overruled to the extent that they are inconsistent with our decision and sustained to the extent that they are in accord.

IN THE MATTER OF

COMPETITIVE CAPITAL CORPORATION

RICHARD E. BOESEL, JR.

ROBERT L. SPRINKEL, III

File No. 3-2126. Promulgated May 25, 1971

Securities Exchange Act of 1934—Section 15(b) and 15A

BROKER-DEALER PROCEEDINGS

Grounds for Remedial Sanctions

Failure to Comply with Prospectus Requirements

Inadequate Supervision

Where registered broker-dealer, which acted as investment adviser and principal underwriter to registered investment company, and certain of its officers and directors who were also officers and directors of investment company, engaged in a campaign to publicize company prior to time registration statement for initial sale of company's shares had become effective, and failed reasonably to supervise activities of other employees of broker-dealer who were engaged in similar publicity efforts, *held*, respondents made offers to sell securities in violation of Section 5(b) of Securities Act of 1933 and failed to exercise appropriate supervision, and it is in public interest to impose sanctions of censure and suspension.

APPEARANCES:

Phil Gross, *Theodore Altman* and *James L. Rothenberg*, for the Division of Corporate Regulation of the Commission.

Mark Kaplan, *Ezra Levin* and *Gerald F. Lerman*, of Marshall, Bratter, Green, Allison & Tucker, for respondents.

FINDINGS AND OPINION OF THE COMMISSION

This was a private proceeding under Sections 15(b) and 15A of the Securities Exchange Act of 1934 with respect to Competitive Capital Corporation ("registrant"), a registered broker-dealer and a member of the National Association of Securities Dealers, Inc., and Richard E. Boesel, Jr. and Robert L. Sprinkel, III, who at the times relevant here were registrant's principal executive officers and together owned over 90 percent of its outstanding voting stock.

Respondents have submitted an offer of settlement, solely for the purposes of the settlement of this proceeding and without admitting any of the findings which may be made, in which they consent to the entry of an order censuring registrant and suspending Boesel and Sprinkel for ten business days from association with any broker or dealer or investment adviser, for violations of Section 5(b) of the Securities Act of 1933 and for a failure to exercise reasonable supervision to prevent such violations. The violations in question arose from the holding of press interviews and the issuance and distribution of a press release prior to the effective date of a registration statement under the Securities Act of Competitive Associates, Inc. ("Fund"), an investment company registered under the Investment Company Act of 1940. In connection with the offer, respondents solely for purposes of this proceeding have admitted certain stipulated facts and agreed that the record shall include the transcripts of testimony and exhibits obtained by our staff in its investigation of this matter.

After due consideration of the offer of settlement, and upon the recommendation of our staff, we have determined to accept such offer. On the basis of the order for proceedings and the offer of settlement, we make the following findings.

On February 20, 1969, Fund, a management, open-end diversified investment company, filed with us a registration statement under the Securities Act with respect to its initial public offering of 5,000,000 shares of common stock at $20 per share. Registrant was Fund's investment adviser and principal underwriter, and also at that time was acting as investment adviser and principal underwriter for another registered open-end management investment company, Competitive Capital Fund ("CCF"). Registrant, Fund and CCF were then managed by a common group of officers headed by Boesel and Sprinkel.

Upon the filing of the registration statement, including Fund's preliminary prospectus, registrant and a public relations firm which it had previously retained in January 1968 to provide continuing financial public relations services for registrant and the investment companies it was managing and advising, sent copies of that prospectus, together with an accompanying press release announcing the proposed initial public offering, to approximately 120 business and financial editors throughout the country. That mailing was the start of a publicity campaign designed to attract attention to the

Fund, through emphasizing, among other matters, the Fund's investment policies and the fact that separate portions of the Fund's assets would be managed by independent portfolio managers who would compete with each other.

The public relations firm also mailed biographical sketches of Boesel and Sprinkel and during the period February 20 through March 4, 1969, arranged a schedule of approximately 19 interviews with members of the business and financial press for Boesel, Sprinkel and two other officers of registrant while such officers were in various cities to discuss the proposed public offering with prospective members of the selling group. At least 11 of the financial reporters participating in those interviews wrote articles concerning the prospective Fund offering which appeared in various newspapers and magazines throughout the country. Some of the articles were written under the by-line of nationally syndicated columnists and were printed in more than one publication. After each interview the public relations consultant communicated with the reporter to determine if he could supply the reporter with additional information. All of these activities took place prior to the effective date of the public offering.[1]

On or about March 4, 1969, the publication of articles concerning the proposed public offering came to the attention of counsel involved in the filing of the registration statement and of members of our staff. As a result, further interviews which had been scheduled were cancelled, and steps were taken to terminate any further publicity or public relations activities by the Fund and respondents, and efforts were made to have articles prepared for publication in various cities withdrawn. Despite such efforts, however, a number of such stories did appear thereafter. The registration statement was not declared effective until April 10, 1969.

A basic purpose of the Securities Act is to require the dissemination of adequate and accurate information concerning issuers and their securities in connection with the offer and sale of securities to the public. To this end, Section 5 of the Act contains various restrictions on offers and sales prior to the filing or the effective date of a registration statement covering a public offering of securities. Thus Section 5(c) prohibits offers to sell securities prior to the filing of a registration statement. Section 5(b), insofar as here pertinent,

[1] In connection with the initial public offering of securities of CCF, which was effected in March 1968, registrant had engaged in a similar public relations campaign which involved the issuance of press releases and interviews with reporters in cities visited by registrant's officers.

prohibits any such written offers during the period between the filing of a registration statement and the date it becomes effective, the so-called waiting period, except an offer which is made by means of a prospectus which meets the informational requirements specified in Section 10 and the rules adopted thereunder. Accordingly, during such waiting period written communications concerning the securities must be restricted to the preliminary or "red herring" prospectus filed as a part of the registration statement, a summary prospectus as authorized by Section 10(b), or the so-called "tombstone" announcements permitted under Section 2(10) or Rule 134 thereunder.[2]

In order to implement the statutory objective, the term "offer to sell" is broadly defined in Section 2(3) to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value," and it has been liberally construed both by us and the courts. We have repeatedly pointed out that publicity or public relations activities under certain circumstances may constitute offers to sell securities within the statutory definition and thus involve violations of the Act. We have specifically noted that the publication of information and statements and publicity efforts generally about an issuer, its securities or a proposed offering, made prior to the filing of a registration statement, may constitute an illegal offer to sell even though not couched in terms of an express offer, where such activities are in effect a sales campaign which conditions the public mind or arouses the public interest in the particular securities.[3] And we have stated that the release of publicity and the publication of information between the filing date and the effective date of a registration statement may similarly raise a question whether the publicity is not in fact a selling effort by an illegal means; i.e., other than by means of a statutory prospectus.[4] Courts have also ruled that press releases announcing that securities would be sold at some time in the future and containing an attractive description of the securities or of the issuer constituted illegal offers to sell.[5]

It is necessary that the managers, investment advisers and

[2] Securities Act Release No. 5009, page 3 (October 7, 1969). See also *First Maine Corporation*, 38 S.E.C. 882, 886 (1959).

[3] Securities Act Release No. 3844, page 3 (October 8, 1957); Securities Act Release No. 4697, page 2 (June 5, 1964); *Carl M. Loeb, Rhoades & Co.*, 38 S.E.C. 843, 850 (1959); *First Maine Corporation*, 38 S.E.C. 882 (1959).

[4] Securities Act Release No. 3844, page 3 (October 8, 1957).

[5] *Chris-Craft Industries, Inc.* v. *Bangor Punta Corporation*, 426 F.2d 569 (C.A. 2, 1970); *S.E.C.* v. *Arvida Corp.*, 169 F. Supp. 211 (S.D. N.Y., 1958)

underwriters of investment companies, as well as retained public relations firms, recognize that the Securities Act imposes certain responsibilities and limitations upon them as well as upon other persons engaged in the public sale of securities, and that failure to exercise proper control at any time over public relations activities respecting the distribution of securities may result in violations of law and adverse consequences to the investment companies and their underwriters in connection with the distribution of the securities.[6] Insofar as this case is concerned, Congress has specified an exclusive procedure by which information concerning a proposed offering may be disseminated during the waiting period. Persons undertaking to employ public media of communication to give publicity to a forthcoming issue in ways not specified in the Act must carefully consider the possibility that such publicity oversteps the statutory limitations and constitutes a type of sales activity prohibited during the waiting period by Section 5(b).

Even if we recognize that the limited advertising that an issuer which has a registration statement pending can employ may pose special problems for an investment company engaged in a continuous offering of its shares to the public, here the issuer was not at the time engaged in a continuous public offering. As has been seen, respondents, solely in connection with a pending registration statement for an essentially new investment vehicle, participated in an organized campaign utilizing a wide distribution of publicity material which was designed to and had the effect of conditioning the public for the forthcoming offering of Fund shares. Such activities constituted an offer to sell, and the publicity material constituted a prospectus which did not meet the requirements of Section 10 of the Securities Act. Its transmittal through various means of interstate commerce and the mails therefore constituted a willful violation of Section 5(b) of the Act by the respondents. In addition, Boesel and Sprinkel, as principal owners and executive officers of registrant, failed reasonably to supervise other officers of registrant who were engaged in similar publicity activities in order to prevent violations of Section 5(b).

In support of the sanctions proposed in the offer of settlement, respondents stated in mitigation that the press release

[6] Violations of the Securities Act subject the persons involved not only to the risk of penal sanctions under the law but also to the possibility of civil liabilities to purchasers of securities, to the denial of acceleration of the effective date of a registration statement, or to elimination of a broker-dealer from participation as an underwriter or as a member of the selling group in a distribution. See Securities Act Release No. 3844 (October 8, 1957).

was used only after consultation with counsel; that the granting of interviews by the individual respondents was considered by them to be in accordance with practice in the industry; that the appropriate sanction of delay in the effectiveness of the Fund's registration statement has already imposed substantial adverse economic consequences to the Fund and registrant; and that respondents otherwise have an unblemished record in the securities business.

We have considered these and other factors, and have concluded that it is appropriate in the public interest to impose the sanctions agreed to in the offer of settlement. With respect to registrant, which is only being censured, we note that Boesel and Sprinkel are no longer officers, that subsequent to the events involved herein another unrelated corporation purchased a controlling interest, and that thereafter registrant filed a notice of withdrawal of its registration as a broker and dealer.[7] In imposing a suspension for ten business days upon Boesel and Sprinkel, we note that each of them is experienced in the securities business and should have been familiar with the requirements of the Securities Act respecting the use of publicity in connection with a public offering.

An appropriate order will issue.

By the Commission (Chairman CASEY, Commissioners OWENS, SMITH, NEEDHAM and HERLONG).

[7] In accordance with Rule 15b6–1 under Section 15(b) of the Exchange Act, the withdrawal notice did not become effective because of the pendency of the instant proceeding. Under the circumstances, registrant's notice to withdraw its registration shall become effective upon the issuance of these findings, opinion and order.

In the Matters of

MANN AND COMPANY, INC.

(formerly Mann and Company)

HERMAN M. SOLOMON

BURTON J. ROSENBLATT

File No. 3-2027. Promulgated June 15, 1971

Securities Exchange Act of 1934—Sections 15(b) and 15A

MEMORANDUM OPINION AND ORDER

In these private proceedings pursuant to Sections 15(b) and 15A of the Securities Exchange Act of 1934 ("Exchange Act") with respect to Mann and Company, Inc. ("registrant"), a registered broker-dealer, and Herman M. Solomon and Burton J. Rosenblatt, officers, directors and sole shareholders of registrant,[1] two former customers of registrant requested that the proceedings be made public. They represented, among other things, that respondents had practiced fraud on them by accepting payment for securities purchased by them through registrant at a time when it had ceased doing business, and by failing to disclose registrant's inability to consummate the transaction and make full delivery of the securities purchased, and that in January 1971 they had brought suit against the individual respondents, alleging violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

The allegations in the order for proceedings as issued in June 1969 charged violations of Exchange Act provisions and rules thereunder relating to disclosure with respect to customers' free credit balances, record-keeping and extension of credit. An amendment to the order authorized by the hearing examiner in December 1970 upon motion of our staff included the allegations that registrant, aided and abetted by Solomon

[1] At the time the proceedings were instituted, registrant was a partnership, with Solomon and Rosenblatt as its general partners.

and Rosenblatt, willfully violated the antifraud provisions of Section 10(b) of the Exchange Act and Rule 10b–5 thereunder by soliciting and accepting customers' orders to purchase securities when registrant was unable to consummate such orders promptly and to make prompt delivery of securities. The order as amended also charged violations of our net capital rule, further violations of the record-keeping requirements and the issuance of a permanent injunction in November 1970 against violations by registrant of the nature charged in the additional allegations and against aiding and abetting of such violations by the individual respondents.

In support of the request that the proceedings be made public, it was urged that such action would facilitate the court proceedings, and would cause no harm to registrant since it was the subject of bankruptcy proceedings. Respondents, in a brief filed in opposition to the request, contended, among other things, that petitioners lacked standing, that many of the issues in the instant proceedings were not involved in the civil litigation and certain stipulations and admissions made in this case were not binding in other contexts, and that public disclosure of these proceedings could subject the individual respondents to nuisance suits by other potential litigants.

Exercise of our discretion to determine whether a proceeding shall be public or private[2] involves a balancing of the desire of respondents not to be subjected to the impact of public knowledge of charges of misconduct, on the one hand, and the extent of the public interest in the subject matter of the proceedings, on the other.[3] In determining whether a substantial public interest exists, we have in the past considered such factors as the gravity of the charges made against the respondents, the extent to which public investors appear to have been affected by the misconduct charged, and the pendency of civil suits involving allegations similar to those made in the administrative proceedings.[4] We have also taken into account the extent to which the allegations in the administrative proceedings or facts underlying those allegations are already a matter of public record. We have pointed out that public proceedings not only apprise investors of possible causes of action against broker-dealers prior to the running of the statute of limitations, but also enable them to institute such actions promptly

[2] Section 22 of the Exchange Act provides that hearings ordered by the Commission "may be public."

[3] See *J. H. Goddard & Co., Inc.*, 41 S.E.C. 964 (1964); *W. H. Bell & Co., Inc.*, Securities Exchange Act Release No. 4039 (December 17, 1947); *Haight & Co., Inc.*, 44 S.E.C. 479, 507–08 (1971), app. pending.

[4] *Ibid.*

before witnesses become unavailable and may alert them to certain activities of broker-dealers.[5]

We are of the opinion that the fact that petitioners have not previously sought to participate in the case should not preclude consideration of the petition[6] and that under all the circumstances presented here it is appropriate to make these proceedings public. Subsequent to the institution of these proceedings as private, the public injunctive action was instituted in which the allegations included in the amendment to the order for proceedings herein became a matter of public record and the permanent injunction was entered against respondents.[7] Moreover, as noted, at least one civil action has been instituted, by petitioners, against the individual respondents which is based on allegations similar to some of those involved in these proceedings. We conclude that making these proceedings public at this juncture is fully warranted.[8]

Accordingly, IT IS ORDERED that the petition to make these proceedings public be, and it hereby is, granted.

By the Commission.

[5] *J. H. Goddard & Co., Inc., supra*, at 966.

[6] See *W. H. Bell & Co., Inc., supra*, where we made private broker-dealer proceedings public at the request of persons who were plaintiffs in civil suits against one of the respondents.

[7] In those proceedings, respondents, without admitting or denying the allegations in the complaint, consented to issuance of the injunction.

[8] On May 21, 1971, the hearing examiner in these proceedings issued an initial decision adverse to the respondents, and thereafter the individual respondents filed a petition for review of that decision which is now pending before us. Our conclusion that these proceedings should be made public of course in no way represents a determination with respect to the substantive issues presented.

IN THE MATTER OF

L.A. FRANCES, LTD.

A. FRANK SIDOTI

LAWRENCE MARTIRE

LOUIS BENJAMIN MEADOWS

File No. 3-1987. Promulgated June 22, 1971

Securities Exchange Act of 1934—Section 15(b)

BROKER-DEALER PROCEEDINGS

Sale of Unregistered Securities

Inadequate Supervision

Where two registered broker-dealers and manager of one effected sales of unregistered stock of issuer's controlling persons as to which by exercise of reasonable diligence they should have known no exemption from registration provisions of Securities Act of 1933 was available, *held*, their conduct constituted willful violations of registration provisions and in public interest to impose suspensions on them and on president and sole stockholder of broker-dealer who failed reasonably to supervise manager.

APPEARANCES:

Kevin Thomas Duffy, *Paul Chernis*, *Dennis J. Block*, and *David M. Greenberg*, of the New York Regional Office of the Commission, for the Division of Trading and Markets.

Irwin L. Germaise, of Germaise and Quinn, for L. A. Frances, Ltd., A. Frank Sidoti and Lawrence Martire.

Efrem A. Gordon, for Louis Benjamin Meadows.

FINDINGS, OPINION AND ORDER

Following hearings in these proceedings pursuant to Section 15(b) of the Securities Exchange Act of 1934, the hearing examiner filed an initial decision concluding that the registration as a broker and dealer of L. A. Frances, Ltd. should be suspended for 20 days, that A. Frank Sidoti, the manager of Frances, should be suspended from association with any broker or dealer for one year, and that Lawrence Martire, Frances' president and sole stockholder, and Louis Benjamin Meadows should each be suspended from such association for a period of 2 months.[1] We granted petitions for review filed by the respondents and in addition determined to review the initial decision on our own initiative with respect to all issues which were before the examiner. Briefs were filed by respondents and by our Division of Trading and Markets. On the basis of an independent review of the record, and for the reasons set forth herein and in the initial decision, we make the following findings.

As found by the examiner, during the period December 1966–February 1967, Frances, Sidoti, and Meadows willfully violated Sections 5(a) and 5(c) of the Securities Act of 1933 in the offer and sale of common stock of Vista Industries Corporation when no registration statement had been filed or was in effect with respect to such securities, and Martire failed reasonably to supervise Sidoti in the operations of Frances with a view to preventing such violations. The transactions in question involved the distribution of a total of 60,000 shares of Vista stock owned by a controlling group comprised of Harry Vogel, his brother Eugene Vogel and Philip Levy, who during the above period were Vista's officers and together owned about 32 percent of its approximately 2 million outstanding shares. Of the total, 5,000 shares were sold by H. Vogel and 10,000 shares by Levy directly to Frances, in the names of nominees, while the remaining 45,000 shares were sold by the three insiders in their own names through Meadows to Frances. All 60,000 shares were resold by Frances to its customers; during the period of such sales, its prices ranged from about 65c to about $1.12 per share.

It is evident that respondents' transactions in unregistered Vista stock violated Section 5, unless an exemption from the registration requirements of that Section was available.[2] The burden of proving the availability of an exemption from the general policy of the Securities Act requiring registration rests with those claiming the exemption.[3] Here it is not clear that an

[1] During the period relevant to these proceedings, Meadows was engaged in the securities business as sole proprietor of Louis B. Meadows & Co., a registered broker-dealer. That registration was withdrawn in December 1967 and Louis B. Meadows & Co., Inc., of which Meadows is president and principal stockholder, succeeded to its business. The corporate successor was not named as a respondent in these proceedings.

[2] See, *e.g.*, *Gilligan, Will & Co.*, 38 S.E.C. 388, 391 (1958), *aff'd* 267 F.2d 461 (C.A. 2, 1959), *cert. denied* 361 U.S. 896.

[3] See *S.E.C.* v. *Ralston Purina Co.*, 346 U.S. 119 (1953); *S.E.C.* v. *Culpepper*, 270 F.2d 241, 246 (C.A. 2, 1959).

exemption is even being claimed, although the Frances respondents seem to suggest that an exemption was available under Section 4(4) of the Securities Act and Rule 154 thereunder.[4] The record shows, however, that no such exemption was available. It is clear that the three closely related sellers effected a distribution of 60,000 shares, or approximately 3 percent of the shares outstanding, substantially exceeding the 1 percent limitation of Rule 154.[5] Moreover, Frances executed the transactions in a manner which did not comply with the conditions for an exemption. Its sales were not "brokers' transactions," within the meaning of Section 4(4), since it purchased and resold the shares as principal, and in addition it solicited purchasers.

Respondents' principal contentions are that Sidoti and Meadows acted with due diligence to satisfy themselves that the transactions were legal, that they were misled by the sellers, and that any violations by them were not willful. The record does not support their position. It is well established that a broker-dealer offered or asked to sell a substantial amount of securities has a responsibility to take reasonable steps to determine that the proposed sales by him would not constitute participation in transactions by an issuer or controlling person which require registration under the Securities Act.[6] Here the proposed transactions were rife with "red flags" which called for a searching inquiry on the part of Sidoti and Meadows before lending the facilities of their firms to a substantial distribution without the investor protections provided by Section 5.

With respect to the first 15,000 shares, the orders, as noted, were placed directly with Sidoti by H. Vogel and Levy. The nominee sellers were relatives of Vogel and Levy, but that fact was not disclosed to Sidoti. However, Sidoti, who had dealt in Vista stock for some time on behalf of Frances, was personally acquainted with the Vogels and Levy and knew of their official position in and control relationship with Vista. Despite the fact that the orders which were placed by them involved substantial blocks of stock, he admittedly did not inquire into the

[4] Section 4(4) exempts from the provisions of Section 5 "brokers' transactions executed upon customers' orders . . . but not the solicitation of such orders." Rule 154 was adopted by this Commission to interpret and define various terms used in Section 4(4) and to indicate more clearly the scope of the exemption for a broker offering or selling securities on behalf of a person in a control relationship to the issuer. See Securities Act Release No. 4818 (January 21, 1966).

[5] Rule 154 defines "distribution" as not including sales of not more than 1 percent of the shares outstanding.

[6] See *Sutro Bros. & Co.*, 41 S.E.C. 470, 479 (1964).

manner in which the purported sellers had acquired the shares[7] and made no effort to contact them.

As indicated above, the remaining 45,000 shares, which were comprised of 15,000 shares owned by H. Vogel, 20,000 by E. Vogel and 10,000 by Levy, travelled a more circuitous route. H. Vogel initiated the sales by contacting S, a trader with a New York securities firm which had been making a market in Vista stock. He identified himself as an officer of Vista, advised S of the identity of the proposed sellers, and stated that they wanted to avoid paying New York stock transfer taxes on the transactions, and that he had an "opinion letter" covering the stock. S in turn asked K, whom he believed to be associated with Meadows, a Massachusetts firm, whether Meadows could handle the transaction. S specified the amount of commission to be charged, which was less than would normally be payable, and designated Frances as the firm to which Meadows would resell the stock, having obtained Sidoti's agreement to purchase the stock. K, who was actually employed by a New York firm which had a direct wire to Meadows' office and made a market in New York for Meadows, called Meadows who, upon being advised by K that he could see nothing wrong with the proposed transaction, agreed to handle it. According to Meadows, he was not informed by K that the sellers were affiliated with Vista. Meadows communicated with the sellers, who represented orally or on customer cards which two of them filled out, that they were associated with Vogel's Dairy. That company was a subsidiary of Vista; however, the sellers did not advise Meadows of that fact or of any connection between them and Vista.

With respect to the role of the Frances respondents in the sale of this block, Sidoti knew that the sellers were controlling persons of Vista. He saw an opinion letter, which each of the Vista principals had obtained from an attorney, stating that the sales of Vista stock by such principal could be made without registration provided that, among other things, the sales were made through a broker who did not solicit any buy orders.[8] As noted, however, Sidoti caused Frances to purchase the shares for its own account, and he admitted that purchasers were solicited. Moreover, even aside from counsel's

[7] Sidoti testified that he asked Levy whether the 10,000 shares were "good stock, because it was a large piece" and that he consummated the transaction after Levy assured him that the stock was "good."

[8] The three opinion letters of the attorney, which bore the same date, stated that the opinion that an exemption was available under Section 4(4) of the Securities Act and Rule 154 thereunder was based on the understanding that the proposed sale by the principal together with all sales by him and his immediate family within the preceding 6 months would not exceed 1 percent of Vista's outstanding shares.

letter, which failed to give consideration to the aggregate size of the sales being made by the three Vista principals, Sidoti and Frances had a responsibility to be aware of the requirements necessary to establish an exemption from the registration requirements of the Securities Act.[9]

Meadows asserts that he did not know of any connection between the selling stockholders and Vista, that he was assured by H. Vogel that the sales were proper, and that he relied on the advice of K, who was more experienced than he was, as well as on the fact that, as reflected by published quotations, Vista stock was being actively traded. However, the circumstances surrounding the transaction were such as to put Meadows on notice of possible irregularities and called for more diligent investigation than he undertook. The transaction itself was unusual in nature and it involved a substantial amount of stock being sold by persons previously unknown to him and who he knew were all associated with the same company, and an issuer with which he was not familiar. According to Meadows, he was advised by K that the firm which employed S could not handle the transaction because it was not a retail house.[10] This was not a plausible reason, however, in light of the fact that the purchase of the whole block by Frances had already been arranged and no retail effort was required for that transaction. Moreover, although Meadows inquired of the sellers regarding their business or occupation, he did not specifically inquire of them or of K whether they were connected with Vista.

Respondents suggest that in view of the deception practiced by the sellers on them, and the fact that Vista was its own transfer agent, further inquiry would have been fruitless. However, we need not speculate as to what reasonable inquiry would have disclosed where no such inquiry is made.[11] Nor are respondents aided by the fact that the Vista certificates involved in the transactions did not contain restrictive legends.[12] In such a context as that presented here, it is not sufficient for a broker-dealer merely to accept self-serving statements of his sellers without reasonably exploring the possibility of contrary facts.[13] It is clear that in light of their failure to do so, the violations by Frances, Sidoti and Meadows were willful.[14]

[9] See, *e.g.*, *Strathmore Securities, Inc.*, 43 S.E.C. 575, 582 (1967), *aff'd* 407 F.2d 722 (C.A.D.C., 1969).

[10] The confirmations sent by Meadows to two of the sellers were marked "through courtesy of" S' firm.

[11] See *Strathmore Securities, Inc.*, *supra*, p. 584.

[12] See *Quinn and Company, Inc.*, 44 S.E.C. 461 (1971), app. pending (C.A. 10, No. 71-1090).

[13] *Cf. S.E.C.* v. *Culpepper*, 270 F.2d 241, 251 (C.A. 2, 1959).

[14] See *Strathmore Securities, Inc.*, *supra*, p. 585.

On the issue of Martire's supervision, the record shows that during the period in question he delegated complete authority over the day-to-day operations and decisions to Sidoti.[15] Although Sidoti testified that Martire was in daily communication with him and discussed such matters as profits and losses and problems of the firm, Sidoti was not required to check with Martire before taking positions in securities and Martire did not review the firm's records. As president and chief executive officer Martire "necessarily assumed the duties of keeping himself informed of registrant's activities, of providing adequate supervision, and of taking whatever steps might be necessary to secure compliance with the law." [16] His reliance on Sidoti did not constitute compliance with those duties and we agree with the examiner's conclusion that he failed reasonably to supervise Sidoti with a view to preventing the Section 5 violations.

PUBLIC INTEREST

Respondents contend that the public interest does not require the imposition of any sanctions.[17] Aside from the arguments regarding their asserted diligence which we have discussed, respondents argue that no detriment to public investors appears to have resulted from their transactions. That argument overlooks the fact that their conduct deprived public investors of the protection afforded by the registration and prospectus provisions of the Securities Act which are designed to permit prospective purchasers to make an informed investment judgment. Indeed, in light of the cardinal role occupied by broker-dealers in the securities distribution process, we cannot overemphasize the importance of their obligation to take all reasonable steps to avoid participation in distributions violative of those provisions. Respondents' conduct fell far short of meeting that obligation.

In reaching his conclusions regarding sanctions, the examiner took into consideration disciplinary action taken against Sidoti and Meadows by the National Association of Securities Dealers, Inc. ("NASD"). In 1963, Sidoti's registration as a registered representative was suspended for one year and he

[15] Martire was president, director and sole stockholder of a company engaged in the automobile repair business.

[16] *Albion Securities Company, Inc.*, 42 S.E.C. 544, 547 (1965). See also *Aldrich, Scott & Co., Inc.*, 40 S.E.C. 775, 778 (1961).

[17] The Frances respondents also claim that due process required a separate hearing on the sanctions issue after the examiner had determined that violations had occurred. They have not, however, presented any supporting reasons for this contention, and we find it to be without merit.

was fined and severely censured, based on findings of violations of certain NASD and Commission rules by a broker-dealer of which he was then president. Those violations included improper hypothecation of customers' securities, improper extension of credit, failure to make proper disclosure in dual agency transactions, failure to register a representative with the NASD and non-compliance with net capital requirements. In 1969, the NASD suspended Meadows' registration for 30 days and fined and censured him. That action was based on violations by a broker-dealer of which he was a principal prior to May 1966, including violations of net capital requirements and failure to maintain written supervisory procedures, to make appropriate disclosure to customers with free credit balances, and to maintain required information regarding customer accounts.[18]

We have concluded that under all the circumstances the two-month suspension imposed by the examiner with respect to Meadows and Martire and the one-year suspension of Sidoti are appropriate in the public interest. However, as to Sidoti, we consider that his conduct demonstrates that he should not be entrusted in the future with supervisory responsibilities, and we will therefore additionally provide in our order that, following his one-year suspension he may not be associated with any broker or dealer in a managerial or supervisory capacity without our approval. We further consider that the public interest requires a two-month suspension of Frances' registration.[19]

Accordingly, IT IS ORDERED that the registration as a broker and dealer of L. A. Frances, Ltd. be, and it hereby is, suspended for a period of two months; that A. Frank Sidoti be, and he hereby is, suspended from association with any broker or dealer for a period of one year and thereafter barred from such association in a managerial or supervisory capacity except with the prior approval of the Commission; and that Lawrence Martire and Louis B. Meadows be, and they hereby are, suspended from association with any broker or dealer for a

[18] Contrary to Meadows' assertion that he was no longer associated with that firm at the time of the net capital violations, the NASD decisions show that he was a principal of the firm during most of the period for which such violations were found. There is no basis for his assertion that he was not given an opportunity to offer any evidence concerning the NASD action; moreover, such action was not open to collateral challenge in the instant proceedings. See *Richard C. Spangler, Inc.*, 43 S.E.C. 1093 (1969).

[19] The exceptions to the initial decision of the hearing examiner are overruled or sustained to the extent they are inconsistent or in accord with our decision.

period of two months. The above suspensions are to take effect at the opening of business on June 28, 1971.

By the Commission (Commissioners OWENS, SMITH, NEEDHAM and HERLONG), Chairman CASEY not participating.

In the Matter of

DANIEL J. BRESLIN

doing business as

DANIEL BRESLIN & ASSOCIATES

File No. 3–2225. Promulgated June 24, 1971

Securities Exchange Act of 1934—Sections 15(b) and 15A

BROKER-DEALER PROCEEDINGS

Where registrant broker-dealer was found by hearing examiner to have made offers and sales of unregistered stock without disclosing adverse financial condition of issuer, and to have failed to comply with record-keeping requirements and to segregate funds received from prospective purchasers, *held*, examiner's suspension of registrant's registration, membership in national securities association and right to be associated with any broker or dealer *affirmed*, as appropriate in the public interest under all circumstances, including facts that illegal offers and sales appeared to result from lack of understanding of requirements and all prospective purchasers recovered their funds.

APPEARANCES:

Edward P. Delaney and *Willis H. Riccio* of the Boston Regional Office of the Commission, for the Division of Trading and Markets.

Daniel J. Breslin, pro se.

FINDINGS, OPINION AND ORDER

Following hearings in these proceedings pursuant to Sections 15(b) and 15A of the Securities Exchange Act of 1934 ("Exchange Act"), the hearing examiner ordered suspensions, for a period of 45 days, of the registration as a broker-dealer of Daniel J. Breslin, doing business as Daniel Breslin & Associates, of his membership in the National Association of Securities Dealers, Inc., and of his right to be associated with any broker or dealer. The only issue presently before us is whether such sanctions are adequate to protect the public interest.[1]

As found by the hearing examiner, Breslin, who had never before participated in an underwriting, agreed in January 1969, to become an underwriter on a best efforts basis for a proposed public offering, pursuant to Regulation A under the Securities Act of 1933, of shares of common stock of Design International Corporation ("DIC"), which were to be sold at $9 per share in units of 100 shares. Although no filing had been made with respect to the offering, in February 1969, Breslin posted an office notice which stated "Design International Corporation speculative new issue now in registration, indications of interest now being accepted." Beginning in February he also caused the DIC offering to be included in newspaper listings under the heading "Securities Now in Registration." At a meeting with his personnel in March 1969, Breslin spoke of the proposed offering, described DIC's business (the design and manufacture of hairpieces), stated that it was not currently in a good financial condition but spoke highly of its potential, admonished his representatives not to discuss the offering with anyone until they had offering circulars to distribute, but told them they could take "indications of interest" in the stock. Between about April 1 and June 16, 1969, some 56 persons deposited $90,300 with registrant in amounts or multiples of $900. A number of those persons testified that after speaking to one of registrant's representatives about DIC, they deposited the money with the intention of using it to purchase DIC stock. The deposits were recorded as credits to the customers' accounts; 45 of the depositors had never done business with registrant before and new accounts were opened for them. Although Breslin was aware of the general intention of the persons to purchase DIC stock, he treated the funds as general deposits in their accounts and he maintained that no sales were made, that the persons were not guaranteed that they would receive DIC stock when it became available, and they were free to use the funds to their credit in any way they chose. Other "indications of interest" were received for an aggregate of 50,000 to 60,000 shares.

In fact, no DIC shares were ever issued. In May 1969 DIC did make a Regulation A filing with respect to the proposed offering of 33,333 shares of its stock. After receiving a letter of

[1] The hearing examiner also ordered that two of registrant's representatives be suspended from association with a broker or dealer for periods of 20 and 15 days, respectively. No review was sought or ordered of such rulings, and the initial decision has become final as to those respondents.

comment from our staff in the following month, it filed three amendments to the offering circular. On November 12, 1969, when the instant proceedings were instituted, an order was also entered temporarily suspending the Regulation A exemption on the basis of allegations relating to registrant's activities with respect to the proposed DIC offering, and the suspension was thereafter made permanent when no hearing was requested. Of the $90,300 deposited to customers' accounts with registrant, $35,700 was used by the customers to purchase other securities, $48,300 was refunded to the depositors on their request, and $6,300 was left in various accounts to the credit of the customers.

The examiner found that registrant's activities described above constituted offers and sales of DIC stock in violation of Section 5 of the Securities Act; that the failure to advise customers of DIC's poor financial condition, of the details of the underwriting, and of the possible violations of the Securities Act, constituted violations of the antifraud provisions of the Securities Act and of the Securities Exchange Act; that registrant's failure to segregate the sums received for DIC shares until such shares could be legally transferred to the customers constituted a violation of Section 15(c) of the Exchange Act and Rule 15c2-4 thereunder; and that recording the deposits as credits in customers' accounts rather than as receipts for DIC stock violated the record-keeping provisions.

The examiner concluded from his observation of the witnesses and other evidence in the case that Breslin's violations were attributable to his lack of understanding of the rules regarding the marketing of Regulation A issues, and that it was appropriate in the public interest to impose the forty-five days suspensions described above. The Division of Trading and Markets urges that a more severe sanction is necessary in the public interest for the protection of investors.

We do not agree that registrant's activities constituted, as he asserts, at most technical violations. As the hearing examiner noted, the provisions involved are key sections designed to protect the public in the offer and sale of new issues of securities such as the DIC stock offering, and we view violations of those regulations as serious matters. Nevertheless, we are satisfied that the remedial sanctions imposed by the hearing examiner are adequate to meet the remedial requirement of the public interest under the circumstances of this case. On the basis of our independent review of the record, we accept his finding that the violations relating to the registration provisions were the result of registrant's lack of understanding of the applicable rules. While, as the examiner recognized, that fact does not excuse the violations, it is a factor to consider in assessing the appropriate sanction.

Accordingly, IT IS ORDERED that for a period of 45 days beginning with the opening of business on June 28, 1971, the registration as a broker and dealer of Daniel J. Breslin, doing business as Daniel Breslin & Associates, be and it hereby is, suspended, and that registrant be, and he hereby is, suspended for the same period from membership in the National Association of Securities Dealers, Inc., and from association with any broker or dealer.[2]

By the Commission (Commissioners OWENS, SMITH, NEEDHAM and HERLONG), Chairman CASEY not participating.

[2] In October 1970, registrant filed a notice of withdrawal of his broker-dealer registration, which notice did not become effective because of the institution of these proceedings. Under the circumstances, absent further action by registrant, the notice to withdraw his registration shall become effective upon the expiration of the period of suspension.

IN THE MATTER OF

MURRAY A. KIVITZ

File No. 3-1972. Promulgated June 29, 1971

Securities Act of 1933—Rule 2(e), Rules of Practice

ATTORNEYS—PRACTICE AND PROCEDURE

Suspension of Privilege to Practice Before Commission

Where attorney allowed layman, who acted as intermediary between him and prospective corporate client seeking to register securities offering, to exploit his privilege to practice before Commission and to negotiate fee for his proposed legal services; participated in arrangement for proposed payment of portion of fee to such layman purportedly for use in obtaining political influence to secure registration; and acquiesced in layman's representation that accountant who would "stretch a point" could be obtained to prepare financial information in registration statement, *held*, attorney engaged in unethical and improper professional conduct and was lacking in character and integrity within meaning of Rule 2(e) of the Commission's Rules of Practice, and under all the circumstances, suspension of attorney's privilege of practicing before Commission warranted.

Jurisdiction to Discipline Attorneys

Where federal statute provides that member of bar of highest court of State may practice before federal agency but does not limit discipline of attorneys who appear before agency, *held*, statute does not deprive Commission of jurisdiction under its general rule-making authority to discipline attorneys practicing before it.

APPEARANCES:

Jacob H. Stillman, *Robert M. LaPrade*, and *Michael J. Roach*, for the Office of General Counsel of the Commission.

Jacob A. Stein, of Stein and Mitchell, for Murray A. Kivitz.

FINDINGS AND OPINION OF THE COMMISSION

Following a private hearing in these proceedings pursuant to Rule 2(e) of our Rules of Practice, the hearing examiner filed an initial decision in which he concluded that Murray A. Kivitz, an attorney at law, should be denied the privilege of appearing or practicing before this Commission for a period of two years.[1] We granted a petition for review filed by respondent, briefs were filed by him and our Office of the General Counsel, and we heard oral argument. Our findings are based upon an independent review of the record.

Respondent is a member of the District of Columbia and Maryland bars and has engaged in the general practice of law since 1951. Since 1952 or 1953 he has also practiced before this Commission in connection with, among other things, filings pursuant to Regulation A under the Securities Act of 1933 and registration statements under that Act with respect to public offerings of securities.

The charges in these proceedings arose from the efforts of one Harold G. Quase, a non-lawyer, to arrange for the employment of respondent to prepare and file a registration statement on behalf of Houses of Plastic, Inc. ("Plastic"), which proposed to engage in the manufacture of low cost plastic housing. The examiner concluded that the record established, by clear and convincing evidence, that respondent engaged in unethical and improper professional conduct and was lacking in character and integrity, within the meaning of Rule 2(e), in that, among other things, he allowed Quase to control and exploit his professional services and his privilege to practice before us and to negotiate and formulate the terms of the fee for his proposed legal services; participated in an arrangement whereby his fee was to be divided with Quase, who represented that part of the fee was to be used to secure political influence; and acquiesced in the representation by Quase that an accountant who would "stretch a point" could be obtained to prepare the financial information regarding Plastic, for inclusion in the registration statement, in such manner as to appear to meet our accounting requirements. After careful review of the record, we are satisfied that it supports the conclusions of the hearing examiner.[2]

[1] Rule 2(e) of our Rules of Practice provides in pertinent part:

> "The Commission may deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice of and opportunity for hearing in the matter . . . (2) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct."

[2] Whether or not the evidence is clear and convincing, and we think it is, in our opinion all that is necessary to sustain the staff's burden of proof in these proceedings is a preponderance of the evidence. Rule 2(e) proceedings do not affect the attorney's license to engage in the general practice of law but only his privilege to practice before us. We have, with court approval, applied the preponderance standard in administrative proceedings before us which may have such consequences as the revocation of a broker-dealer's license to engage in the securities business or a bar of an individual's association with any broker-dealer. See *James De Mammos*, 43 S.E.C. 333, 337 (1967), *affirmed without opinion*, Docket No. 31469 (C.A. 2, October 13, (1967); *Norman Pollisky*, 43 S.E.C. 852, 861 (1968).

Prior to the events in question in which respondent participated in October 1964, Robert Ackles, president of Plastic, had made two unsuccessful attempts through different law firms to file with this Commission a satisfactory registration statement with respect to a proposed offering of 12,000,000 shares of Plastic stock at $1 per share.[3] On October 19, Ackles told one Mary Jo Freehill, a public stenographer in Washington, D.C., who had typed portions of a registration statement for him, that he needed help in securing registration. She referred him to Quase, who was engaged in public relations work, as one who could get the registration cleared through the use of various people with influence. Quase told Ackles that what was required were the services of "someone who knew people" in Washington, that Quase had a "direct telephone line to the White House," and that if Ackles would at that point pay $10,000, Quase would distribute it to "various people" and the registration would "go right through without everybody putting a bunch of roadblocks in front of" Plastic.

Ackles reported his conversation with Quase to his counsel, David Doane, a member of an Idaho law firm which had prepared the second registration statement. Doane then spoke by telephone with Quase, who told him that, depending upon the facts, registration could be accomplished in 30 days, but might take an additional 15 days; that experienced persons would be utilized and "our" attorneys are very qualified; that money was the principal factor and would be distributed to the "right areas"; that a certain percentage of the fee, which Quase fixed at no less than $20,000, would be wanted then, followed by additional cash in an amount to be discussed later and stock in such amount as Plastic thought fair; that usually a fee of $50,000 was charged initially and the balance (apparently referring to stock) later; and that the check for $20,000 was to be made payable to an "SEC attorney" whose name Quase would furnish later and whom he described as "a top man in Washington." Doane discussed Quase's proposition with Ackles, who stated he would consider it further.

On October 26, Freehill, at Quase's request, called Doane's office to speak to Ackles but, Ackles not being there, she spoke to Doane. She stressed, as instructed by Quase, the importance

[3] Plastic was incorporated in Idaho in September 1964. The first registration statement, which contained no financial statements, was submitted shortly thereafter but was not accepted for filing. The second registration statement, dated October 17, 1964 and containing a financial statement showing current assets of $24, total assets of $697, and liabilities of $1,001, was in acceptable form for filing but was not filed after various deficiencies therein were pointed out by our staff.

of completing arrangements before election day because one must "show the faith before hand," and she urged Doane to come to Washington as soon as possible. Ackles agreed to Doane's meeting with Quase, and three days later a meeting was held in Quase's office, which was attended by respondent, Quase, an associate of Quase, Doane, and Freehill. Within the week preceding that meeting, respondent, at Quase's request, had inquired of our Public Reference Room whether Plastic had filed a registration statement, and had informed Quase that no such statement was on file.[4]

At the meeting, Quase introduced respondent to Doane as "a great SEC lawyer, the finest in the city, with lots and lots of experience." According to Doane's account of the meeting, Quase dominated the discussion and respondent, whom Quase called "my SEC attorney," said little. Quase stated that his "organization" would charge a total cash fee of $50,000, plus stock in an amount to be agreed upon later. Doane and Quase discussed the question of how much stock should be allocated and that discussion ended when respondent suggested that the allocation be in a "mutually agreeable" amount. The importance of making the down payment before election day was stressed by Quase who said to Doane, in respondent's presence, that "you have been in politics and you know about Johnny Come Lately, they don't help much. They don't get anywhere." [5] In addition, Quase asked Doane, in respondent's presence, whether he had accountants who were "willing to stretch a point?" Doane replied, "I don't think we have that kind of accountants . . . out in our country. If we have to do that, we better use your accountants." Respondent made no comment on any of these statements by Quase or Doane, and, at Quase's request, described the financial information required in a registration statement. Quase indicated that he might be able to find a corporation with which Plastic could become associated, and the statement was made that an underwriter would be furnished if necessary. Doane then requested that the proposed terms be reduced to writing, and Quase asked respondent to prepare, together with Doane, a retainer agreement. Respondent dictated the agreement, and after a few minor changes by him and Doane, it was typed on respondent's letterhead and signed by him.

[4] Respondent was not on retainer from Quase and did not bill him for this service. Respondent had previously done some legal work for Quase and for a company in which Quase was an officer, and Quase had referred to him clients with various legal problems.

[5] Doane testified that Quase has a "very deep, resonant voice . . . a loud voice," and, when he made the statement, was conversing with him and respondent who was within 8 or 10 feet from Quase.

The retainer proposal, which was addressed to Doane, purported to be an agreement for the performance of certain services by respondent. It provided that respondent's "office" would, among other things, prepare and process a registration statement in behalf of Plastic for a $12 million stock offering, that the fee for "our" services would be $50,000, payable $20,000 down and $30,000 upon the registration statement becoming effective, plus an indefinite amount of stock mutually agreeable to Plastic and "this office" through the use of warrants or options at not more than 5c per share. It further provided that "this office" would "lend its best assistance" toward obtaining an active corporation to associate with Plastic in the manufacture and sale of its products and toward obtaining an underwriter in the event Plastic desires, but cannot through its own efforts obtain, the services of one.

Respondent's retainer agreement was not accepted by Plastic, and he received no communication with respect to it from Plastic, Doane or Ackles, nor did he make any inquiry of Doane. However, he testified that he "must have asked" Quase concerning the status of Quase's "involvement" with Plastic and received "some negative response."

Respondent testified that the conversation at the October 29 meeting was for the most part between him and Doane; that Quase, who "might have made a comment or two," played no part in proposing the fee of $50,000 plus stock options, and the fee was set by respondent; and that while there was some conversation concerning the impending election, he could not recall Quase stating to Doane that the $20,000 down payment had to be made before the election and that if such a statement and the statement about securing an accountant who would "stretch a point" were made they were not made in his presence. He further testified that although it was not his normal practice to negotiate a fee for preparing a registration statement without any basic facts about the issuer, he set the fee and the option price without knowledge of Plastic's financial condition or the proposed offering price because he was discussing the matter with Doane, who was counsel for the issuer and did not indicate that the issuer would be unwilling or unable to meet such terms; that respondent used the phrase "our services" in the retainer agreement because he was then considering the formation of a firm;[6] that Quase was not to render any services to Plastic in connection with the fee

[6] Respondent entered into a partnership with another lawyer about a year later.

agreement and was not to receive any compensation or any portion of the proposed fee; and that he mentioned the possibility of interim private financing for Plastic and that he had clients in the construction business who might be of assistance in connection with an association of Plastic with another company, and Quase said he had such a company in mind.

Respondent contends that most of the evidence relied upon by the examiner in finding professional misconduct relates to conversations prior to the October 29 meeting in which respondent admittedly had no part and of which he denies knowledge. He stresses that Doane was the only staff witness whose testimony with respect to that meeting allegedly connects him with the activities and statements of the other persons involved,[7] and argues that Doane's testimony should not be credited on the grounds that it contained inconsistent statements and was motivated by a desire to show that the registration statement his firm prepared was considered deficient because of sinister political influences. He further urges that it is not unethical for a lawyer to accept a layman's suggestion as to the amount of a reasonable fee, accept a client recommended by a layman, or even represent a client, such as an insured motorist, who did not employ him, and that there is no direct testimony that respondent agreed to divide the fee with Quase.

There is no merit in respondent's contentions. Not only Doane, but also Freehill, testified that Quase discussed the fee with Doane at the October 29 meeting. The fact that the negotiations for respondent's legal services on October 29 were conducted in Quase's office lends support to Doane's testimony that Quase dominated that meeting. The events which occurred prior to the meeting are also relevant, irrespective of whether respondent had knowledge of them, because they too tend to support the testimony of Doane and Freehill as to what took place at the meeting. They demonstrate the likelihood that the negotiations at the meeting, like the earlier negotiations, were conducted by Quase and dealt with the performance of services by Quase and his associates, whom respondent

[7] Quase was called as a witness for our staff but, during the examination, claimed his privilege against self-incrimination. Respondent asserts that staff counsel "actively prevented" Quase from testifying by declining to seek authority from us to grant Quase immunity from criminal prosecution so that he could have been compelled to testify, and contends that, accordingly, it must be presumed that Quase's testimony would have been adverse to the staff's position.
Respondent, however, cannot legitimately complain of the staff's decision not to waive any rights of the Government to bring a subsequent criminal prosecution against Quase, and, under the circumst-ances, no such adverse presumption can be drawn.

joined by at least October 29, and the proposed use of influence and distribution of a portion of the fee for political purposes.

As we have seen, Freehill made statements to Ackles about the use of influence before Ackles met Quase and Quase made similar statements to Ackles and then to Doane and indicated to Doane that he was in a position to ensure prompt registration and that he was fixing the fee for such services. In addition, the amount, form, and manner of payment of the fee discussed by Quase and Doane prior to October 29, except possibly for the amount due when the registration statement became effective which, however, was also indicated by Quase, were the same as the terms finally arrived at on October 29. It should also be noted that the amount of the proposed Plastic fee was substantially in excess of any fee respondent had previously received for services in connection with a registration statement and of respondent's gross annual income from the practice of law in the years just prior to the events in question.[8] And it is further consistent with Quase's control of the negotiations that, as previously indicated, respondent apparently looked to Quase, rather than Doane, for information as to whether Plastic intended to accept the retainer agreement.

We find no warrant for rejecting Doane's testimony respecting the events in question. The only testimony at variance with his on the important issues is respondent's own account of the meeting. However, the hearing examiner, who observed the demeanor of both Doane and Kivitz and weighed the circumstantial evidence in the record, chose to believe Doane's version of the essential facts. And the asserted inconsistencies in Doane's testimony are either not real or not material, and none reflects on the credibility of Doane's basic factual account of his dealings with Quase and respondent.

For example, Doane's statements that Quase dominated the October 29 meeting and set the essential terms of the fee and that respondent did not have much to say in the presence of Quase are not inconsistent with Doane's testimony that respondent had by the questions he asked Doane indicated a knowledge of Commission rules and regulations and had answered in the negative a question privately put by Doane concerning whether respondent had been successful on all his

[8] Through 1967 the largest amount received by respondent for services in connection with a registration statement was $15,000, which included the fee payable for services rendered by an accountant. His gross annual fees from the practice of law for 1961 to 1964 ranged from $25,000 to $42,000.

"SEC applications" (as Quase had indicated).[9] Nor is respondent aided by the stress he places on a comparison of Doane's testimony that his purpose in meeting with Quase was merely to gather evidence against Quase with Doane's testimony that he told Ackles that the proposed down payment was "to open up the doors for them from this present administration and many things that I don't want to know about," or with Ackles' testimony that his principal purpose in hiring Doane was to secure the registration of the stock.[10] While the hearing examiner did not credit Doane's testimony that his sole purpose in meeting Quase was to expose apparent misconduct,[11] he concluded that Doane's purpose in that regard was not a matter on which the charges against respondent were dependent and that Doane's effort to present his motivations in a better light did not justify disregarding his testimony generally, which he found was in its basic aspects "strongly corroborated by other direct testimony and by a tight structure of very compelling circumstantial evidence."

The record does not bear out respondent's assertion that Quase merely referred a client to him and that he merely accepted Quase's suggestion as to the amount of a reasonable fee. It shows that Quase offered Ackles the services of what Quase described as an "organization," including legal and political services, negotiated with a considerable expenditure of time and some phone expense with Ackles and Doane, used his office for the meeting on October 29, set the fee for such services and the form and manner of payment, and asked respondent to furnish the legal services and reduce the proposed agreement to writing. Thus, Quase, not respondent, was determining the manner in which Plastic was to be represented and the fee was to be paid, and exploiting respondent's legal services toward that end. The participation of respondent as an attorney in such an arrangement is precisely the type of conduct which the pertinent provision of the Canons of Professional Ethics of the American Bar Association was designed to

[9] Respondent also states that Doane's testimony that when he arrived at Quase's office on October 29 respondent was already present was contradicted by respondent and Freehill. However, not only is such conflict immaterial, as respondent essentially concedes, but Freehill testified that she was not certain whether he arrived after her or not because he may have been in another room of Quase's suite.

[10] Moreover, contrary to respondent's assertion, there is no inconsistency between Doane's stated purpose of gathering evidence against Quase and his characterization of Quase's "dealings" as "above board," in view of Doane's explanation of that phrase as meaning merely that Quase "very bluntly and frankly, laid out to us that he had an organization to do what he [previously] said he could do."

[11] Doane testified that if Quase would have been willing to perform the services without receiving a down payment, he might have engaged Quase's services for Ackles, but that under those circumstances he "would then have disassociated [his] law firm from the operation."

prevent.[12] Quase's role was not, as respondent argues, like that of an insurance company which retains a lawyer to defend an accident suit against its policyholder. The insurance company bears the risk of liability and, by agreement with the insured, pays the attorney from the proceeds of the premiums paid. Quase, however, would sustain no liability were the registration statement not cleared.

The evidence shows that respondent placed himself under the control of a layman who was not subject to professional discipline and who made unethical and indefensible representations to counsel for the prospective client in respondent's presence. The absence of direct testimony in the record that respondent agreed to divide the fee with Quase is, of course, not conclusive. The record clearly supports the inference that Quase and respondent anticipated Quase's receiving a portion of the fee from respondent purportedly to pay for political influence to clear the registration statement to be prepared by respondent.[13]

Respondent further contends that we cannot discipline him for the activities in question because they do not in fact involve representation of Plastic before this Commission. He notes that he did not prepare any document for filing nor file any document with the Commission, and that the proposed retainer agreement was not accepted by Plastic. We disagree with this contention. It is clear that respondent practices before this Commission. He is therefore subject to discipline under Rule 2(e) if he is found "to be lacking in character or integrity or to have engaged in unethical or improper professional conduct." This language does not limit our disciplinary control to cases of misconduct committed in actual dealings with us or our staff, or, indeed, in connection with any form of practice before this Commission.[14] But it is not necessary to

[12] Cannon 35 provides:

> "*Intermediaries.* The professional services of a lawyer should not be controlled or exploited by any lay agency, personal or corporate, which intervenes between client and lawyer. A lawyer's responsibilities and qualifications are individual. He should avoid all relations which direct the performance of his duties by or in the interest of such intermediary. A lawyer's realtion to his client should be personal, and the responsibility should be direct to the client . . ."

[13] As stated by the hearing examiner, "Whether Quase was in fact in a position, or intended, to so employ some of the funds is not disclosed by this record, and is not material; his representations do show, however, that some part of the fee was destined for Quase and was for other than the legal services to be rendered" by respondent. *Cf.* ABA Canon 34: "*Division of Fees.* No division of fees for legal services is proper, except with another lawyer, based upon a division of service or responsibility." See also *Opinions on Professional Ethics*, Legal Studies of the William Nelson Cromwell Foundation (1956, Columbia U. Press), pp. 350–52.

[14] See *Paul M. Kaufman*, 44 S.E.C. 372, 374 (1970).

decide here whether we may discipline an attorney practicing before us on the basis of conduct totally unrelated to Commission practice. Respondent is charged with unprofessional conduct in a matter which directly related to a proposed filing of a registration statement with us. As the agency charged with the responsibility of protecting investors as well as dealing fairly with issuers, we are vitally concerned by a layman's exploitation of an attorney's privilege to practice before us, by improper fee arrangements involving the proposed use of political influence to secure registration, and by the possible inclusion in the registration statement of financial statements prepared by an accountant willing to "stretch a point." Such misconduct provides a sufficient basis for this Commission to protect the integrity of its administration of the federal securities laws by taking disciplinary action against respondent.

JURISDICTION TO DISCIPLINE ATTORNEYS

Respondent contends that because there is no specific statutory grant to us of authority to discipline attorneys practicing before us, our jurisdiction to discipline attorneys can be derived only from the power to admit them to practice, which he claims has now been preempted by federal statute (Act of November 8, 1965, 79 Stat. 1281, codified in 5 U.S.C. 500), and cannot be exercised under our general rule-making power.

There is no substance to this contention. Subsection (b) of the cited statute provides that an attorney who is a member in good standing of the bar of the highest court of a State or territory or possession of the United States or the District of Columbia may represent a person before a federal agency on filing an appropriate written declaration with the agency. However, this provision does not in fact preempt the matter of admission to practice before federal agencies but merely makes automatically eligible a certain class of attorneys. Subsection (d)(1) specifically states that the statute does not deny to an individual who is not a member of the bar of the designated courts the right to represent others before an agency.[15] Moreover, subsection (d)(2) provides that the statute "does not . . . limit the discipline, including disbarment, of individuals who appear in a representative capacity before an agency." We cannot agree with respondent's construction of the latter provision as preserving only such power to discipline

[15] Rule 2(b) of our Rules of Practice makes eligible to practice before us, in addition to members of the bar of the highest court of any State or Territory of the United States, attorneys admitted to practice before the U.S. Supreme Court, or the Court of Appeals or the District Court of the United States for the District of Columbia.

attorneys as is expressly conferred by statute. The legislative history of that provision indicates that it is applicable to all federal agencies which exercised disciplinary power over attorneys, whether carried out under their general rule-making authority, which had been the case in virtually all federal agencies for a long time prior to the enactment of the statute in question,[16] or pursuant to a specific statutory grant.[17] To apply respondent's construction would leave most of the federal agencies without power to control the large number of attorneys who regularly practice before them, a result which we think it is clear Congress did not intend.

Remedial Sanction

As previously stated, the hearing examiner determined to suspend respondent's privilege of appearing or practicing before us for two years. Respondent has advanced various factors in urging that we impose no sanction or a lesser sanction. Among other things, respondent points out that this case involves a single transaction which occurred in October 1964 and resulted in the institution of Rule 2(e) proceedings almost five years later, and asserts that such transaction constituted his "first offense"; that his alleged misconduct involved no moral turpitude; that although past misconduct is evidence under Rule 2(e), the fitness of an attorney to practice is to be determined on the basis of his present integrity, and the record shows that his present character and reputation are unimpeachable; and that the sanction assessed is unduly harsh compared to sanctions imposed by the courts in disbarment proceedings and by this Commission in broker-dealer disciplinary proceedings.

We view the misconduct found on the part of respondent to be very serious and disturbing, particularly since an attorney

[16] It had been well established that an administrative agency that has general authority to prescribe its rules of procedure may prescribe grounds on which an attorney's right to appear may be revoked. *Herman* v. *Dulles*, 205 F.2d 715, 716 (C.A. D.C. 1953); *Goldsmith* v. *U.S. Board of Tax Appeals*, 270 U.S. 117, 122 (1926); *Manning* v. *French*, 21 N.E. 945 (Mass. 1889). See also *Schwebel* v. *Orrick*, 153 F. Supp. 701, 704 (D.D.C. 1957), *aff'd on other grounds*, 251 F.2d 919 (C.A.D.C. 1958), *cert. denied* 356 U.S. 927.

[17] The House Report which accompanied the bill stated that "the legislation does not . . . limit discipline by agencies of persons who appear before them as representatives." H. Rep. No. 1141, 89th Cong., 1st Sess., U.S. Code Cong. & Ad. News, pp. 4170, 4173-74 (1965). In a letter annexed to the Report, *Id.*, at 4178, the then Deputy Attorney General pointed out that the Department of Justice "has eliminated formal admission procedures and special examinations for practice before the administrative boards and agencies under its supervision. The Department, however, has retained the power to discipline attorneys . . ." He noted that "the bill retains in Federal agencies an element of control, particularly in disciplinary situations," and stated that, subject to the retention of this feature, the Department favored the bill. Likewise, on the floor of the House of Representatives, Congressman Willis, when introducing the bill, stated: "It does not affect the power of agencies to discipline persons who appear before them." 111 Cong. Record 27193.

holds himself out as observing the highest standards of professional behavior. Respondent became a knowing party to an arrangement the nature of which was to undermine the integrity of the Bar and the processes of an agency of the United States, erode the protection to which public investors are entitled under the Securities Act, and debase the registration and accounting requirements which this Commission is charged to enforce. We cannot accept the argument that no moral turpitude is involved in participating in an arrangement which contemplates the use of a portion of a legal fee for political influence and of an accountant who might stretch a point in order to secure the registration of a public offering. While a number of character witnesses testified that respondent's reputation is excellent, such testimony must be considered in light of the facts that these proceedings have been private and that respondent has since the investigation of Plastic in 1965 acted on notice that his conduct might be under scrutiny. Moreover, the remedial action which is appropriate in a disciplinary proceeding depends upon the facts and circumstances of each particular case and cannot be precisely determined by comparison with other cases.[18] We have also taken into account the fact that a suspension from practice before this Commission would not be as serious as a court-ordered suspension which would completely bar the attorney from engaging in any form of law practice during the period of the suspension. Finally, the imposition of a sanction here no less serves a remedial purpose because of the lapse of time since the misconduct occurred, and it does not appear that respondent's defense was prejudiced thereby.[19] Under all the circumstances, we are of the opinion that the two-year suspension imposed by the hearing examiner is appropriate.

An order denying Kivitz the privilege of practicing before us for that period will issue.

[18] *Cf. Winkler* v. *S.E.C.*, 377 F.2d 517, 518 (C.A. 2, 1967); *Dlugash* v. *S.E.C.*, 373 F.2d 107 (C.A. 2, 1967); *Haight & Co., Inc.*, 44 S.E.C. 479, 510 (1971).

[19] *Cf. Kroll* v. *U.S.*, 433 F.2d 1282, 1286 (C.A. 5, 1970).

Respondent has requested that these proceedings remain private, and that, in the exercise of our discretion, we direct that notice of our decision not be published, as is our practice, in this Commission's News Digest. This request is denied. Under the Administrative Procedure Act as amended (5 U.S.C. 552(a)(2)), this Commission is required in accordance with published rules (see 17 CFR 200.80) to make available to the public final opinions and orders made in the adjudication of cases. Moreover, no sufficient showing has been made to warrant the exclusion of notice of our decision from the News Digest.

The exceptions to the initial decision of the hearing examiner are overruled to the extent that they are inconsistent with our decision, and sustained to the extent that they are in accord with it.

By the Commission (Commissioners OWENS, SMITH and HERLONG), Commissioner NEEDHAM concurring in part and dissenting in part, and Chairman CASEY not participating.

Commissioner NEEDHAM, concurring in part and dissenting in part:

Under the circumstances presented by this record, including the delay in instituting the proceedings and the character testimony, I believe that censure of Kivitz would be a sufficient sanction in the public interest for the improper professional conduct in which he engaged.

In the Matter of

AUGION-UNIPOLAR CORPORATION

File No. 3-2079. Promulgated July 5, 1971

Securities Act of 1933—Section 8(d)

STOP ORDER PROCEEDINGS

Material Deficiencies in Registration Statement

Failure to Cooperate

Where registration statement under Securities Act of 1933 was materially deficient in describing intended use of proceeds of offering and certain inventions on which issuer's business was dependent, failed to disclose possibility of adverse claim to inventions and that issuer's licensee did not have financial capacity to honor potential contractual commitments, and contained financial statement not complying with Regulation S-X, and where issuer failed to cooperate in examination pursuant to Section 8(d), *held*, Commission would not consider issuer's post-effective amendments, and stop order issued.

Practice and Procedure

Issuer's contentions that Section 8(e) examination can be conducted only after institution of stop-order proceedings, that issuer cooperated in examination to extent permissible without infringement of privilege against self-incrimination, that Commission was estopped from bringing proceedings because registration statement was prepared in accordance with its staff's advice at pre-filing conference, that hearing examiner's decision was not in proper form and examiner was biased, and that Section 8(c) required Commission to declare post-effective amendments effective and dismiss proceedings, *rejected.*

APPEARANCES:

Thomas N. Holloway, *L. Keith Blackwell*, and *Alois Lubiejewski*, for the Division of Corporation Finance of the Commission.

Walter F. Wessendorf, Jr., for Augion-Unipolar Corporation.

FINDINGS, OPINION AND STOP ORDER

Following hearings in this stop-order proceeding pursuant to Section 8(d) of the Securities Act of 1933 ("Act"), the hearing examiner filed an initial decision in which he concluded, among other things, that a registration statement filed on May 2, 1969 by Augion-Unipolar Corporation ("registrant") was materially deficient in various respects and that a stop order should issue suspending its effectiveness. We granted registrant's petition for review, and registrant and our Division of Corporation Finance ("Division") filed briefs. On the basis of an independent review of the record, we reach the same conclusion as the hearing examiner.

Registrant was organized in February 1969 to engage in research and development with respect to, among other things, "unipolar-ion" devices. It has done no business, has no plant, research facilities, services or products, and uses office space provided in his residence without charge by its president, Walter F. Wessendorf, Jr., who is also registrant's counsel, a director, a promoter and a controlling stockholder. The registration statement, which became effective by lapse of time on May 21, 1969, relates to a proposed public offering of 1,000,000 shares of registrant's $.01 par value common stock at $10.00 per share, to be made through registrant's executive officers and directors to residents of the State of New York.[1]

Deficiencies in Registration Statement

(a) Use of Proceeds

The registration statement estimates that, if all the securities covered thereby are sold, registrant will receive net proceeds of $9,210,000. Of that amount, the registration statement states that it is proposed to spend over a four-year period an aggregate of $7,200,000 ($1,800,000 each year) for "Research and Development" in five categories listed in order of priority, and a total of $2,000,000 ($500,000 each year) for "General Administration." It is further stated that if the offering is undersubscribed, funds will be used for some research in the five categories in their order of priority although the funds may be used "in altered proportions", but that, if insufficient funds are raised to conduct any research and development, registrant will simply pay officers' salaries and allow itself to become bankrupt.

The descript on of the intended use of the proceeds of the offering is materially deficient. The Act provides, with exceptions not relevant here, that a registration statement must set forth "the specific purposes in detail and the approximate amounts to be devoted to such purposes, so far as determina-

[1] Registrant filed post-effective amendments on June 12 and August 14, 1969, which have not been declared effective pursuant to Section 8(c). Registrant states that it has not offered or sold any of the securities covered by the registration statement.

ble, for which the security to be offered is to supply funds."[2] The generalities supplied in the registration statement give an investor no clear idea of the specific uses to which the proceeds will be put within each category or over-all,[3] despite the fact that registrant, which is seeking to obtain $10,000,000 from the investing public, has no functioning existence at the present time. For example, no information is supplied as to the charges which each category of the proposed budget will bear for start-up costs before research and development can begin. Nor does registrant disclose on what basis it will determine the "altered proportions" in which it may allocate the proceeds in the event of undersubscription,[4] or the minimum amount of funds it considers necessary to embark upon its program rather than allowing itself to become bankrupt, or the maximum period of time during which the offering is to be continued in order to establish its success or failure to raise such minimum amount.[5] Registrant's assertions that it lacks expertise and will be operating "in the field of the unknown and esoteric" do not justify its failure to supply any meaningful information as to its intended use of the proceeds as required by the disclosure standards of the Act.[6]

(b) Organization and Business

1. The registration statement recites that registrant owns the rights to five inventions invented solely or jointly by Paul B. Fredrickson, registrant's vice-president, treasurer, and executive director of research, and that its business "is and will be materially dependent" upon obtaining patent protection for such inventions, improvements thereon, and for other "in-house" inventions and discoveries. It is further stated that, since 1963, Fredrickson has been employed as a nuclear physicist by another firm. No disclosure is made, however, of Fredrickson's agreement with that employer, executed in 1963, which requires Fredrickson to inform it of and assist it in obtaining patents on inventions and discoveries made by him individually or jointly with others while an employee which

[2] Section 7 and Schedule A(13) of the Act.

[3] See *Lewis American Airways, Inc.*, 1 S.E.C. 330, 344 (1936).

[4] *Cf. Central Oils Incorporated*, 39 S.E.C. 349, 350 (1959).

[5] See *Texas Glass Manufacturing Corp.*, 38 S.E.C. 630, 635 (1958).

[6] Registrant further contends that the information it furnished with respect to its intended use of the proceeds of the offering is consistent with that appearing in recent registration statements of other companies. The adequacy of those other registration statements, of course, is not before us in this proceeding, but even if we were to assume that those registration statements contained deficiences similar to those we have found here, we would not be precluded thereby from taking action in the present instance. See *F.C.C.* v. *WOKO, Inc.*, 329 U.S. 223, 227–8 (1946); *Maxwell Company* v. *N.L.R.B.*, 414 F.2d 477, 479 (C.A. 6, 1969); *Fotochrome, Inc.*, 43 S.E.C. 151, 153 (1966).

relate directly or indirectly to the work or products of the employer or companies in which it may have a substantial interest, and provides that such inventions and discoveries shall be and remain the property of the employer whether patented or not. While at least one of the inventions listed in the registration statement appears to have been specifically exempted from Fredrickson's agreement as pre-dating his employment, the possibility that the employer may assert rights to some of the inventions upon which registrant's business is said to be dependent, and the existence of the agreement on which this possibility is based, are obviously material facts which should have been disclosed to potential investors. Registrant's failure to do so rendered the registration statement materially misleading.

2. The registration statement is also materially deficient with respect to its discussion of certain license agreements entered into be registrant. Those agreements are cited as sources of potential multi-million dollar payments to registrant provided that within four years it successfully develops certain patent protected anti-pollutant devices, and provided further that the licensee then gives its approval. No disclosure is made, however, that the licensee does not have the financial capacity to make the payments called for by the agreements, that it does not believe it will be able by itself to generate such funds in the future, and that it has no arrangement or plan for raising the moneys from other sources. Without such disclosure, an investor would clearly be misled as to the potential value of the agreements to registrant.[7]

Registrant argues that it was required to disclose only bilateral executory contracts and that those at issue here are "unilateral" agreements not requiring disclosure, and that, in any event, the contracts are not material since the licensee is not bound thereunder to give its approval, which is a condition precedent, to its incurring any obligations to registrant. Disclosure is required, however, of all material contracts of whatever type which are not made in the ordinary course of business and are to be executed in whole or in part at or after the filing of the registration statement.[8] We have defined a material contract as "one concerning which an average prudent investor ought reasonably to be informed before purchasing the registered security."[9] The contracts in question appear

[7] See *Brandy-Wine Brewing Company*, 1 S.E.C. 123, 134 (1935).

[8] Schedule A(24) of the Act.

[9] *Winnebago Distilling Company*, 6 S.E.C. 926, 934 (1940).

plainly material, but, even assuming they were not, once registrant chose to describe them in the registration statement it was obligated to do so in a manner that would not mislead potential investors.

3. The registration statement is also materially deficient with respect to the descriptions of the inventions claimed by registrant, two of which are described in technical terms incomprehensible to the average investor. Registrant points to the fact that the patent for one of those inventions is attached as an exhibit to the registration statement, and asserts that the other was necessarily described in technical terms since it is "in the field of the unknown and esoteric." However, these factors cannot excuse registrant's failure to make meaningful disclosure.

(c) Financial Statement

Article 5A of Regulation S–X,[10] which is applicable to the financial statement filed as part of the registration statement, provides, with exceptions not relevant here, that in the case of intangible property[11] and unrecoverable promotional and development costs,[12] dollar amounts are to be extended only for cash transactions. The balance sheet contained in the registration statement lists assets totalling $55,000, of which $35,000 is attributed to "Property" and $10,000 to "Organization Expense". The $35,000 represents the value placed by registrant on intangible property consisting of four inventions which were acquired in exchange for 3,500,000 shares of registrant's stock; the $10,000 is based on Wessendorf's bill for legal services in organizing registrant, which registrant paid by issuing him 1,000,000 shares. Since both items were paid for by issuing shares of registrant's stock, the balance sheet in showing dollar amounts for these items was not prepared in the form required by the Regulation, and was materially misleading.[13]

Failure to Cooperate

Section 8(e) of the Act empowers this Commission to make an examination in any case in order to determine whether a stop order should issue, and provides that if the issuer fails to cooperate "such conduct shall be proper ground for the issuance of a stop order." The examiner found that in a private examination pursuant to Section 8(e) conducted prior to the

[10] Regulation S-X governs the form and content of financial statements filed with us.

[11] Rule 5A–02(13) (a).

[12] Rule5A–02(14).

[13] See *Strategic Minerals Corporation of America*, 39 S.E.C. 798, 805 (1960).

institution of this stop-order proceeding under Section 8(d), registrant failed to cooperate in that (1) registrant's president, Wessendorf, claiming his privilege against self-incrimination, refused to answer a question by a staff member duly designated to conduct the examination as to whether Wessendorf were willing, either by subpoena or voluntarily, to produce registrant's corporate books and records for examination, and (2) registrant did not respond to a duly served subpoena duces tecum which required it to appear on June 5, 1969, by its president, Wessendorf, for the purpose of testifying and producing certain specified corporate books and records.

Registrant argues that no examination can be conducted pursuant to Section 8(e) of the Act prior to the formal institution of a stop-order proceeding under Section 8(d), and so the examination conducted in this case was illegal; that, in any event, registrant cooperated in the investigation to the extent permissible without infringement of the privilege against self-incrimination; and that our staff agreed that registrant would not have to honor the subpoena duces tecum for June 5, 1969 if Wessendorf agreed to testify on May 27, 1969.

There is no merit to these contentions. Nothing in the language of Sections 8(d) and (e) or in the legislative history of the Act supports the construction urged by registrant. On the contrary, there would be little logic or common sense in requiring the institution of formal stop-order proceedings before an examination order could issue under Section 8(e) "to determine whether a stop order should issue," especially since examinations are generally conducted privately. It has been our normal practice over the years to authorize examinations pursuant to Section 8(e) prior to the institution of stop-order proceedings under Section 8(d),[14] although a Section 8(e) examination is not, of course, a prerequisite to the institution of such stop-order proceedings.[15] Since the privilege against self-incrimination is not available to a corporation, Wessendorf's claim of the privilege does not excuse registrant's failure to produce its books and records or otherwise cooperate.[16] Finally, the examiner concluded that the testimony of Wessendorf and another of registrant's officers that Division counsel had excused registrant from compliance with the June 5 subpoena could not be credited. We find nothing in the record to

[14] See 1 Loss, *Securities Regulation*, 274–5 (2d ed. 1961).

[15] *Breeze Corporations, Inc.*, 3 S.E.C. 709, 713–15 (1938).

[16] See *Campbell Painting Corp.* v. *Reed*, 392 U.S. 286, 288–89 (1968); *United States* v. *White*, 322 U.S. 649, 698, 699 (1944).

move us to a different conclusion.[17] Accordingly, we affirm the examiner's findings of a failure to cooperate.

OTHER MATTERS

Registrant argues that we are estopped from bringing this proceeding because the registration statement was prepared in accordance with "the recommendations and advice" given to Wessendorf by our staff at a pre-filing conference. However, not only may the doctrine of estoppel not be invoked against the Government acting in a sovereign capacity to protect the public interest,[18] but the record does not show any basis for a claim of estoppel. Staff members gave Wessendorf no reason to believe that their comments, with respect to a draft prospectus which they had never seen before, were definitive, or that a filing by registrant in accordance with Wessendorf's interpretation of their views would satisfy applicable requirements.

Registrant further contends that the hearing examiner's initial decision did not comply with Rule 16(a) of our Rules of Practice because he failed to rule on each proposed finding of fact and conclusion of law, [19] that the decision was also deficient because the examiner did not label his findings and conclusions as such, and that in various respects the examiner was biased and prejudiced. These contentions also lack merit. An examiner's decision may be in narrative form and need not specifically show his ruling on each proposed finding and conclusion as long as such rulings are in some way indicated.[20] The examiner's decision, which included the statement that all proposed findings and conclusions had been considered and had been accepted to the extent they were consistent with such decision, was sufficiently explicit to enable the bases for his action to be ascertained.

In support of its claim that the examiner was prejudiced, registrant contends that the examiner ignored an instance of

[17] Not only did members of our staff give testimony contrary to that of registrant's officers but, as the examiner noted, the transcript of Wessendorf's testimony of May 27, in exchange for which registrant asserts it was excused from compliance with the subpoena, reveals that Wessendorf refused to answer the staff's question whether he intended to honor the June 5 subpoena and particularly the demand for the production of the corporate books, a circumstance hardly consistent with the claim the registrant had been excused from responding to that subpoena. As the examiner found, the record is clear that staff members were "deeply interested" in examining registrant's records, that such records were never made available, and that it is incredible to believe that staff counsel abandoned efforts to examine such records.

[18] *Richard N. Cea*, 44 S.E.C. 8, 21 and cases there cited in note 18.

[19] Rule 16(a) provides, in relevant part, "An initial decision shall include: findings and conclusions, with the reasons or bases therefor, upon all the material issues of fact, law or discretion presented on the record."

[20] *Norman Pollisky*, 43 S.E.C. 852, 861–62 (1968).

our staff's "tampering" with a witness during the hearings, and asserts that the examiner was a respondent, along with this Commission, in two interlocutory applications to the Court of Appeals made by registrant in connection with this proceeding.[21] These arguments are entirely lacking in substance. During the hearings, Wessendorf, appearing as attorney for registrant, requested the hearing examiner to "admonish all persons present not to engage in any facial expressions" with respect to the answers being given by the witness then testifying. The examiner stated that he had not observed "any such signalling" but nevertheless warned those present as Wessendorf had requested. Not only did Wessendorf fail to file an affidavit with the examiner seeking his disqualification because of this incident, in accordance with Rule 11(c) of our Rules of Practice, but he specifically stated to the examiner on the record that "there was no reason at this time for us to charge any bias on your part." As to registrant's naming of the examiner as a respondent in its interlocutory applications, which were dismissed by the Court, what we said, in denying its prior similar motion to disqualify this Commission, is equally applicable with respect to the examiner. As we there indicated, it would be anomalous indeed if by registrant's own abortive legal actions it could disqualify the hearing examiner from performing his statutory functions in the instant remedial proceedings.[22]

CONCLUSIONS

We have found material deficiencies in the registration statement as well as a failure to cooperate on the part of registrant. Registrant contends, however, that no stop order should issue, arguing that since the Division has not raised any question with respect to registrant's post-effective amendments and registrant has not sold any of its registered securities to public investors, Section 8(c) of the Act makes it mandatory that we declare those amendments effective and thereupon dismiss these proceedings. We cannot agree.

Under Section 8(c) of the Act we are required to permit an amendment filed after the effective date of a registration statement to become effective only if such amendment upon its face appears not to be incomplete or inaccurate in any mate-

[21] Civil Actions Nos. 34071 and 35615, filed in the United States Court of Appeals for the Second Circuit on September 22, 1969 and November 17, 1970, respectively. The Court dismissed both applications.

[22] See *Augion-Unipolar Corporation*, 44 S.E.C. 436, 439 (1970).

rial respect and then only when such action is consistent with the public interest and the protection of investors. Whether such an amendment should be considered by us after stop-order proceedings have been instituted is a matter for the exercise of our discretion in the light of those provisions and the requirements of an orderly procedure.[23] We think that consideration of the post-effective amendments as an alternative to the issuance of a stop order would be inappropriate here. As noted above, registrant and its offices failed to make its books and records available for examination, and, indeed, its officers, asserting their privileges against self-incrimination, refused to answer questions put to them in the examination. Even if we could assume that registrant's post-effective amendments were fully curative of the designated deficiencies in the registration statement, the information which registrant and its officers refused to furnish might have disclosed further material deficiencies.[24] Under the circumstances, consideration of registrant's post-effective amendments at this time would be inconsistent with the public interest and the protection of investors.

In view of the foregoing a stop order should issue suspending the effectiveness of the registration statement.[25]

Accordingly, IT IS ORDERED that the effectiveness of the registration statement filed by Augion-Unipolar Corporation be, and it hereby is, suspended.

By the Commission (Commissioners OWENS, SMITH, NEEDHAM and HERLONG), Chairman CASEY not participating.

[23] See *T.I.S. Management Corporation*, 3 S.E.C. 174, 181–3 (1938); *Doctor Dolittle Animal Fairs, Inc.*, 44 S.E.C. 309, 311 (1970).

[24] The examiner found that while registrant's amendments cured some of the deficiencies, they did not correct others or raised additional questions, and, in some respect, the record did not contain sufficient information to enable him to determine whether the amendments were curative or not.

[25] We have considered all exceptions to the hearing examiner's rulings, including those set forth in a "supplemental petition for review" filed after we had granted review of the examiner's initial decision and briefs had been filed. Such exceptions are overruled to the extent that they are inconsistent with our decision herein and sustained to the extent that they are in accord.

In the Matter of

BENJAMIN WERNER

doing business as

BENJAMIN WERNER & CO.

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

File No. 3–2786. Promulgated July 9, 1971

Securities Exchange Act of 1934—Sections 15A(g) and (h)

REGISTERED SECURITIES ASSOCIATION—REVIEW OF DISCIPLINARY PROCEEDINGS

Proceedings for review of disciplinary action by registered securities association, including censure, fine and suspension of member, for conduct violative of association rule requiring observance of just and equitable principles of trade, *dismissed*, the Commission finding that association's enforcement of rule, even though no violation of law is found, carries out mandate of Securities Exchange Act and provisions of association's charter and does not violate member's rights to due process of law.

APPEARANCES:

Stanley Kligfeld, for Benjamin Werner, doing business as Benjamin Werner & Co.

Lloyd J. Derrickson and *Frank J. Wilson*, for the National Association of Securities Dealers, Inc.

FINDINGS, OPINION AND ORDER

Benjamin Werner, doing business as Benjamin Werner & Co., a member of the National Association of Securities Dealers, Inc. ("NASD"), filed an application for review, pursuant to Section 15A(g) of the Securities Exchange Act of 1934, of disciplinary action taken against him by the Association in which he was censured, fined $7,500, suspended from membership for five business days, and assessed with costs in the amount of $287.

The NASD found that during the period from August 1964 to August 1966, applicant, as a member of selling groups for underwritten offerings of securities that had been previously outstanding, purchased an aggregate of 46,300 shares on which he received discounts or concessions of $46,663 from the respective managing underwriters. This compensation was paid for distribution of the securities to the public. Instead of attempting to effect such public distributions, however, applicant immediately sold such securities through accounts maintained by him with three broker-dealers to other broker-dealers, retaining the dealer's concessions. The NASD determined that he entered into the selling group agreements with no intention of effecting a public offering of the securities, and that accordingly his participations in such groups, which were actively solicited by him, constituted express or implied misrepresentations to the underwriters that he would distribute the shares to the public. It concluded that by reason of such misrepresentations applicant engaged in conduct inconsistent with just and equitable principles of trade and thereby violated Section 1 of Article III of the NASD Rules of Fair Practice.[1]

In his brief filed in support of the application, applicant has not denied that he engaged in the acts found by the NASD, nor has he questioned its finding that such acts were in violation of Section 1 of Article III of its Rules. He challenges, however, the right of the NASD to impose any penalty other than a censure for conduct the only impropriety of which is that it is inconsistent with just and equitable principles of trade in violation of Section 1 of Article III. He argues that, absent a finding of unlawful or illegal conduct, the NASD may not impose a fine or a suspension or assess costs against him, contending *that any such* action by the NASD is beyond its power under the Act, *ultra vires*, and in violation of his rights to due process under the Fifth and Fourteenth Amendments to the United States Constitution.

Applicant cites no statutory provision, legislative history or decisional authority to support his contentions. His argument is stated in conclusory form and is to the effect that since the NASD is not purely a private association but a registered association which is a part of the statutory scheme for the regulation of the securities industry, it may not enforce moral standards by the imposition of a fine or suspension or assessment of costs absent a finding of illegal or unlawful conduct. We find applicant's contention to be without merit.

[1] Section 1 of Article III reads as follows: "A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."

As a registered national securities association, the NASD of course must exercise its functions within the limits laid down by Congress in Section 15A of the Act.[2] Such limits, however, clearly encompass the disciplinary action in this case. The NASD's rule requiring the observance of just and equitable principles of trade,[3] and its rules providing for the imposition of a full range of penalties in connection with a violation of any of its Rules of Fair Practice,[4] carry out and implement the congressional mandate expressly set forth in Section 15A. Thus, Section 15A(b) specifically prohibits our registration of a national association of brokers or dealers, such as the NASD, unless, among other things, its rules are designed "to promote just and equitable principles of trade," [5] provide that its members and associated persons "shall be appropriately disciplined, by expulsion, suspension, fine, censure, or being suspended or barred from being associated with all members, or any other fitting penalty, for any violation of its rules," [6] and require that the determination of any disciplinary proceeding shall include a statement whether the acts or practices prohibited by the rule found to have been violated "are deemed to constitute conduct inconsistent with just and equitable principles of trade." [7] The statutory scheme thus clearly not only empowered but directed the NASD to promulgate rules to promote just and equitable principles of trade and to take disciplinary action including the imposition of fines and suspensions or other appropriate penalties for conduct inconsistent with such principles in violation of such rules.[8]

Under the circumstances, the imposition of penalties by the NASD for conduct which violates its rules (even though such conduct is *not held* to be unlawful) [9] obviously cannot be held to constitute an *ultra vires* act by the NASD. The NASD's Certifi-

[2] *National Association of Securities Dealers, Inc.*, 19 S.E.C. 424, 435 (1945).

[3] Section 1, Article III of the NASD's Rules of Fair Practice.

[4] Article V of the NASD's Rules of Fair Practice.

[5] Section 15A(b) (8).

[6] Section 15A(b) (9).

[7] Section 15(a) (b) (10) (C).

[8] When we permitted the NASD to become registered we found that its rules satisfied the requirements of the Act. *National Association of Securities Dealers, Inc.*, 5 S.E.C. 627 (1939). The argument that Section 15A unconstitutionally delegates power to the NASD has been rejected. *R. H. Johnson & Co.* v. *S.E.C.*, 198 F.2d 690 (C.A. 2, 1952), *cert. denied*, 344 U.S. 855. The Court of Appeals in that case referred to the Act as "a statute explicity concerned with adherence to 'just and equitable principles of trade." *Ibid* 696.

[9] We have long recognized that Section 1 is not limited to rules of legal conduct but rather that it states a broad ethical principle which implements the requirements of Section 15A(b). See, *e.g.*, *Lerner & Co.*, 37 S.E.C. 850, 855 (1957); *Samuel B. Franklin & Company*, 38 S.E.C. 113, 116 (1957). Our dismissal of a petition for review of NASD disciplinary action based on a finding of conduct inconsistent with just and equitable principles of trade in violation of Section 1 has been upheld on judicial appeal. *Nassau Securities Service* v. *S.E.C.*, 348 F.2d 133 (C.A. 2, 1965).

cate of Incorporation specifically states that the Association's objects and purposes are, among other things, to register as a national securities association pursuant to Section 15A of the Act and thereby to provide a medium for effectuating the purposes of that Section; to adopt and enforce rules of fair practice; and to promote high standards of commercial honor and just and equitable principles of trade. And we have stated that the NASD through its disciplinary powers can and should play an important role in improving the ethical standards of its members, subject always to their rights to obtain review by this Commission and the courts.[10]

While the NASD in its decision referred to applicant's misrepresentations as "fraudulent," it found only a violation of Section 1 and it did not find, nor did the complaint against applicant charge, any violation of the antifraud provisions of the securities acts and that issue is not before us.

We reject the argument that in the absence of a finding of unlawful or illegal conduct the action of the NASD constitutes application of a moral standard which is void for vagueness and which violates applicant's rights to due process under the Fifth and Fourteenth Amendments to the Constitution of the United States. Apart from the fact that the Fourteenth Amendment imposes certain restraints on state action and is not applicable to NASD proceedings, we are of the opinion that the Rule in question appropriately carries out the requirements of the Act, is sufficiently specific and provides an adequate standard of compliance.[11]

In view of the foregoing, we conclude that the application for review should be dismissed.

Accordingly, IT IS ORDERED that the application filed by Benjamin Werner, doing business as Benjamin Werner & Co., for review of the disciplinary action taken against him by the National Association of Securities Dealers, Inc. be, and it hereby is, dismissed.

By the Commission (Chairman CASEY, Commissioners OWENS, SMITH, NEEDHAM and HERLONG).

[10] *Valley Forge Securities Co., Inc.*, 41 S.E.C. 486, 490 (1963). We there also sustained the NASD's position that violations of the securities acts and rules thereunder also constitute conduct contrary to just and equitable principles of trade in violation of Section 1. *Ibid*, 488.

[11] *Cf. Boren & Co.*, 40 S.E.C. 217, 277–8 (1960). It may also be noted that under the rules of the NASD all complaints in disciplinary proceedings are required to be in writing and to specify in reasonable detail the nature of the charges and the rules allegedly violated, the respondent is given an opportunity to answer and to request a hearing at which he may be represented by counsel and a record is kept, and a determination to impose disciplinary actions must be in writing and include a statement of the acts committed and the rules deemed violated. See NASD Code of Procedure for Handling Trade Practice Complaints, NASD Manual, Paragraphs 3001 *et seq.*

IN THE MATTER OF

MONMOUTH CAPITAL CORPORATION

File No. 3-2322. Promulgated July 14, 1971

Securities Act of 1933—Section 8(d)

STOP ORDER PROCEEDINGS

Where registration statement under Securities Act of 1933 showed registrant as having made stock distribution under such circumstances as to convey impression they were stock dividends, when in fact registrant did not have sufficient undistributed earnings to equal value of stock distributions and such distributions were accounted for by transfers from paid-in surplus account, *held*, registration statement materially misleading in failing to disclose that financial statements were not prepared in accordance with generally accepted accounting principles.

FINDINGS, OPINION AND ORDER

Monmouth Capital Corporation is a small business investment company licensed under the Small Business Investment Act of 1958 and registered under the Investment Company Act of 1940 as a closed-end, non-diversified, management investment company. It filed a registration statement pursuant to the Securities Act of 1933 relating to a proposed rights offering to holders of its common stock to subscribe to 92,170 shares of common stock at a price of $8.00 per share for an aggregate of $737,360. After this proceeding was instituted under Section 8(d) of the Securities Act to determine whether a stop order should issue with respect to that statement, which has not become effective, Monmouth submitted an offer of settlement in which it waived a hearing and post-hearing procedures.

In the offer Monmouth consented to the entry of an order finding that the registration statement was materially misleading in failing to disclose that the financial statements contained therein had not been prepared and presented in accordance with generally accepted accounting principles. The offer further provided that Monmouth would file a correcting amendment to the registration statement and that this stop order proceeding would be dismissed.

After due consideration of the offer of settlement, and upon the recommendation of our Division of Corporate Regulation, we have determined to accept the offer.

On the basis of the registration statement as amended, the order instituting this proceeding and Monmouth's offer of settlement and consent, we make the following findings.

From 1966 through 1968 the registrant made a series of four stock distributions to its shareholders, two each of 10 percent of the stock outstanding at the time of the distribution, and two each of 25 percent. The prospectus included in the registration statement characterizes these distributions in a number of ways. It uses terminology such as "stock splits," "stock distributions," and "stock split payable in the form of stock dividend." Registrant had consistently chosen to qualify as a regulated investment company under Section 851 of the Internal Revenue Code, which required distribution to shareholders of at least 90 percent of each year's net income. As a consequence, the amounts of undistributed earnings remaining after such cash distributions when the various stock distributions were made were only a fraction of what would have been required to account for the stock distributions as stock dividends reflecting a capitalization of undistributed earnings in an amount equal to the fair value of the shares distributed.[1] As is indicated by the Statement of Paid-In Capital in the prospectus, registrant accounted for the stock distributions by transferring the par value of the shares issued ($1 per share) from the Paid-In Surplus account to its Capital Stock account.

Generally accepted accounting principles required that registrant's stock distributions be accounted for by the transfer from retained earnings to the category of permanent capitalization (the Capital Stock and Paid-In Surplus accounts), of an amount, not exceeding the retained earnings, equal to the fair market value of any additional shares issued. As the American Institute of Certified Public Accountants ("Institute") has expressed in its Accounting Research Bulletin No. 43 ("ARB No. 43"), Chapter 7 (September, 1961), small or frequent distributions of stock in pro rata amounts convey an impression that such stock distributions are stock dividends (regardless of their designation by the issuer), and as stock dividends (or the equivalent thereof due to the impression created) such distributions should, in the public interest, be made only when the

[1] Capitalization of undistributed earnings involved a transfer from retained earnings (that part of a company's equity normally considered to be available for dividends) of an amount equivalent to the fair value of the shares distributed to permanent capital (capital stock and paid-in surplus accounts).

issuer has undistributed earnings equal to the fair market value of the shares distributed. This principle is based upon the fact that, in general, the recipients of stock dividends regard such dividends as non-cash distributions of earnings rather than simply a fragmentation of their existing equity interest.

The stock distributions in this case could reasonably be construed by investors as some sort of profit distribution notwithstanding the facts that two of the distributions were in the substantial amounts of 25 percent and that the issuer had in some references characterized them (albeit not consistently) as stock splits. The Institute in ARB 43, Chapter 7 (Section B), paragraph 16 refers to this type of situation as follows:

> "The committee believes that the corporation's representations to its shareholders as to the nature of the issuance is one of the principal considerations in determining whether it should be recorded as a stock dividend or a stock split-up. Nevertheless, it believes that the issuance of new shares in ratios of less than, say, 20 percent or 25 percent of the previously outstanding shares, would destroy the presumption that transactions represented to be split-ups should be recorded as split-ups."

Inasmuch as two of the distributions were below the 25 percent range and all were "part of a frequent recurrence of issuances of shares," we conclude that under generally accepted accounting principles they should have been accounted for as stock dividends. The prospectus not only failed to disclose that those principles had not been followed in the accounting treatment of such distributions, but it contained an accountant's report which stated that the financial statements had been prepared and presented in accordance with such principles. In these respects the prospectus was materially misleading.

We must stress the importance of the principle enunciated in the introduction of ARB No. 43, namely, that the body of generally accepted accounting principles has been set down to narrow the differences in accounting practices and to provide a degree of uniformity in accounting presentations.

In concluding that it is appropriate in the public interest to accept registrant's offer of settlement and consent, we have given due consideration to all the circumstances, including the fact that no public offering under the registration statement has been made, registrant's cooperation, and the fact that the amendment, filed after this proceeding was commenced pursuant to the offer of settlement, appears to have cured the omissions which rendered the prior prospectus materially misleading. The registrant has now also filed a further amendment requesting that the registration statement as amended, be withdrawn, which we will grant.

Accordingly, IT IS ORDERED that this proceeding under Section 8(d) of the Securities Act of 1933 be, and it hereby is, dismissed.

IT IS FURTHER ORDERED that the registration statement filed by Monmouth Capital Corporation, as amended, be, and it hereby is, permitted to be withdrawn.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM and HERLONG).

IN THE MATTER OF

GREGORY & SONS

WILLIAM H. GREGORY III

File No. 3-2528. Promulgated July 15,1971

Securities Exchange Act of 1934—Sections 15(b), 15(A) and 19(a)(3)

FINDINGS, OPINION AND ORDER

In these proceedings pursuant to Sections 15(b), 15A and 19(a)(3) of the Securities Exchange Act of 1934 ("Exchange Act"), a registered broker-dealer which is in the process of liquidation by a liquidator appointed by the New York Stock Exchange ("Exchange"),[1] and by William H. Gregory III who was registrant's managing partner.

Under the terms of their offers, respondents waived a hearing and post-hearing procedures. Solely for the purpose of settling these proceedings, registrant, without admitting or denying the allegations in the order for proceedings or any violation of law, consented to certain findings of willful violations or willful aiding and abetting of such violations and to findings of a failure of supervision. In addition, respondents consented to the entry of an order imposing certain sanctions upon them.

On the basis of the offers of settlement and certain investigative material,[2] we make the following findings.[3]

Registrant, willfully aided and abetted by Gregory, willfully violated Section 17(a) of the Exchange Act and Rule 17a-5 thereunder by filing with this Commission a report of financial condition as of July 27, 1969 which was inaccurate, and they failed reasonably to supervise persons under their supervision with a view to preventing such violation. The report did not

[1] The liquidator was appointed October 23, 1969. Prior to that time registrant was a member of the Exchange and other national securities exchanges.

[2] Respondents agreed that we could make findings and draw conclusions and inferences based on material obtained in connection with the investigation of registrant.

[3] The findings herein are solely for the purpose of disposing of these proceedings as against the named respondents and are not binding against any other persons.

reflect the extent to which registrant's net capital was below that required by the Exchange because it included, as marketable securities held in registrant's trading and investment accounts, securities with a substantial market value whose resale was restricted under the provisions of the Securities Act of 1933 and which were therefore not readily marketable.[4]

Registrant's record-keeping procedures made inadequate provision for distinguishing between "restricted" and other securities in firm and partnership accounts. Its computer was not programmed to make such distinctions, and key back-office personnel were not alerted to the distinction. As a result, registrant during a period in 1969 prior to October continued to engage in business as a broker-dealer although not in compliance with the Exchange's net capital requirements,[5] and without disclosing such noncompliance. Moreover, respondents were on notice that the list of restricted securities prepared by the certifying accountants prior to the filing of the financial report was substantially incomplete. As a result of registrant's underwriting activities, it had received substantial amounts of unregistered securities, some of which were not included in that list and some of which did not contain a legend to denote their restricted character. Yet respondents advised the accountants, as part of a "representation letters," that the list was complete and a sworn statement by Gregory attached to the report stated that the information therein, including a supplement containing that list, was true and correct to the best of his knowledge and belief.

Registrant consented to revocation of its registration, provided that such revocation would not prevent the liquidator from winding up registrant's affairs. Gregory consented to suspension from association with a broker or dealer for a period of 30 days commencing with the date of the order herein and to a bar from acting in a supervisory or managerial capacity with any broker-dealer, provided that after one year from such date he may apply for the termination of such bar.

In support of his offer of settlement Gregory asserts, among other things, that he relied on registrant's key employees and newly created back-office systems, was unaware of any violations, and promptly notified the Exchange when the error in computing registrant's net capital was discovered. He further

[4] Under the net capital rule of the Exchange (Rule 325), no value may be ascribed to securities "which have no ready market."

[5] As a member of the Exchange, registrant was not subject to the provisions of Rule 15c3-1, our net capital rule.

states that he has not been engaged in the securities business since October 1969 when registrant ceased its operations, and that he has been engaged in the securities business for almost 20 years without having previously been the subject of any disciplinary proceedings by the Commission.

In view of the foregoing, we find that it is in the public interest to impose the sanctions specified in the offers of settlement.

Accordingly, IT IS ORDERED that the registration as a broker-dealer of Gregory & Sons be, and it hereby is, revoked, provided, however, that such revocation shall not prevent its liquidator from winding up its affairs.

IT IS FURTHER ORDERED that commencing with the date of this order William H. Gregory III be, and he hereby is, suspended from being associated with a broker or dealer for a period of 30 days and barred from acting in a supervisory or managerial capacity with any broker-dealer, provided that at the expiration of one year from such date he may apply to the Commission for the termination of such bar.

By the Commission (Commissioners OWENS, SMITH, NEEDHAM and HERLONG), Chairman CASEY not participating.

In the Matters of

INVESTORS MANAGEMENT CO., INC. ET.AL*

File No. 3-1680. Promulgated July 29, 1971

Securities Exchange Act of 1934—Sections 15(b), 15A and 19(a)(3)

Investment Advisers Act of 1940—Section 203(e)

USE OF NON-PUBLIC INFORMATION

Where respondent investment advisers, mutual funds and investment partnerships received, from broker-dealer which they knew was prospective managing underwriter of issuer's debentures, non-public information it had been given by issuer concerning sharp drop in earnings and reduction of earnings forecasts, and respondents thereupon effected sales and short sales of issuer's stock, *held*, respondents violated antifraud provisions of securities acts, the requisite elements of violation having been shown, namely, receipt of information that was material and non-public, recipient knew or had reason to know it was non-public and had been obtained improperly by selective revelation or otherwise, and information was factor in decision to effect transactions; and censure of respondents by hearing examiner affirmed.

Information concerning security or its issuer which is non-public because not disseminated in manner making it available to investors generally, is material in nature under antifraud provisions where it is of such significance that it could reasonably be expected to affect judgment of investors as to security's merits and, if generally known, to affect materially its market price.

Among factors to be considered in determining whether information is material are degree of its specificity, extent to which it differs from information previously publicly disseminated, and its reliability in light of its nature and source and circumstances under which it was received.

That recipient of non-public information acts immediately or shortly after receipt to effect securities transaction consistent with such information is evidence of information's materiality.

Where recipient of material non-public information which he knows or has reason to know is non-public effects securities transaction of kind indicated by information, prior to its public dissemination, such circumstances give rise to inference that information was factor in decision to effect transaction.

*Madison Fund, Inc.; J. M. Hartwell & Co.; Hartwell Associates; Park Westlake Associates; Van Strum & Towne, Inc; Fleschner Becker Associates; A. W. Jones & Co.; A. W. Jones Associates; Fairfield Partners; Burden Investors Services Inc.; William A. M. Burden & Co.

APPEARANCES:

Irwin M. Borowski, *Alfred E. T. Rusch*, *Richard H. Kogan*, *John J. Kelleher*, *Ralph K. Kessler*, *Daniel Glickman*, and *Allan A. Martin*, for the Division of Trading and Markets of the Commission.

John E. Hoffman, Jr., *W. Foster Wollen*, and *Lewis C. Evans II*, of Shearman & Sterling, for Investors Management Co., Inc.

Frederic L. Ballard, *Oliver C. Biddle*, *Duncan O. McKee*, and *Frederic W. Clark*, of Ballard, Spahr, Andrews & Ingersoll, for Madison Fund, Inc.

Joseph A. McManus, *Stephen Sayre Singer*, *David H. Smith*, and *Charles R. Stevens*, of Coudert Brothers, for J. M. Hartwell & Co., Hartwell and Associates, and Park Westlake Associates.

William E. Jackson, *Andrew J. Connick*, and *Anthony C. Stout*, of Milbank, Tweed, Hadley & McCloy, for Van Strum & Towne, Inc.

Marvin Schwartz and *M. Blane Michael*, of Sullivan & Cromwell, for Fleschner Becker Associates.

Eugene P. Souther and *Anthony R. Mansfield*, of Seward & Kissel, for A. W. Jones & Co. and A. W. Jones Associates.

Joseph B. Levin and *Wendell Lund*, of Brown Lund & Levin, for Fairfield Partners.

Samuel E. Gates, *Richard D. Kahn*, and *Standish F. Medina, Jr.*, of Debevoise, Plimpton, Lyons & Gates, for Burden Investors Services, Inc., and William A. M. Burden & Co.

FINDINGS, ORDER AND OPINION

Introduction

This is a limited review on our own motion of the hearing examiner's initial decision in these proceedings pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(e) of the Investment Advisers Act of 1940. The examiner found that the above-captioned respondents willfully violated or aided and abetted violations of the antifraud provisions of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Exchange Act and Rule 10b–5 thereunder in the sale of stock of Douglas Aircraft Co., Inc. without disclosing to the purchasers material information as to a reduction in Douglas' earnings which they had received from the prospective managing underwriter of a proposed Douglas debenture offering, Merrill Lynch, Pierce, Fenner &

Smith, Inc. ("Merrill Lynch").[1] The examiner ordered that those respondents be censured.

No petition for review of the examiner's decision was filed by any of the parties, and we were of the opinion that there was not sufficient reason to review on our own motion the examiner's factual findings or inferences, or the adequacy of the sanction of censure imposed upon the respondents who he found had committed violations, or his determinations that the proceedings should be discontinued or dismissed as to three other firms.[2] However, since we felt that the legal issues raised respecting the obligations of persons other than corporate insiders who receive non-public corporate information (sometimes referred to as "tippees") had significant implications for the securities industry and investing public, we deemed it appropriate to consider those issues and express our views on them.[3] The Division filed a brief in support of the examiner's conclusions of law, certain of the censured respondents filed a statement of views and reply briefs in opposition, and the Division filed a reply brief.

Factual Background

The following summarizes the principal facts which were found by the hearing examiner and are described in detail in his initial decision.

In 1966 Douglas was a leading producer of commercial transport aircraft and its common stock was actively traded on the New York Stock Exchange and the Pacific Coast Stock Exchange. Immediately prior to the events described below, many analysts had viewed Douglas' earnings outlook as favorable, and the company itself estimated that per share earnings would be $4 to $4.50 for 1966 and $8 to $12 for 1967.[4] On June

[1] Merrill Lynch and fourteen of its officers and employees has been named as respondents in the order for proceedings. They submitted an offer of settlement, and pursuant thereto we found violations of the stated antifraud provisions and imposed certain sanctions. *Merrill Lynch, Pierce, Fenner & Smith, Inc. et al.*, 43 S.E.C. 933 (1968). Another respondent named in the order for proceedings also submitted an offer of settlement, which we accepted, providing for censure. *City Associates*, Securities Exchange Act Release No. 8509 (January 31, 1969).

[2] The hearing examiner dismissed the proceedings as to an investment adviser which he found did not commit the violations charged in the order for proceedings; and he discontinued the proceedings with respect to two other firms which he found had no connection with the activities in question other than that they each occupied a control relationship to a censured respondent.

[3] *Investors Management Co., Inc., et al.*, Securities Exchange Act Release No. 8947 (July 30, 1970). Contrary to the contention of some of the respondents, we find that our order undertaking review of the examiner's initial decision was made within the time prescribed by our Rules of Practice, 17 CFR 201.17(c), since our records show service of that decision on June 30, 1970 upon the last respondent to be served.

[4] References herein with respect to Douglas' quarterly, six-month and annual earnings are for its fiscal year, ending November 30.

20, 1966, Douglas informed the Merrill Lynch vice-president in charge of the proposed underwriting of Douglas debentures, of substantially reduced Douglas earnings and earnings estimates. It advised that it had a loss in May, that earnings for the first six months of 1966 were expected to be only 49c per share, it would about break even for 1966, and it expected 1967 earnings to be only $5 to $6. The next day, June 21, this information was relayed to Merrill Lynch's senior aerospace analyst, who gave it to two salesmen in Merrill Lynch's New York Institutional Sales Office. The latter informed three other Merrill Lynch employees and the five employees began imparting it to decision-making investment personnel of respondents which were investment companies or partnerships with substantial capital or the advisers or managers for such interests. All of the respondents knew that Merrill Lynch was the prospective underwriter of the anticipated public offering of Douglas debentures, and some of them had indicated to Merrill Lynch an interest in buying debentures in such offering. Most of them had shortly before purchased Douglas stock.

Upon receiving the unfavorable Douglas earnings information between June 21 and June 23, respondents on those days sold a total of 133,400 shares of Douglas stock from existing long positions, which constituted virtually all of their holdings of Douglas stock, and sold short 21,100 shares, for an aggregate price of more than $13,300,000. The price of Douglas stock, which had a high of 90 on June 21, rose to 90½ the next day, apparently because of an optimistic newspaper article on the aerospace industry, and fell to 76 when Douglas publicly announced the disappointing earnings figures on June 24. On the following trading day, when those figures received further publicity the price of Douglas stock fell to 69, and subsequently declined to a low of 30 in October 1966.

As set forth below, the circumstances under which the information from Merrill Lynch was received and Douglas shares sold by the various respondents were similar in their essential aspects, although in some cases they differed in certain respects.

Respondent Madison Fund, an investment company, had purchased 6,000 shares of Douglas stock in early June 1966 on the basis of a favorable assessment of Douglas' earnings prospects for its second quarter and for 1966, and on June 13 had advised Merrill Lynch of its interest in purchasing Douglas debentures in the anticipated public offering. However, on June 21, within 15 minutes of being advised of the adverse

Douglas earnings figures by one of the Merrill Lynch employees, it placed an order with Merrill Lynch for the sale of all those shares, which was executed that day. Respondent Investors Management Co., Inc. ("IMC") acted as investment adviser to several mutual funds, two of which had on its recommendation purchased 100,000 and 21,000 shares of Douglas stock, respectively, between January and April 1966. On the afternoon of June 21 and the morning of June 22, one of the Merrill Lynch salesmen called the IMC vice-presidents who were the fund managers for the two funds and told them that Douglas would have disappointing earnings for the first six months and break even for 1966. After an unsuccessful effort to verify that information with a Merrill Lynch analyst, IMC advised the two funds to sell all their Douglas shares, and part of the shares were sold on June 22 and the balance over the next three trading days. Respondent Van Strum & Towne, Inc., which was the investment adviser to the Channing Growth Fund, and also considered the Douglas stock to be a desirable acquisition as late as June 20, when it caused that fund to buy 1,500 shares. On June 22, while attending a luncheon for professional investors, the firm's president overheard remarks implying that Douglas would have no earnings. When on making inquiry he was told that a portfolio manager for a large fund had received similar information from Merrill Lynch, he called a Merrill Lynch employee and was given the new Douglas earnings figures. He thereupon caused the 1,500 shares of Douglas stock to be sold that day.

Respondents William A. M. Burden & Co., a family investment partnership, and Burden Investors Services, Inc., which acted as investment adviser to other members of the Burden family, had on the advice of a broker purchased a total of 11,000 shares of Douglas stocks on the morning of June 21. That afternoon, one of the Merrill Lynch salesmen informed a principal Burden partner that Douglas' earnings for May were very disappointing, that its quarterly earnings would be down, and that its earnings for 1966 would be "flat". Inquiries to three analysts did not produce any verification of the information, although at the June 22 luncheon for professional investors the Burden partner heard rumors that Douglas' earnings would be very disappointing. Early on June 23, the broker on whose advice the Douglas shares had been purchased reported that he had just been cautioned about the Douglas situation and he recommended the sale of those shares. Such sale was effected later that day.

Respondent Fleschner Becker Associates, a family investment partnership formed in April 1966 which operated as a hedge fund,[5] had informed Merrill Lynch early in June of its interest in purchasing debentures in the forthcoming offering. On June 21 one of the Merrill Lynch salesmen advised respondent that Douglas' earnings would be disappointing and would show a loss for May. When the optimistic aerospace article appeared the following morning respondent decided that if the price of the Douglas stock rose, it would effect short sales of the stock. The opening price on June 22 did reflect a rise and respondent sold short 5,000 shares that day and 3,500 shares the next day.[6] Respondents A. W. Jones & Co. and A. W. Jones Associates were partnerships, with the same general partners, which operated as hedge funds. On the afternoon of June 21, a managing partner was informed by a Merrill Lynch salesman that Douglas' earnings would be disappointing and show a loss for May 1966. The next day the partner effected short sales of 2,000 shares on behalf of each of the partnerships.[7]

Respondent J. M. Hartwell & Co. managed on a discretionary basis about 200 individual and institutional securities portfolios including that of Hartwell and Campbell Fund, Inc. and a $2,000,000 segment of the portfolio of A. W. Jones & Co. Principal partners were also partners of respondents Hartwell Associates and Park Westlake Associates, hedge funds, whose investments they managed. Earlier in June 1966 a total of 1,600 shares of Douglas stock had been purchased for two of the managed portfolios. Those shares were immediately sold on June 21 when one of the Merrill Lynch salesmen advised that Douglas' earnings for the second quarter would probably show a loss and for the year would be "flat". Following the optimistic aerospace article the next day, short sales were made on behalf of Hartwell Associates, Park Westlake Associates and A. W. Jones & Co., of 2,500, 1,500 and 2,000 shares, respectively. Respondent Fairfield Partners, which operated as a hedge fund and managed about $31,000,000, had been

[5] The term "hedge fund" is frequently used to identify a limited partnership which engages in securities trading by means that customarily include the use of borrowed money, options and short sales.

[6] In recognition of the Merrill Lynch salesman's assistance with respect to the Douglas stock respondent directed a $3,000 give-up to the salesman's credit on June 28. A give-up is in effect a division of the commission received by an executing broker with another broker designated by the customer. In December 1968, the New York Stock Exchange prohibited such practice.

[7] The facts were similar with respect to City Associates, an investment partnership which as noted *supra* was censured pursuant to an offer of settlement. That respondent also effected short sales of Douglas stock after receipt of the Merrill Lynch information. It thereafter directed give-ups to Merrill Lynch. The discussion hereinafter as to violations of the antifraud provisions is also appliable to the conduct of that respondent.

skeptical about Douglas' ability to improve its earnings and had developed a short position in Douglas of 7,100 shares by June 2, 1966. When on June 21 a Merrill Lynch salesman called a partner and informed him that Douglas would show a loss for May, the firm immediately sold short an additional 900 shares.

APPLICABLE ANTIFRAUD PRINCIPLES

The maintenance of fair and honest markets in securities and the prevention of inequitable and unfair practices in such markets are primary objectives of the federal securities laws.[8] Congress has recognized the essential importance of providing full information for both the buyer and seller:

> "The concept of a free and open market for securities necessarily implies that the buyer and seller are acting in the exercise of enlightened judgment as to what constitutes a fair price. Insofar as the judgment is warped by false, inaccurate, or incomplete information regarding the corporation, the market price fails to reflect the normal operation of supply and demand."[9]

And the Supreme Court, in discussing the securities laws, has stated:

> "A fundamental purpose, common to these statutes, was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry . . . 'It requires but little appriciation . . . of what happened in this country in the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail' in every facet of the securities industry."[10]

The federal securities laws contain provisions specifically prohibiting fraudulent or deceptive acts or conduct by any person in connection with securities transactions, and we have adopted various rules implementing those provisions. The antifraud prohibitions have been applied and enforced in administrative and judicial proceedings dealing with a wide variety of securities activities which were found to have been improper in light of the statutory objectives. A number of cases have not only established that the antifraud prohibitions embrace transactions by persons who occupy a special relationship to the issuer giving them access to non-public information, but have indicated that under certain circumstances they extend to transactions by others who have received such information as a result of its selective disclosure.

[8] See the preamble and Section 2 of the Exchange Act. See also the preamble to the Securities Act.

[9] S. Rep. No. 1455, 73d Cong., 2d Sess. 68 (1934). See also *id* pp. 55–68; S. Rep. No. 792, 73d Cong., 2d Sess. 3 (1934); H. Rep No. 1383, 73d Cong., 2d Sess. 11 (1934).

[10] *S.E.C.* v. *Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963).

In *Cady Roberts & Co.,*[11] a broker had received information of a corporate dividend reduction from a salesman in the broker's firm who was a director of the corporation. The broker thereupon sold shares of the corporation's stock, on the exchange on which it was listed, for his customers and wife before such information became public. We held that the broker violated the antifraud provisions, stating that any person who is in a relationship giving access, directly or indirectly, to material information intended to be available only for a corporate purpose, violates those provisions if having such information and knowing it is unavailable to those with whom he is dealing, he effects a securities transaction without disclosing it to them.

In a number of other cases, one prior to *Cady Roberts*, we also found violationf of antifraud provisions where persons effected transactions after having obtained non-public information. In the earlier case a broker obtained from an employee of a trust company administering a bond sinking fund confidential information relating to tenders by other bondholders, and with the benefit of such information he purchased bonds and successfully tendered them to the fund at higher prices.[12] In another case, an investment adviser effected purchases of securities after receiving information of a sharp rise in sales and earnings obtained through a director of the issuer.[13] In a third, similar information was obtained from the issuer in connection with a prospective underwriting of its stock by a broker-dealer which together with partners and employees purchased securities of the issuer for themselves and customers.[14] And another case involved transactions in government securities effected by a broker-dealer who had received advance information concerning the terms of new government financings from a Federal Reserve Bank employee.[15]

The *Cady Roberts* principles were cited with approval and applied in the leading judicial decision in this area, *S.E.C.* v. *Texas Gulf Sulphur Co.* ("Texas Gulf").[16] There market purchases of a company's stock by persons connected with it who had obtained non-public information concerning a major ore strike by the company were held violative of Section 10(b) and Rule 10b–5. The Court stated that the Rule ". . . is based in

[11] 40 S.E.C. 907 (1961).

[12] *Herbert E. Hanahan*, 13 S.E.C. 754, 757–8 (1943).

[13] *Mates Financial Services*, 44 S.E.C. 245 (1970).

[14] *Van Alstyne, Noel & Co.*, 43 S.E.C. 1080 (1969).

[15] *Blyth & Company, Inc.*, 43 S.E.C. 1037 (1969).

[16] 401 F.2d 833 (C.A. 2, 1968), *cert. denied* 394 U.S. 796 (1969).

policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information," and is not limited to traditional corporate insiders. In that case the persons who had obtained the information had also communicated it to certain other persons who then purchased stock. Although the latter were not defendants in the case and the Court expressly refrained from deciding whether they had committed violations, the Court nevertheless saw fit to observe that if they acted with knowledge that the material information was undisclosed, their conduct "certainly could have been equally reprehensible."

The *Cady Roberts* rationale was also referred to in another case in which it formed the foundation for the imposition of legal liability, based on violation of Rule 10b–5, upon purchasers of securities who were close friends of officers and directors of the issuer and had received from them, pursuant to an arrangement to share profits, undisclosed information of proposed offerings by the issuer at much higher prices. The Court considered that under the circumstances the defendants in question could be deemed "insiders," but stated that if they were not insiders they would seem to have been "tippees" and "subject to the same duty as insiders."[17]

It is clear that in light of the foregoing principles the conduct of respondents in this case came within the ambit and were violative of the antifraud prohibitions of the securities laws. All the requisite elements for the imposition of responsibility were present on the facts found by the examiner. We consider those elements to be that the information in question be material and non-public; that the tippee, whether he receives the information directly or indirectly, know or have reason to know that it was non-public and had been obtained improperly by selective revelation or otherwise, and that the information be a factor in his decision to effect the transaction.[18] We shall discuss these elements in turn in light of the contentions that have been presented by the parties and pertinent considerations under the securities laws.

[17] *Ross* v. *Licht*, 263 F. Supp. 395, 410 (S.D.N.Y. 1967).

[18] Our formulation would clearly attach responsibility in a situation where the recipient knew or had reason to know the information was obtained by industrial espionage, commercial bribery or the like. We also consider that there would be potential responsibility, depending on an evaluation of the specific facts and circumstances where persons innocently come into possession of and then use information which they have reason to know is intended to be confidential. Our test would not attach responsibility with respect to information which is obtained by general observation or analysis.

With respect to materiality, we held in our findings with regard to Merrill Lynch in these proceedings that the information as to Douglas' earnings that it divulged was material because it "was of such importance that it could be expected to affect the judgment of investors whether to buy, sell or hold Douglas stock and, i f generally known, . . . to affect materially the market price of the stock."[19] Among the factors to be considered in determining whether information is material under this test are the degree of its specificity, the extent to which it differs from information previously publicly disseminated, and its reliability in light of its nature and source and the circumstances under which it was received. While the test would not embrace information as to minor aspects or routine details of a company's operations, the information received by the respondents from Merrill Lynch was highly significant since it described a sharp reversal of Douglas' earnings realization and expectations. Although all respondents did not receive identical information, in each instance the information received was specific and revealed the existence and significant extent of the adverse earnings developments. Such extraordinary information could hardly help but be important to a reasonable investor in deciding whether he should buy, sell or hold Douglas stock. The information's significance was immediately clear; it was not merely one link in a chain of analytical information.[20]

Respondents are not aided by their claim that as far as the earnings projections were concerned such projections in the aerospace industry are uncertain. Douglas was an established company with a history of operations and its adverse earnings projections were short-term and of such specific importance as would necessarily affect the judgment of investors to buy, sell or hold the company's securities. Moreover, the fact that respondents acted immediately or very shortly after receipt of the information to effect sales and short sales of Douglas stock, is in itself evidence of its materiality.[21]

The requirement that the information divulged be non-

[19] *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933, 937 (1968).

[20] The probability of the accuracy of the information was strongly indicated by the fact that it was highly adverse and, as all the respondents knew, the informant was engaged in acting for Douglas as prospective managing underwriter of an offering seeking to raise new funds from the public, at a time when it was thus the company's and the underwriter's interest to promote a favorable earnings picture. *Cf. Texas Gulf, supra*, at p. 849: "Whether facts are material within Rule 10b-5 when the facts relate to a particular event . . . will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in the light of the totality of the company activity."

[21] See *Texas Gulf*, at p. 851.

public was also satisfied here. Information is non-public when it has not been disseminated in a manner making it available to investors generally.[22] Although during the first half of 1966 some aerospace analysts had indicated pessimism concerning Douglas' earnings prospects, and there were adverse rumors circulating in the financial community on June 21, 22 and 23 regarding Douglas' earnings, the information conveyed to respondents by Merrill Lynch personnel was much more specific and trustworthy than what may have previously been known to those analysts or could be said to have been general knowledge. The rumors circulated at the June 22 luncheon, which was attended by about 50 representatives of professional investors, to the effect that Douglas' earnings would be disappointing and that it was having production problems and would not be able to meet its delivery schedules, did not, as respondents urge, reflect specific public knowledge of the earnings information disclosed by Merrill Lynch. Unlike that information, the rumors did not include specific figures of actual and projected earnings and were not attributed to a corporation-informed source. Moreover, even if the rumors had contained the more specific data, their circulation among the limited number of investors present at the luncheon could not constitute the kind of public disclosure that would suffice to place other investors in an equal position in the marketplace. It was not until after Douglas had issued its press release that the earnings data became available to the investing public.

The specific Douglas earnings information imparted to respondents having thus been of the material and non-public character bringing it within the scope of the antifraud provisions, we turn to the question of the awareness on the part of respondents that is required to establish a violation. As has been indicated, in our opinion the appropriate test in that regard is whether the recipient knew or had reason to know that the information was non-public and had been obtained improperly by selective revelation or otherwise. We reject the contentions advanced by respondents that no violation can be found unless it is shown that the recipient himself occupied a special relationship with the issuer or insider corporate source giving him access to non-public information, or, in the absence of such relationship, that he had actual knowledge that the information was disclosed in a breach of fiduciary duty not to reveal it.

[22] *Id.* at p. 854: "Before insiders may act upon material information, such information must have been effectively disclosed in a manner sufficient to insure its availability to the investing public."

We consider that one who obtains possession of material, non-public corporate information, which he has reason to know emanates from a corporate source, and which by itself places him in a position superior to other investors, thereby acquires a relationship with respect to that information within the purview and restraints of the antifraud provisions. Both elements are here present as they were in the *Cady Roberts* case. When a recipient of such corporate information, knowing or having reason to know that the corporate information is non-public, nevertheless uses it to effect a transaction in the corporation's securities for his own benefit, we think his conduct cannot be viewed as free of culpability under any sound interpretation or application of the antifraud provisions.

Considerations of both fairness and effective enforcement demand that the standard as to the requisite knowledge be satisfied by proof that the recipient had reason to know of the non-public character of the information, and that it not be necessary to establish actual knowledge of that fact or, as suggested by respondents, of a breach of fiduciary duty. The imposition of responsibility where one has reason to know of the determinative factors in violative conduct is in keeping with the broad remedial design of the securities laws and has been applied under other of their provisions[23] as well as the antifraud provisions.[24] That standard is clearly appropriate in the situation where it is shown that the respondent received and made use of information that was material and non-public. In such situation, the question of whether the recipient had the requisite "reason to know" is properly determinable by an examination of all the surrounding circumstances, including the nature and timing of the information, the manner in which it was obtained, the facts relating to the informant, including his business or other relation to the recipient and to the source of his information, and the recipient's sophistication and knowledge of related facts.

[23] See *S.E.C.* v. *Mono-Kearsarge Consolidated Mining Company*, 167 F. Supp. 248, 259 (D.C. Utah, 1958); *S.E.C.* v. *Culpepper*, 270 F.2d 241, 250 (C.A. 2, 1959); *Kennedy, Cabot & Co., Inc.* 44 S.E.C. 215, 218 (1970).

[24] See *Texas Gulf*, where the Court stated (at p. 855) ". . . a review of other sections of the Act from which Rule 10b–5 seems to have been drawn suggests that the implementation of a standard of conduct that encompasses negligence as well as active fraud comports with the administrative and the legislative purposes underlying the Rule." The Court noted that such standard satisfies the "fraud" concept as reflected in the legislation which "whether it be termed lack of diligence, constructive fraud, or unreasonable or negligent conduct, remains implicit in this standard, a standard that promotes the deterrence objective of the Rule." See also *Stone* v. *U.S.*, 113 F.2d 70, 75 (C.A. 6, 1940); *U.S.* v. *Schaefer*, 299 F.2d 625, 629 (C.A. 7, 1962), *cert. denied* 370 U.S. 917.

In this case, it is clear that respondents had the knowledge requisite to a finding of violation of Rule 10b–5. They knew Merrill Lynch, from whom they obtained the Douglas information, was the prospective underwriter of the company's securities. As professionals in the securities industry, they knew that underwriters customarily receive non-public information from issuers in order to make business judgments about the proposed public offering. Although such information is not publicly disclosed, it may be conveyed to the prospective underwriter by the issuer for a valid corporate purpose; however, the prospective underwriter, as we have previously held, may not properly disclose or use the information for other than that purpose. Under the circumstances there can be no doubt that respondents, all of whom were sizeable existing or potential customers of Merrill Lynch, knew or had reason to know that they were selectively receiving non-public information respecting Douglas from Merrill Lynch.[25] Respondents cannot successfully argue that their obligations under the antifraud provisions were any less because they were "remote tippees" who received their information from Merrill Lynch salesmen who were themselves "tippees." It would appear that the corporate insider position that Merrill Lynch in effect occupied by virtue of its role in assisting Douglas in its corporate financing functions would embrace anyone in its organization who obtained and transmitted the Douglas information, and not merely those in its underwriting division. But even if respondents are viewed as indirect recipients of the Douglas information, the same criteria for finding a violation of the antifraud provisions by the respondents properly apply. Although the case of such an indirect recipient may present more questions of factual proof of the requisite knowledge, the need for the protections of those provisions in the tippee area is unaffected. While there are some express restraints on transactions by traditional insiders, such as the prohibition against short-swing trading under the Exchange Act and the requirement for registration under the Securities Act of securities received from the issuer which they desire to sell, they do not apply to other persons who receive and act upon non-public

[25] Some of the respondents have pointed out that they received the information from Merrill Lynch without solicitation by them. While under some circumstances a finding with respect to whether the recipient knew or had reason to know that information was non-public might be affected by whether or not it had been soliciated by him, it did not under the facts of this case, as the examiner held.

information. In addition, the ability of a corporate insider to take action with the benefit of non-public information may be limited by his position in the company and his own personal resources. However others may have a greater capacity to act, particularly those who, like the respondents here, are engaged in professional securities activities and have not only access to or advisory functions with respect to substantial investment funds but also the sophistication to appraise and capitalize upon the market effect of the information.[26]

We appreciate the concerns that have been expressed about the need to facilitate the free flow of information throughout the financial community. We have consistently required or encouraged the broadest possible disclosure of corporate information so as to provide public investors and their professional financial advisers with the most accurate and complete factual basis upon which to make investment decisions. We also recognize that discussions between corporate management and groups of analysts which provide a forum for filling interstices in analysis, for forming a direct impression of the quality of management, or for testing the meaning of public information, may be of value.[27] In some cases, however, there may be valid corporate reasons for the nondisclosure of material information. Where such reasons exist, we would not ordinarily consider it a violation of the antifraud provisions for an issuer to refrain from making public disclosure. At the same time we believe it necessary to ensure that there be no improper use of undisclosed information for noncorporate purposes.

Turning next to the requirement that the information received be a factor in the investment decision, we are of the opinion that where a transaction of the kind indicated by the information (*e.g.*, a sale or short sale upon adverse information) is effected by the recipient prior to its public dissemination, an inference arises that the information was such a factor. The recipient of course may seek to overcome such

[26] The instant case is illustrative of the potential magnitude of tippee trading. As noted above, the information concerning the change in the Douglas earnings picture precipitated sales of Douglas stock with a value of more than $13,300,000 by the respondents as to whom the examiner found violations.

[27] See New York Stock Exchange Company Manual A-20: "The competent analyst depends upon his professional skills and broad industry knowledge in making his evaluations and preparing his reports and does not need the type of inside information that could lead to unfairness in the marketplace." See also *Haack, Corporate Responsibility to the Investing Public*, CCH FED. Sec. L. Rep. ¶ 77,554 at 83, 173: "If, during the course of discussion [between the issuer and analyst], some important information is divulged that has not yet been published—information which could affect the holding or investment decision of any stockholder—that information should be made the subject of an immediate and comprehensive news release."

inference by countervailing evidence. Respondents did not meet that burden in this case.[28]

We do not find persuasive the claim made by respondents that as persons managing funds of others they had a fiduciary duty to their clients to sell their Douglas stock upon learning of the poor Douglas earnings, and that a failure to do so might have subjected them to liability for breach of such duty. The obligations of a fiduciary do not include performing an illegal Act,[29] and respondents could have sold the Douglas stock in a legal manner if they had secured the public disclosure of the information by Douglas.[30] And there is no basis for the stated concern that a fiduciary who refrains from acting because he has received what he believes to be restricted information would be held derelict if it should later develop that the information could in fact have been acted upon legally. If that belief is reasonable, his non-action could not be held improper.

CONCLUSION

We find no reason for disturbing the hearing examiner's conclusion that each of the respondents be censured. Although the facts in this case may be novel in certain respects, the findings of violation here do not represent an impermissible application of new standards, as respondents have claimed. The ambit of the antifraud provisions is necessarily broad so

[28] The examiner rejected contentions by various of the respondents that their sales of Douglas stock were motivated by factors other than the Merrill Lynch information. Van Strum had contended that its decision to sell Douglas stock two days after its purchase was based on an "unconfirmed rumor" that cast doubt on the assumption which formed the basis of its decision to buy the stock; the Jones respondents contended that their short sales of June 22, 1966 resulted from "a careful, painstaking analysis of Douglas made over a period of years"; Fleschner-Becker contended that it sold Douglas short as a result of the stream of bearish information on Douglas and because of its own analysis that production problems would have an adverse affect on Douglas' earnings; and the Burden respondents stress that they did not act for several days after receiving the information and not until after they were advised to do so by the broker who originally recommended purchase of their Douglas shares.

On the other hand, in dismissing the proceedings with respect to one respondent, an adviser to a large investment fund, the examiner credited its defense that a junior analyst who received the Merrill Lynch information and thereupon recommended sale of all Douglas holdings to his superior, who made the investment decisions for the fund, did not advise his superior of such receipt, and that other considerations led to the fund's sales. We consider it appropriate to observe that in future cases we would view as suspect and subject to close scrutiny a defense that there was no internal communication of material non-public information and its source by a member of a broker-dealer firm or other investment organization who received it, where a transaction of the kind indicated by it was effected by his organization immediately or closely thereafter. A showing of such receipt and transaction prior to the time the information became public should in itself constitute strong evidence of knowledge by the one who effected the transaction and by the firm.

[29] See *Cady Roberts, supra*, at p. 916; *Restatement of Trusts*, 2d (1959) § 166; *Scott on Trusts* (3d ed. 1967) § 166.

[30] Since respondents did not disclose to their immediate purchasers of Douglas securities the non-public information they had received from Merrill Lynch, we need not decide whether it would have nonetheless constituted a violation of the antifraud provisions had they done so.

as to embrace the infinite variety of deceptive conduct.[31] The inherent unfairness of the transactions effected by respondents on the basis of the non-public information imparted to them from an inside source should have been evident to respondents.

Accordingly, IT IS ORDERED that the imposition by the hearing examiner of the sanction of censure upon the above-captioned respondents be, and it hereby is, affirmed.

By the Commission (Chairman CASEY and Commissioners OWENS, HERLONG and NEEDHAM), Commissioner SMITH concurring in the result.

Commissioner SMITH, concurring in the result:

The Commission here spells out, in effect, four questions to be asked in determining the applicability of Rule 10b-5 to an inside information trading case: One, was the information material? Two, was the information non-public? Three, was the person effecting the transaction an insider or, if not an insider but a "tippee", did he know or have reason to know that the information "was non-public and had been obtained improperly by selective revelation or otherwise"? And four, was the information "a factor" in the person's decision to effect the transaction?[1]

I agree generally with the progression of elements set forth in the majority opinion as requisite to a finding of violation of Rule 10b-5 under the facts of this case and with the conclusion that respondents' conduct constituted a violation of the rule. However, I would have formulated the third and fourth elements differently. It is important in this type of case to focus on policing insiders and what they do, which I think appropriate, rather than on policing information *per se* and its possession, which I think impracticable. I believe the emphasis in the law should continue to be upon the conduct of corporate insiders and their privies, as it has been since *Strong* v. *Repide*, 213 U.S. 419 (1909) and as it was in *Cady Roberts*, *Texas Gulf* and *Merrill Lynch*, rather than upon a concept—too vague for me to apply with any consistency—of relative informational advantages in the marketplace.

[31] See *S.E.C.* v. *Captial Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963). *Cf. Chasins* v. *Smith Barney & Co., Inc.*, 438 F.2d 1167 (C.A. 2, March 2, 1971); *Opper* v. *Hancock Securities*, 200 F. Supp. 668, 676 (S.D. N.Y. 1966), *aff'd* 367 F.2d 157 (C.A. 2, 1966).

[1] I do not understand later summaries in the majority opinion of the requisite elements of a violation as departing from this explicit formulation, despite some apparent inconsistencies in expression.

The significance of this case is undoubtedly in recognizing the inhibitions on primarily large institutional investors which might otherwise indirectly receive inside information by reason of their investing power and attractiveness as business customers. While the problem may not be as simple in all cases as implied by the majority, they are right in not permitting such abuse of power to be hidden behind claims of fiduciary obligations institutions have to their beneficiaries. The majority is also right in not permitting inside information to be cloaked as "research" or "analysis." Nevertheless, in accomplishing the objectives of Rule 10b–5, it is important not to over-generalize and thereby to penalize or thwart the quest for new knowledge by analysts and researchers. That quest keeps practical pressure on corporate managements to disclose business affairs and contributes valuably to more informed investing and consequently to more accurate market pricing. The relatively high threshold of materiality for purposes of Rule 10b–5, as set forth in the majority opinion, and the explicit recognition of the analyst's role, go some distance in this regard. It must be recognized, of course, that investors willing and able to engage in research and analysis will have a quantum informational advantage over investors who do not. But so far as I know, this is not violative of the securities laws even if the two transact with each other—so long as, the majority opinion reserves, there is no specific extraordinary information not generally known that was improperly obtained by one side of the transaction and not disclosed to the other.

With that reservation—ir. the sense that in this case the impropriety consisted of Merrill Lynch's disclosure to respondents of material non-public information that had been obtained from the issuer for a corporate purpose by the firm in its capacity, known to respondents, as the issuer's prospective underwriter—I agree. But I think the nexus of the special relationship between Merrill Lynch and Douglas and respondents' knowledge of that relationship as the source of the information is essential to the case. It is not necessary here to decide whether impropriety would attach in other cases less clearly involving a breach of duty by an insider or other person having a particular relationship with the issuer. Certainly there is no need to dispute Chief Examiner Blair's acceptance of the appropriate test in this regard, indicated by *Texas Gulf*, that the tippee must know or have reason to know "that the company was the source of informant's knowledge" (Initial Decision, p. 34). The company source is what makes the information "inside" and the special relationship (as director, employee, consultant, prospective underwriter, etc.) is what creates the duty. Elaboration of the duty of tippees viewed as part of the evolution of federal regulation of securities fraud, should not dispense with the requirement that the tippees have this knowledge. I would therefore have framed the third test in terms of the respondents knowing or having reason to know that the material non-public information became available to them in breach of a duty owed to the corporation not to disclose or use the information for non-corporate purposes.[2] Such knowledge, in effect, renders the tippee a participant in the breach of duty when he acts on the basis of the information received. I would hope that is what the majority means by "improperly obtained".

I do not see that it is important to require proof of actual or constructive knowledge that the information was non-public. Its non-public status is an objective—not subjective—fact just as is its materiality. Nor do I understand what "selective revelation" adds. To the extent that selective revealment (by the tippor I assume) is not simply a redundant way of saying the information is still non-public, it is improper only if done in breach of a duty owed to the corporation. The fact that the tippor tells only A and not B hardly seems germane to whether either the tippor or the tippee has any responsibility. Would Merrill Lynch or any of the respondents have none if Merrill Lynch had passed on the Douglas information indiscriminately? At what point does the revelation cease being selective, if at all? And if anything short of a public announcement constitutes selective revelation, then its simply means non-public.

I also have difficulty with the expression of the causation test. The Commission's staff in this case, and in *Cady Roberts* and *Texas Gulf*, accepted the burden of proving that the inside information was the motivating factor, and not just a factor, in the decision to effect the transaction. The burden was satisfied in each of these cases and it is evidently not an unduly difficult one to meet in the proper case—especially where a transaction of the kind indicated by the inside information is effected within a relatively short period of time after its receipt, and

[2] This would, I believe, cover the situations not involved in this case about which the majority seems concerned, where a person purloins corporate information, or knowingly receives such purloined information, or accidentally finds a lost document containing inside information in circumstances indicating that the document is confidential and belongs to the corporation. A duty not to steal or knowingly receive stolen goods or execise dominion over goods known to be owned by others exists toward the corporation even without the presence of a special relationship.

there is the inference (which I consider appropriate) that the information substantially contributed to the recipient's decision to buy or sell. The majority's opinion may appear to do violence to the traditional concept of causation, but I do not read its requirement that the information be "a factor" as, for instance, encompassing situations where a firm decision to effect a transaction had clearly been made prior to the receipt of the information and the information played no substantial role in the investment decision.

In sum, I believe the tippee responsibility must be related back to insider responsibility by a necessary finding that the tippee knew the information was given to him in breach of a duty by a person having a special relationship to the issuer not to disclose the information, and that the information must be shown not only to have been material and non-public, but also to have substantially contributed to the trading which occurred. I agree with the examiner's finding of facts which satisfy the requirements in this case.

IN THE MATTER OF

SOUTHERN CALIFORNIA FIRST NATIONAL BANK OF SAN DIEGO

File No. 3-2658. Promulgated August 16, 1971

Securities Exchange Act of 1934—Sections 15(b), 15A and 19(a)(3)

FINDINGS, OPINION AND ORDER

In these proceedings pursuant to Sections 15(b), 15A and 19(a)(3) of the Securities Exchange Act of 1934, one of the issues presented was whether, as alleged in the order for proceedings, Southern California First National Bank of San Diego ("the bank") willfully violated and willfully aided and abetted violations of the registration provisions of the Securities Act of 1933 in connection with the offer and sale of common stock of Mastercraft Electronics Corp. The bank has submitted an offer of settlement in which it waives a hearing and post-hearing procedures, and, solely for the purpose of this proceeding and any other proceedings pursuant to the above sections and without admitting or denying the allegations in the order for proceedings, consents to findings of the conduct alleged in that order and to the entry of an order censuring it.

After due consideration of the offer of settlement and upon the recommendation of our staff, we have determined to accept the offer. On the basis of the order for proceedings, the offer of settlement, and certain investigative material,[1] we make the following findings.[2]

During the period from February to May 1968, the bank sold 20,000 shares of common stock of Mastercraft, as to which no registration statement had been filed or was in effect, through an account which the bank maintained with a branch office of Goodbody & Co., at that time a registered broker-dealer.[3]

[1] The bank agreed that we could make findings and draw conclusions and inferences based on material obtained by our staff in connection with the investigation of the matters involved herein.

[2] Our findings are solely for the purpose of disposing of these proceedings with respect to the bank and are not binding on other respondents in the proceedings.

[3] By prior order in these and other proceedings, the broker-dealer registration of Goodbody & Co. was revoked. Securities Exchange Act Release No. 9122 (April 2, 1971).

Those shares were sold purportedly for one Joseph Soncino, an employee of Mastercraft, although it appears that Soncino was used as a nominee by persons engaged in a large-scale distribution of unregistered Mastercraft stock. Two sell orders, each covering 10,000 shares, were placed with the bank by one Arnold Kimmes, a customer of the bank, who gave the orders for the account of Soncino in telephone calls from New York. Kimmes gave no information concerning Soncino to the bank official who handled the transaction, and the latter did not know Soncino or inquire whether he was connected with Mastercraft or into the circumstances of the transaction. The certificates which were furnished were in Soncino's name and in 5,000-share denominations, two being sent initially to the bank and two directly to Goodbody. With respect to the first order Kimmes directed the bank to make its checks for the proceeds of sales payable to Soncino but to send them to "L. Kimmes" in New York. On the second order the checks were also to be made payable to Soncino but sent to Soncino ℅ H. J. Gluskin, who was an officer and director of Mastercraft and its house counsel.

Under these circumstances, the bank was a participant in the illegal distribution. In our opinion, if banks wish to maintain brokerage accounts for the convenience of their customers or others, it is incumbent upon them to take precautions to avoid the use of such accounts in connection with unlawful distributions of unregistered securities. It appears that the use of bank brokerage accounts for transactions by bank customers or other persons is widespread and that often the banks do not disclose the seller's name to executing brokers. Such practice may provide essentially unregulated channels of distribution. Obviously, the nature of the inquiry to be undertaken by a bank varies with the circumstances of particular cases.[4] Generally speaking, it would seem that the bank would be expected to follow procedures substantially equivalent to those which we have required broker-dealers to establish and maintain and which were recently re-emphasized in a statement issued by the Director of our Division of Trading and Markets.[5] We would consider that, alternatively, a bank could meet its responsibilities by requesting the broker-dealer with which it maintains its account to conduct the necessary investigation of the circumstances surrounding a proposed securi-

[4] *Cf.* Securities Act Release No. 4445 (February 2, 1962).

[5] Securities Act Release No. 5168 (July 7, 1971).

ties transaction, of course with the full cooperation of the bank.

In the case before us, it appears that not even the most elementary safeguards were observed, despite the many "red flags" present. Among these were the facts that the purported seller, who lived in New York, had had no prior relationship whatever with the bank, and in fact was totally unknown to the bank official; the sales instructions were given by another person; and the certificates were in large amounts. Yet, as noted above, the bank official made no inquiries whatever. Thus, the bank facilitated one segment of an unlawful distribution. We find that it thereby willfully violated and willfully aided and abetted violations of Sections 5(a) and 5(c) of the Securities Act.

As part of its offer of settlement, the bank agreed that prior to entering into any securities transactions, including an accommodation sale for a customer, it will make such inquiry as is considered reasonable under the circumstances to determine whether such sale would be in compliance with the registration provisions of the Securities Act, or inform the broker through which the securities are to be sold to make such inquiry on its behalf.

Under all the circumstances, we deem it appropriate in the public interest to censure the bank as provided for in its offer of settlement.

Accordingly, IT IS ORDERED that, subject to the undertaking set forth above, Southern California First National Bank of San Diego be, and it hereby is, censured.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM and HERLONG).

IN THE MATTER OF

LASALLE STREET CAPITAL CORPORATION

File No. 3-2875. Promulgated August 23, 1971

Investment Company Act of 1940—Sections 6(c) and 17(b)

TRANSACTIONS BETWEEN AFFILIATED PERSONS

Merger of Affiliated Investment Companies

Transfer of Assets to and Operation of Affiliated Subsidiary by Merged Company

Where terms of proposed merger of two affiliated registered closed-end investment companies are reasonable and fair and do not involve overreaching and are consistent with stated policies of companies and general purposes of Investment Company Act of 1940, *held*, proposed merger transactions exempted from Section 17(a), and additional exemptions from Sections 12(e), 17(a) and 17(d) granted as appropriate, subject to conditions, to allow merged company to transfer up to 25 percent of assets to and operate small business investment company subsidiary.

APPEARANCES

Thomas A. Reynolds, Jr., of Winston, Strawn, Smith & Patterson, for LaSalle Street Capital Corporation.

Samuel H. Young, for Atlanta/LaSalle Corporation.

Harold Sweetwood and *Jerold H. Rosenblum*, for the Division of Corporate Regulation of the Commission.

FINDINGS AND OPINION OF THE COMMISSION

LaSalle Street Capital Corporation ("LaSalle") is a licensed small business investment company under the Small Business Investment Company Act of 1958 and a registered closed-end non-diversified management investment company under the Investment Company Act of 1940 ("Act"). It proposes to merge with Atlanta/LaSalle Corporation ("Atlanta"), also a registered investment company[1] and the owner of approximately 86 percent of the outstanding common stock of Atlanta Braves, Inc. ("Braves Inc."), the owner and operator of the Atlanta

[1] Atlanta registered as an investment company in view of its proposed acquisition by the merger of the portfolio securities of LaSalle.

Braves National League baseball franchise. LaSalle has applied for (1) an order pursuant to Section 17(b) of the Act exempting from Section 17(a) certain transactions incident to its proposed merger with Atlanta; and (2) an order pursuant to Section 6(c) of the Act granting exemptions from Sections 12(e), 17(a) and 17(d) so that, following the merger, the surviving company would be able to transfer a portion of its assets to and operate a wholly owned subsidiary, LSC Corporation ("LSC"), which has registered as an investment company and would continue LaSalle's small business investment company activities.

After appropriate notice, public hearings were held at which Atlanta as well as LaSalle appeared in support of the application. An initial decision by the hearing examiner was waived, LaSalle filed briefs in support of its application, and our Division of Corporate Regulation filed a brief in opposition. Upon an independent consideration of the record, we make the following findings.

THE COMPANIES AND TERMS OF MERGER

As of December 22, 1970, LaSalle had outstanding 1,126,750 shares of common stock held by 677 stockholders of record, and Atlanta, 1,172,240 shares of common stock held by 28 persons. As of March 31, 1970, LaSalle's balance sheet showed total assets per books of $7,370,054, including $5,158,177 representing investments in small business companies. Total liabilities as of that date were shown at $4,571,335, of which $4,365,000 was long-term indebtedness to the Small Business Administration. Atlanta's principal asset is its holding of 265,371 shares, or 85.9 percent of the outstanding common stock of Braves Inc. As of August 31, 1970, Atlanta's consolidated balance sheet showed total consolidated assets per books of $5,742,634, and consolidated liabilities of $4,323,404 of which $2,350,509 was long-term debt. The consolidated balance sheet of Braves Inc. as of October 31, 1970 showed total assets of $5,260,229.

Under the terms of the proposed merger Atlanta would be the surviving company, and each share of LaSalle common stock would be converted into one share of Atlanta common stock, so that the present' stockholders of Atlanta would own about 51 percent of the outstanding shares of the combined company and the present stockholders of LaSalle the remaining 49 percent.

It is proposed that following the merger certain of LaSalle's assets, including small business investments and the name

LaSalle Street Capital Corporation, will be transferred to LSC which will also acquire LaSalle's small business investment company license and assume LaSalle's indebtedness to the Small Business Administration. The new merged company would hold the balance of LaSalle's assets (primarily marketable securities) and the Braves Inc. stock. It plans to acquire other operating companies and ultimately to change the nature of its business so as to cease to be an investment company, and to seek an order deregistering it as an investment company.[2]

STATUTORY STANDARDS

Four individuals, each of whom owns more than 5 percent of Atlanta's outstanding voting securities and three of whom are officers or directors of Atlanta, are also officers or directors of LaSalle. Atlanta is thus an affiliated person of those individuals and they in turn are affiliated persons of LaSalle within the meaning of Section 2(a)(3) of the Act.[3] Section 17(a) of the Act, in relevant part, prohibits an affiliated person of an affiliated person of a registered investment company from selling to or purchasing from such company any securities or other property, subject, however, to the provision in Section 17(b) that upon application we shall exempt any such proposed transaction from the prohibition if evidence establishes that the terms of the proposed transaction, including the consideration to be paid, are reasonable and fair and do not involve overreaching on the part of any person concerned, and that the proposed transaction is consistent with the policy of each investment company involved and with the general purposes of the Act. Since no issue has been raised concerning the consistency requirements, and we find no basis for adverse findings with respect to them, the essential issue before us is whether the evidence establishes that the terms of the proposed merger are reasonable and fair and do not involve overreaching on the part of any person concerned.

FAIRNESS OF MERGER TERMS

Two members of LaSalle's management who are substantial stockholders of LaSalle and own no shares in Atlanta testified

[2] Each company's board of directors has approved the merger. It was also approved by the stockholders. Since our approval of the merger plan is required before it can become effective, the appropriate procedure would have been to secure such approval before submitting the merger to a vote of stockholders. See *Talley Industries, Inc.*, 44 S.E.C. 164, 169 n. 10 (1970).

[3] Section 2(a) (3) of the Act defines an "affiliated person" of another person as, *intra alia*, any person 5 percent or more of whose outstanding voting securities are owned by such other person and any officer or director of such other person.

in support of the fairness of the proposed merger. Ralph A. L. Bogan, Jr., a director and a member of LaSalle's investment committee and its largest stockholder, and prospectively the largest stockholder of the combined company,[4] testified that the combined company would have a broader base, a larger cash flow and greater cohesiveness, and would afford an increased potential for economic gain to stockholders. Daniel J. Donahue, president of LaSalle and proposed president and chief executive officer of the combined company,[5] stated that at the time of the merger discussions he thought the value of LaSalle was in the range of $9,000,000 and that he felt that he had to be satisfied that the value of 100 percent of Braves Inc. was something in excess of $10,000,000 in order to conclude that the proposed ratio was fair as between LaSalle and Atlanta. He pointed out that in 1968 when the National Baseball League expanded by admitting two teams from Montreal, Canada and San Diego, California, $10,000,000 was paid to that League for each franchise and a roster of 30 players, and he reasoned that the Braves are worth substantially more since they are an established team with a full complement of players, a farm system, and a territory covering the entire southeast section of the United States.[6] Donahue noted that the proxy material sent to LaSalle stockholders in January 1971 recited that the directors of Atlanta had determined the fair value of Atlanta's 85.9 percent of Braves Inc. to be $11,167,000, a figure which indicated a value of around $13,000,000 for 100 percent, and he testified that he considered Braves Inc. to be worth almost $15,000,000.

Further testimony in support of the fairness of the merger proposal was received from Raymond C. L. Greer, Jr., an investment and financial analyst who is executive vice president and a director of Duff, Anderson & Clark, Inc. ("Duff"), a firm engaged in the business of rendering service as investment and financial analysts. Duff was retained by the boards

[4] Bogan, his family and a corporation of which he may be deemed a controlling person together own 179,640 or approximately 15.3 percent of the LaSalle shares. Another corporation owned by members of his family holds an additional 115,760 shares or approximately 10.3 percent of the outstanding La-Salle shares. Bogan is an investment banker and had an ownership interest in the Chicago White Sox team in the American League.

[5] Donahue beneficially owned 27,300 LaSalle shares as of May 31, 1970, and held jointly with another director options to purchase 36,600 shares from certain other stockholders.

[6] The difference in value between a newly franchised and an established team is also indicated by the fact, as recited in LaSalle's application, that in 1961 Houston and another new expansion team in the National League paid about $2,000,000 each for their franchise and a roster of 23 players, whereas in 1962 the Braves, then in Milwaukee, Wisconsin, were acquired at a cost of $6,218,480. In addition, LaSalle submitted affidavits that in 1963 or 1964 Houston offered to exchange its roster of 40 players for the Braves' 40 player roster and pay in addition $5,000,000, and that the offer was refused.

of directors of both LaSalle and Atlanta to make a preliminary determination as to the economic and financial feasibility of a merger from an investment and financial standpoint. Duff's report, submitted in February 1970, stated that in carrying out this assignment, Duff representatives visited top management of both companies and reviewed their operations, historical earnings and financial data, and management projections. The report concluded that a merger appeared feasible, with the principal advantage being a resulting substantially broadened business, capital and earning power base,[7] and with various advantages also accruing to the stockholders of each company including diversification of income with increased flexibility in investment policy and potentially greater enhancement of market values.

The report concluded with the statement that while it was not part of Duff's assignment to determine a basis of merger that would be fair and equitable to the shareholders of both companies,

> ". . . there would appear to be little difficulty in resolving this issue in light of our present knowledge. As you know, representatives of both companies have preliminarily discussed a basis of valuation which would result in the Atlanta Braves shareholders receiving 55 percent of the equity in the combined enterprise and the LaSalle Street Capital shareholders 45 percent. While we do not intend to draw conclusions at this time, combination on such a basis might very well prove to be in the realm of reason. Taking the relative contribution approach and based on present information which assumes we uncover no real problems applicable to a more definitive evaluation of both LaSalle Street Capital and the Braves, it is our opinion that the Braves stockholders are entitled to more than 50 percent of the combined enterprise but not in excess of 60 percent. A fair range of negotiations, therefore, could fall in this area."

The report also included certain financial schedules relating to LaSalle and Braves Inc. prepared in connection with Duff's evaluation of the feasibility of a merger. Greer testified that although Duff accepted market values used by the directors of the two companies of about $9,000,000 for LaSalle and $13,000,000 for Braves Inc., it did undertake practically all the evaluation work it would normally do in appraising a merger and it saw nothing which would disturb it about those values. Greer testified that Duff was asked to express a judgment as to an appropriate range of the relative contribution to the combined

[7] The report observed that combined capital would increase from $6,000,000 to $9,000,000 and total assets from $16,000,000 to $19,000,000 "*exclusive* of additional values applicable to the Braves over and above very low balance sheet investment." The report also referred to "the possibility of making acquisitions or investments in the Southeast that could effectively capitalize on the Braves' name, and inherent franchise value."

company by each stockholder group, and based on its investigation it came to the conclusion noted above that an appropriate range as a basis of merger would be between 51 percent to 60 percent of the combined company to the shareholders of Atlanta. He stated that he compared the Braves' attendance figures with those of other major league baseball teams, and had looked through regular sources of published investment information for other data on major league baseball teams as well as data on professional football, hockey and basketball teams, and was unable to obtain meaningful figures.

Greer testified that various factors should be considered in determining the fairness of the merger proposal and that while LaSalle shareholders would suffer a dilution in asset value on a per share basis, they would gain through an increase in earnings. He concluded that, considering all factors, the negotiated end result of 51 percent to Atlanta, at the bottom of the range considered fair, would certainly have to be fair and equitable to LaSalle.

William C. Bartholomay, chairman of Atlanta and chairman, president and treasurer of Braves Inc.,[8] also testified that he considered the merger terms fair and stated that Atlanta agreed to the low end of the range envisaged in the Duff report to insure the fairness of the proposal to the public stockholders of LaSalle.

The Division takes the position that applicants have not met their burden of showing the fairness of the merger terms. It asserts that much of the evidence is of a general nature and that the various factors and figures considered have not been specifically related to the relative contributions of the shareholders of each company. It contends that on the basis of the record it appears doubtful that sufficient earning power and cash flow could be shown for Atlanta to warrant approval of the merger on the basis proposed.

Based on the fair market value of LaSalle's investments as computed by its board of directors, the total net asset value of LaSalle's common stock was $8,362,055 as of March 31, 1970, and $7,388,931 as of March 31, 1971. The Division noted that if deductions are made for Federal income taxes applicable to unrealized appreciation, those figures would be reduced to $7,025,000 and $6,287,000, and it would be necessary to find values of at least $7,319,000 to $8,178,000 for 100 percent of the stock of Braves Inc. to justify the proposed merger terms. The

[8] Bartholomay, who owns 8.2 percent of Atlanta's stock, also owns 9,000 shares of LaSalle stock and a corporation controlled by him owns another 1,500 shares.

Division contends that such values are not supported by the Braves' earnings, which it asserts would require a multiplier of more than 30 to reach such levels. Without any deduction for income tax on unrealized appreciation,[9] the net asset values for the LaSalle stock would require ascribing respectively higher values to Braves Inc. of $8,601,782 to $9,734,639 to justify the proposed 49 percent 51 percent ratio.

In making its analysis, the Division arrived at an earnings figure of $228,000. It used as a basis Braves Inc.'s net income of $70,000 before extraordinary items for the fiscal year ended October 31, 1970, which it adjusted upward to reflect completion in 1972 of the amortization of the cost of the original player contracts acquired with the purchase of the Braves in 1962. It selected the 1970 figure rather than the substantially higher net income figures of $492,000 and $347,000 in fiscal years 1966 and 1969 because it considered that the 1966 figure was influenced by the fact that that year was a "novelty" year, i.e., the first year of the team's location in Atlanta, and that the 1969 revenues were increased by the Braves' participation in the league championship games. LaSalle, noting that the net income of Braves Inc. has fluctuated, points out that a higher base earnings figure would result from using the average of earnings for a five year period,[10] which would indicate a correspondingly lower price-earnings multiplier (in the 23–26 range). In any event, Donahue testified that he did not consider price-earnings ratios to be an important factor in arriving at a valuation of Braves Inc. for merger purposes.

In assessing the fairness and reasonableness of the merger proposal, we have taken into consideration, among other things, the fact that the boards of directors of the two companies after discussions and negotiations unanimously approved the merger proposal as fair and reasonable. We consider it significant, as LaSalle notes, that the beneficial ownership of LaSalle's shares by its directors and their families is in excess of 52 percent of the outstanding shares, and that Bogan, who participated with Donahue on behalf of LaSalle in the merger negotiations leading to the agreed upon ratio of 49 percent–51 percent, has a very large stock interest in LaSalle and none in

[9] Donahue testified that there is no indication that it will be necessary to pay Federal income taxes on the unrealized appreciation of LaSalle's investments.

[10] The average annual net income of Braves Inc. before extraordinary items for the five fiscal years ended October 31, 1966 through 1970 is $212,852, as compared with the 1970 fiscal year earnings of $70,000 used by the Division.

[11] For the fiscal year ended March 31, 1970, LaSalle had a net operating income of $58,079, before losses pertaining to investment portfolio of $707,541, resulting in a net loss of $649,462.

Atlanta and thereby has a substantial economic stake in the transaction and its fairness to LaSalle's stockholders.

Furthermore, the fact that those who appear to have a dominant influence in the affairs of LaSalle have no interest in Atlanta, together with the fact that Atlanta is a closely held corporation whose stockholders may be expected to follow developments of this kind more closely than the average public investor, appears to afford safeguards against overreaching on the part of any person concerned in contravention of Section 17(b) of the Act. In addition, the evidence indicates a belief on the part of all concerned that this merger will be advantageous to the stockholders of both companies since it will result in a stronger enterprise and one in a better position to take advantage of future opportunities than would be available to either merger participant alone. Expectations of this kind must, of course, be viewed with caution since quite frequently they are not realized, but we believe such evidence should not be disregarded. In addition, the unique nature of a major league baseball franchise warrants giving consideration to the indicated market value of that asset and less weight to an evaluation of earnings than would be proper in the case of the usual type of industrial or commercial venture, and we note in this connection that the Division did not value LaSalle on an earnings basis,[11] but used the estimated fair market value of its assets.

While the sale value of a particular major league baseball organization is not susceptible to precise determination, we do not consider it essential for present purposes, and we do not here undertake, to make such a determination. The evidence in the record as to sales of other baseball teams affords a considerable measure of guidance as to market value.[12] We agree with applicant's witnesses that the fact that $10,000,000 was paid in 1968 by two expansion teams in the National League for a limited roster of players and a franchise[13] constitutes a valid basis for placing a higher value for merger purposes on an established club such as the Braves which has a full

[12] *Cf. Ivy Fund, Inc.*, 44 S.E.C. 558 (1971), where, although we concluded that the applicant in that case, whose board of directors had acted without the benefit of any independent expert assistance, had not sustained its burden of showing the reasonableness and fairness of the consideration to be paid, we noted that helpful guidance could have been obtained from a consideration of analogous sales.

[13] The record shows that groups in at least two other cities were also prepared to pay the same amount for the expansion franchises. LaSalle also states that in 1969 the Washington Senators of the American League were sold for $9,945,000 ($9,000,000 to be paid by the buyer with the seller retaining the right to receive $945,000 due from the league), and contends that the Atlanta franchise is substantially more valuable, pointing to the fact that the Senators are located about 40 miles from Baltimore which has another American League team.

complement of players, four farm system clubs, a stadium lease with concession rights, an established radio and television network, and a very extensive drawing area in that it is the only major league baseball club in the southeastern section of the country.

Applicant might have been better served in meeting its burden of proving the availability of an exemption if Duff had been specifically requested to, and had made, a specific valuation of each company for purposes of a merger allocation. If the companies had specifically engaged Duff or other qualified valuation experts to determine a definitive basis for the proposed merger that would be fair to the shareholders of each of the merging companies, and such an independent evaluation of Atlanta and LaSalle had been made, a report pursuant to such an engagement would have carried more weight than that submitted by Duff, and a hearing on LaSalle's application, with its attendant delay, might thereby have been avoided.[14] Nevertheless, we think it significant that Duff, an independent firm of financial analysts which the record indicates is expert in the evaluation of companies for merger purposes, saw nothing in the course of its investigation which ran counter to the valuations arrived at by the directors of the two companies.

We also consider it significant that in consideration of the interests of the public stockholders of LaSalle, the merger ratio finally agreed upon is at the conservative end of the range considered appropriate by Duff. And while we note that the book net asset value of the LaSalle shares may be somewhat diluted as a result of the merger, we also take into account the other benefits to those shareholders which the Duff report states would result from the proposed merger including an indicated broadened market for the stock.[15] On the basis of the evidence as a whole relating to the value of Atlanta's interest in Braves Inc. and the other factors adverted to above, we are of the opinion that a sufficient basis has been shown for concluding that the proposed merger terms come within a range which is reasonable and fair to both groups of stockholders and do not involve overreaching on the part of any person concerned.

[14] See *Ivy Fund, Inc., supra.*

[15] The Duff report stated the new company would have greater market acceptance than LaSalle has solely as a small business investment company, and that "in many investment circles, baseball holds real attraction."

In view of the foregoing, we shall grant the requested exemption from Section 17(a) of the Act.

ADDITIONAL EXEMPTIONS REQUESTED

As noted above, LaSalle has requested additional exemptions from various provisions of the Act, pursuant to Section 6(c), in order generally to enable the new company to transfer the small business investment company license of LaSalle and certain of its assets to LSC and to facilitate thereafter the operation of LSC as a small business investment company while the new company operates as an investment company with broader scope. Specifically, an exemption from Section 12(e) is sought to permit the new company to invest up to 25 percent of the value of its assets in LSC, and to permit LSC to borrow money from and obtain loans guaranteed by the Small Business Administration,[16] as well as a further exemption from Section 17(a) to allow the transfer of assets from the new company to LSC. An exemption is also sought from Section 17(d) and Rule 17d–1 thereunder to permit the new company and LSC to participate in joint transactions with third persons.[17]

LaSalle has agreed that any order which we issue granting these exemptions may contain various conditions. The Division points out, however, that although such conditions are substantially similar to, or accomplish the objectives of, those which have been included in exemptive orders we have issued in similar situations,[18] they fail to require, as have previous conditions to orders which have relaxed the 5 percent investment restriction of Section 12(e), that the new company and LSC have identical officers and directors in order to limit the risk attaching to the new company's investment in LSC. The Division further notes that, contrary to the proposed conditions, the SBA had agreed to release the new company only from primary liability on its indebtedness to the SBA which will be assumed by LSC, instead of completely relieving the

[16] Section 12(e) provides, in relevant part, that a registered investment company may utilize up to 5 percent of its assets to purchase securities of another investment company engaged in the business of financing promotional enterprises provided that the securities issued by such other investment company are limited to short term paper, securities representing bank loans, and one class of common stock.

[17] Section 17(d) and Rule 17d-1 prohibit an affiliated person of an investment company, acting as principal, from participating in any joint enterprise or arrangment with such company without our approval.

[18] *First Midwest Capital Corporation*, Investment Company Act Release No. 6213 (September 15, 1970); *Capital Southwest Corporation*, Investment Company Act No. 5827 (September 30, 1969); *Greater Washington Industrial Investments, Inc.*, Investment Company Act Release No. 5423 (July 1, 1968); *Boston Capital Corporation*, Investment Company Act Release No. 5353 (April 22, 1968).

new company from such liability except for a partial guarantee.

In its reply brief, LaSalle stated that it would "not oppose" the requirement of identical officers and directors for LSC and the new company if that would facilitate approval of its application, and that it has been informed by the SBA that the guaranty agreement will be modified to satisfy the proposed condition.

Under all the circumstances, we conclude that the granting of the requested exemptions, subject to the proposed conditions as modified to require identical officers and directors for the new company and LSC, is appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act.

An appropriate order will issue.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM, HERLONG and LOOMIS).

In the Matter of

HERBERT L. WITTOW

doing business as

WITTOW & COMPANY

JOHN F. COUGHENOUR

File No. 3–2182. Promulgated August 24, 1971

Securities Exchange Act of 1934—Sections 15(b) and 15A

BROKER-DEALER PROCEEDINGS

Fraud in Connection with Sale of Securities

Where registered broker-dealer participated with another broker-dealer in an arrangement under which the latter, in executing customer's orders to sell securities as agent at specified price or better, effected sham sales of such securities to registrant at specified prices, which were below prevailing market prices, and promptly "repurchased" securities at slightly higher prices, and arrangement and resultant profits to broker-dealers were not disclosed to customer, *held*, registrant was participant in a fraudulent scheme and in public interest to impose suspensions on registrant and its sole proprietor.

Sales of Unregistered Securities

Where associate manager of broker-dealer branch office sold securities for customer who had obtained them from controlling person of issuer with a view to distribution and who was therefore statutory underwriter under Securities Act, and associate manager was on notice of facts which should have caused him to inquire regarding customer's status, but failed to make careful inquiry, *held*, no exemption from registration of securities was available under Section 4 of Act, sales violated registration provisions of Act, and in public interest to impose suspension on associate manager.

APPEARANCES:

Joseph F. Krys, *Dilworth A. Nebeker* and *H. Michael Spence*, of the Denver Regional Office of the Commission, for the Division of Trading and Markets.

Donald P. Shwayder, of Rothgerber, Appel & Powers, for Herbert L. Wittow.

Joseph C. Daley, *Thomas B. Bracken* and *Edward W. Long*, of Mudge Rose Guthrie & Alexander, for John F. Coughenour.

FINDINGS, OPINION AND ORDER

These were private proceedings pursuant to Sections 15(b) and 15A of the Securities Exchange Act of 1934 ("Exchange Act") with respect to Herbert L. Wittow, doing business as Wittow & Company, a registered broker-dealer, and with respect to John F. Coughenour, who during the pertinent period was an associate manager of a branch office of a broker-dealer firm.[1] Following hearings, the hearing examiner submitted an initial decision concluding, among other things, that Wittow's registration and his right to be associated with any broker-dealer should be suspended for 14 days, and that Coughenour should be suspended from association with any broker or dealer for 7 days. We granted petitions for review filed by each of those respondents, and briefs were filed by them and by our Division of Trading and Markets. On the basis of an independent review of the record, and for the reasons set forth herein and in the initial decision, we make the following findings.

The issues with respect to Wittow and Coughenour, while relating to securities of the same issuer, arise out of unrelated transactions and involve different provisions of the securities laws. We therefore deal with them separately, turning first to the issues pertaining to Wittow.

I. WITTOW

Violations of Antifraud Provisions

We find, as did the examiner, that in April and May 1968 Wittow willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and aided and abetted violations of those provisions by Birkenmayer & Company, Inc. and Arnold L. Greenberg, Birkenmayer's vice-president, in connection with certain sales of common stock of Worldwide Energy Company, Ltd. by Birkenmayer as agent for customers. Wittow participated with Birkenmayer and Greenberg in an arrangement under which sham sales of such stock by Birkenmayer to Wittow, at prices below the prevailing market, and "repurchases" of the same shares by Birkenmayer were effected, with Wittow and Birkenmayer deriving profits that were not disclosed to the customers.

[1] Issues pertaining to other respondents named in the proceedings have been resolved on the basis of offers of settlement submitted by them. *Birkenmayer & Company, Inc.*, Securities Exchange Act Release No. 8884 (May 15, 1970).

Between February and June 1968, Harry A. Trueblood, Jr., president of Consolidated Oil & Gas, Inc., sold a total of about 195,000 shares of Worldwide stock to or through Birkenmayer on behalf of himself, his children and Consolidated. As to the shares which Trueblood instructed Greenberg to sell on an agency basis,[2] he specified limit prices below which they should not be sold.[3] All those shares were sold at the specified limit prices, which were reported as the sale prices to the customers. A large part, 41,900 shares, was sold to Wittow pursuant to an understanding that Birkenmayer would repurchase the shares at a slightly higher price determined by Greenberg, and such repurchases were effected on the same day or at most within two business days. Confirmations were exchanged between Birkenmayer and Wittow, but the latter made no payments and merely received from Birkenmayer the price differential, which ranged from 2¢ to $6^{1}/_{8}$ per share and for all the transactions totalled $1,525.

The examiner found that Birkenmayer did not obtain the best prevailing market prices for its customers, noting that on each of the six days on which Birkenmayer sold the Worldwide stock to Wittow, it also effected sales on a principal basis at higher than the limit prices. Greenberg, in testifying that he could not have obtained more than the limit prices for his customers, claimed that those prices exceeded the contemporaneous bids of other market-makers and that if he offered the shares at higher prices he would risk "missing" sales at the limit prices. However, an analysis of Birkenmayer's transactions, as reflected by its order tickets and confirmations, shows that contention to be without validity. On at least a number of the days in question, Birkenmayer effected sales as principal at prices higher than the limit price specified by Trueblood on that day, very close to the time of the sales to Wittow and in substantial amounts. For example, on one of the days, Birkenmayer executed a 10,000-share agency order for Consolidated, which it received at 12:25, by selling the shares to Wittow at $4^{3}/_{6}$ at 12:26. At 11:49 and 11:56 it had sold for its own account 3,000 and 1,000 shares, respectively, at $4^{5}/_{8}$ to two other dealers, and at 12:47 it sold a total of 1,200 shares to three other dealers at the same price. In the course of the day, it sold over 19,000 shares for its own account, all at prices exceeding the

[2] According to Greenberg, Trueblood, before placing an order, generally asked him for the market quotations, and would place an agency order if he did not like the quoted bid.

[3] A "limit" order is one that may be executed only at the price specified or better. See *George A. Brown*, 43 S.E.C. 490, 495, n. 7 (1967).

$4^3/_8$ realized for Consolidated, and it repurchased the 10,000 shares from Wittow at 4:40.

It is clear that Birkenmayer did not fulfill the obligation which attached to it in executing the agency transactions to obtain the best price for its customers and not to prefer its own interests over theirs.[4] In substance, it executed those transactions as principal despite the express direction by Trueblood to act as agent. While it appears that Greenberg had asked Trueblood whether he cared if Birkenmayer repurchased the stock and Trueblood replied that he did not as long as the shares were sold at the designated limit price, clearly Trueblood's consent was to repurchases following sales executed on an agency basis with proper effort to obtain the best available price, and did not encompass the kind of arrangement Birkenmayer had with Wittow, which was not disclosed to Trueblood.[5]

Wittow was on notice that Greenberg was not making an effort to obtain the best execution for his customers, but admittedly made no independent inquiry regarding the prevailing market prices. Birkenmayer's same-day "repurchases" at higher prices were inconsistent with the representation that Wittow asserts Greenberg made to him that the limit prices at which the shares were being sold to Wittow reflected the "offer side" of the market. Moreover, even aside from the prices at which the transactions were executed, it seems clear that Wittow must have been aware that the manner of execution was improper. While Wittow testified that Greenberg told him that his customer was aware of the repurchase arrangement, Wittow was informed that the customer wanted agency execution and was under an obligation, in light of the highly abnormal nature of the transactions, to ascertain whether full disclosure was being made to the customer concerning all aspects of the transactions.[6] In view of his failure to do so, Wittow must be deemed a participant in a fraudulent scheme.[7]

PUBLIC INTEREST

Wittow urges that the sanctions imposed by the examiner against him and his firm are too severe, particularly when compared to sanctions imposed against other respondents in these proceedings. However, the appropriate remedial action

[4] See *Investment Service Co.*, 41 S.E.C. 188, 198 (1962), *aff'd sub nom. Barnett* v. *U.S.*, 319 F.2d 340 (C.A. 8, 1953); *Opper* v. *Hancock Securities Corporation*, 250 F. Supp. 668 (S.D.N.Y.), *aff'd* 367 F.2d 157 (C.A. 2, 1966); *Thomson & McKinnon*, 43 S.E.C. 785, 788-89 (1968), and cases cited in note 6 of release.

[5] *Cf. Arleen W. Hughes*, 27 S.E.C. 629 (1948), *aff'd* 174 F.2d 969 (C.A.D.C., 1949).

[6] Wittow testified that he had never before engaged in transactions of such nature.

[7] *Cf. Moore & Co.*, 32 S.E.C. 191 (1951).

as to a particular respondent depends on the facts and circumstances applicable to him and cannot be measured precisely on the basis of action taken against other respondents.[8] Moreover, the sanctions with respect to other respondents in the proceedings were imposed in accordance with offers of settlement which we deemed it appropriate to accept, whereas our present determination a to Wittow is based on a resolution of the issues as developed by the record.[9] In reaching his conclusion regarding Wittow, the examiner took into consideration the mitigative factors presented, including the absence of any prior action against Wittow in his 12 years in the securities business, the fact that he did not originate the unlawful scheme and that his participation was apparently motivated more by a desire to accommodate Greenberg than by the expectation of profit. Under all the circumstances, we consider that the 14—day suspensions ordered by the examiner are appropriate in the public interest.

II. COUGHENOUR

Violations of Registration Provisions

The examiner found that between January 15 and April 15, 1968, Coughenour willfully violated the registration provisions of Sections 5(a) and 5(c) of the Securities Act of 1933 in connection with the offer and sale of 60,000 shares of Worldwide common stock as to which no registration statement had been filed or was in effect. Those shares were sold by Coughenour and his employer for one Doyle H. Baird in a series of 7 agency transactions, for a total of $253,750. Baird had acquired the shares as partial consideration for his sale on January 12, 1968 of certain oil and gas properties to Consolidated, which the examiner found controlled Worldwide at that time and was with Worldwide under the common control of Trueblood, president of Consolidated and board chairman of Worldwide. The examiner held that under the circumstances Baird was an "underwriter" of those Worldwide shares as defined in Section 2(11) of the Securities Act, in that he purchased the shares from an "issuer" (defined in that Section to include a person controlling or under common control with the issuer) with a view to distribution, and that Coughenour's sales were not, as claimed by him, exempt from the registration requirements. The record supports the examiner's findings.

[8] See *Dlugash* v. *S.E.C.*, 373 F.2d 107, 110 (C.A. 2, 1967).

[9] See *Cortlandt Investing Corporation*, 44 S.E.C. 45, 53–55 (1969).

It is well settled that the burden of proving the availability of an exemption from the registration requirements of the Securities Act rests with the person claiming the exemption.[10] Where as here the critical factor determining the availability of an exemption is whether the shares in question emanated from a person in a control relationship with the issuer,[11] one asserting an exemption must show the absence of control, at least where a secondary distribution of significant proportions is involved.[12] No such showing was made in this case.

"Control" is defined in Rule 405 under the Securities Act as the power to direct or cause the direction of management and policies, and the existence of control is determined by the circumstances of each case.[13] It is undisputed that in 1965 Consolidated had acquired control of Worldwide through the acquisition of Worldwide convertible debentures and the accompanying right to designate three of Worldwide's five directors. Consolidated's designees included Trueblood, admittedly a controlling person of Consolidated, and Robert B. Tenison, a vice-president of Consolidated until July 1, 1967, and from early 1967 until well after the period of the sales of Baird's shares, the board included the Consolidated designees as well as another director of Consolidated who also represented a major shareholder of Worldwide.

Coughenour argues that at the time under consideration it was Tenison and not Consolidated or Trueblood who was in control of Worldwide. He points to testimony of both Trueblood and Tenison to that effect, and to the fact that Trueblood had been succeeded by Tenison as Worldwide's president in December 1966 and had advised Tenison that Consolidated intended to divest itself of its Worldwide stock, which it did thereafter. However, while Consolidated sold the major part of its Worldwide shares in a public offering in November 1967 and a further small amount by January 12, 1968, it still held at the latter date 275,000 shares, representing about 10.6 percent of Worldwide's outstanding stock.[14] Viewing the record as a

[10] *S.E.C.* v. *Ralston Purina Co.*, 346 U.S. 119 (1943); *S.E.C.* v. *Culpepper*, 270 F.2d 241, 246 (C.A. 2, 1959).

[11] Coughenour's transactions did not come within the exemption provided by Section 4(1) for transactions by any person other than an issuer, underwriter, or dealer. He was at the very least a participant in transactions effected by his employer which was clearly a "dealer." Although those transactions were executed on an agency basis, Section 2(12) of the Securities Act defines the term "dealer" to include both persons who engage in the securities business as principal and those who do so as agent. See *Quinn and Company, Inc.*, 44 S.E.C., 459, 465 (1971), appeal pending (C.A. 10, No. 71-1090).

[12] *Pennaluna & Co.* v. *S.E.C.*, 410 F.2d 861, 865 (C.A. 9, 1969), *cert. denied* 396 U.S. 1007.

[13] See *Rochester Telephone Corp.* v. *United States*, 307 U.S. 125, 145 (1939).

[14] Consolidated thereafter disposed of the balance of the shares through additional sales over a period of four months.

whole, it does not in our opinion show that the November 1967 sales and the expressed intention to dispose of the balance had operated to dissipate Consolidated's control position by January 12, 1968. Consolidated was still Worldwide's largest single stockholder and Trueblood, who with his minor children owned between 3 percent and 4 percent of the outstanding stock, continued as its board chairman and the other directors, at least two of whom had close ties with him or Consolidated, remained unchanged, with the same directors even being re-elected at the April 1968 shareholders' meeting. The record shows, as the examiner found, that Tenison, although in charge of the day-to-day operations of Worldwide, was subject to the control of the board of directors which exercised the usual and customary powers of a board of directors.[15]

There is no merit in Coughenour's further contention that regardless of Baird's underwriter status, his transactions were exempt under the brokers' exemption provided by Section 4(4).[16] That exemption is not available when the broker knows or has reasonable ground to believe that his customer is an underwriter, since in that event the broker likewise violates Section 5 by participating in a non-exempt transaction.[17] Here the record shows that Coughenour was on notice of facts which should have caused him to make inquiry regarding the status of his customer. The magnitude of the transactions involved and his lack of familiarity with the issuer should have indicated to him the need for a careful inquiry, notwithstanding that a number of dealers were making a market in Worldwide stock, or the absence of any restrictive legend on the certificates involved.[18] In fact, it appears that Coughenour had some concern as to the saleability of the shares without registration, but accepted the statements of Baird and Baird's attorney, whom he called, that the stock was freely tradeable.[19] Coughenour did not know nor did he inquire as to how many shares Baird owned or how many were outstanding and where Baird

[15] Although, as stressed by Coughenour, Tenison held in his name proxies for about 70 percent of the shares voted at the April 1968 shareholders' meeting, those proxies were expressly solicited on behalf of management.

Control by Consolidated of Worldwide at the time of Baird's receipt of his Worldwide shares is not negated nor control by Tenison demonstrated by the fact that in April and May 1968, subsequent to such receipt, the Worldwide board of directors approved acquisition which brought Worldwide into competition with Consolidated. We also note that Trueblood did not oppose the acquisitions, and merely abstained from voting, and that at the May 1968 meeting the board rejected a proposal by Tenison that Worldwide acquire another company.

[16] Section 4(4) exempts brokers' transactions executed upon customers' orders but not the solicitation thereof.

[17] See *Quinn and Company, Inc.*, *supra*, p. 465.

[18] See *Quinn and Company, Inc.*, *supra*, pp. 467–68.

[19] See *S.E.C.* v. *Culpepper*, 270 F.2d 241, 251 (C.A. 2, 1959).

had acquired his shares, and he sought no information from Worldwide itself or from its transfer agent.[20] Under the circumstances it is clear that his transactions were violative of Section 5, and that his violations were willful.[21]

PUBLIC INTEREST

Coughenour urges that the public interest does not require his suspension and that at most his conduct warrants only censure. He asserts that he believed that registration of the Worldwide shares was not required, and argues that his conduct constitutes at most a technical violation of complex provisions and rules. Coughenour points out that the 60,000 shares sold constituted about 2.3 percent of the shares outstanding and states that all were purchased by Birkenmayer & Co., a market-maker, which he asserts did not require the protection afforded by registration, and that Birkenmayer had in its possession the prospectus which had been used in the November 1967 registered offering and which he asserts contained current information concerning Worldwide. He notes that the price of the Worldwide stock increased substantially following the sales in question and claims that no public investors have been damaged. Coughenour further states that he has been engaged in the securities business for 15 years without previously committing any violations and that we have not in the past imposed substantial sanctions on a salesman solely for violations of Section 5.

In our view the factors presented by Coughenour are not sufficient to warrant a reduction of the 7-day suspension imposed on him by the examiner, which appears to us consonant with the nature of the violations and Coughenour's prior good record. We cannot agree with the characterization of the violations of the registration requirements, a keystone of the whole scheme of securities regulation, as technical. Nor is the

. The attorney testified that he had not himself made a sufficient inquiry to have enabled him to give a legal opinion regarding the tradeability of the stock, but had been told by a Consolidated officer, an attorney who had represented that company in the negotiations with Baird, that it was free for sale, and the examiner found that the attorney merely reported that officer's views.

[20] Coughneour is not aided by his assertion that further inquiry would have failed to disclose any control relationship because in the view of those in a position to know such a relationship did not exist. We need not speculate as to what reasonable inquiry would have disclosed where no such inquiry is made. See *Strathmore Securities, Inc.*, 43 S.E.C. 575, 584 (1967), 407 F.2d 722 (C.A.D.C., 1969).

[21] We do not rely upon the examiner's finding, to which Coughenour has objected, that by Coughenour's sales of Worldwide stock he aided and abetted violations of Section 5 by his employer. That finding was not a material factor in the examiner's decision.

We reject Coughenour's contention that the examiner erred in failing to sever the proceedings as to him after settlement offers submitted by most of the other respondents were accepted during the course of the hearings. There is no indication that the examiner relied on evidence that was not relevant to the allegations against Coughenour and we have not considered any such evidence. *Cf. Clinton Engines Corporation*, 41 S.E.C. 408, 411 (1963).

fact that the price of the shares subsequently appreciated determinative of the seriousness of the violations. And while the interpretation of various exemptive provisions may present complexities, the basic concept here involved—that transactions by an underwriter, including one who has purchased securities from a person in a control relationship with the issuer, are not exempt—is clear and well established. Furthermore, although Birkenmayer was the initial purchaser, it must be presumed that some if not most or all of the shares were resold to public investors,[22] and no prospectus covering those shares was in existence.[23]

Accordingly, IT IS ORDERED that the registration as a broker and dealer of Herbert L. Wittow, doing business as Wittow & Company, be, and it hereby is, suspended for a period of 14 days and that Wittow be, and he hereby is, suspended from being associated with a broker or dealer for the same period.

IT IS FURTHER ORDERED that John F. Coughenour be, and he hereby is, suspended from being associated with a broker or dealer for a period of 7 days.

The suspensions are to commence with the opening of business on August 30, 1971.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM and HERLONG).

[22] See *D. H. Blair & Co.*, 44 S.E.C. 318, 321 (1970); Op. Gen. Counsel, Securities Act Release No. 1862 (December 14, 1938).

[23] The exceptions to the initial decision of the hearing examiner are overruled or sustained to the extent they are inconsistent or in accord with our decision.

IN THE MATTER OF

SECURITY SAVINGS AND LOAN

File No. 3-2511. Promulgated August 25, 1971

Securities Exchange Act of 1934—Section 12(h)

EXEMPTION OF REGISTRATION OF OVER-THE-COUNTER SECURITIES

Where guaranty stock savings and loan association applied for exemption from registration pursuant to Section 12(h) of Securities Exchange Act of 1934, *held*, while broad exemption from requirements imposed on issuer by registration of securities under Section 12(g) not warranted, grant of limited exemption from quarterly reporting requirement not inconsistent with public interest under special circumstances of this case, including absence of regular market for stock, origin and nature of investor interest in issuer, limited income and regulated nature of issuer's business, and existence of other reporting requirements under Act and state regulation to which issuer will be subject.

APPEARANCES:

Edward O. Clarke, Jr. and *P. Dennis Belman*, of Smith, Somerville & Case, for Security Savings and Loan (A Stock Corporation).

Richard H. Rowe and *Alois Lubiejewski*, for the Division of Corporation Finance of the Commission.

FINDINGS AND OPINION OF THE COMMISSION

Security Savings and Loan (A Stock Corporation) applied, pursuant to Section 12(h) of the Securities Exchange Act of 1934 ("Act"), for exemption from the registration, reporting and proxy requirements of Sections 12(g), 13 and 14 of the Act. As pertinent here, Section 12(g), which was added to the Act in 1964, requires an issuer with assets exceeding $1,000,000 and a class of equity security not listed on a national securities exchange and held of record by at least 500 persons to register such security with us. Registration subjects the issuer to the reporting and proxy provisions of Sections 13 and 14 of the Act and its insiders to the insider trading provisions of Section 16. Under Section 12(h) of the Act we may exempt any issuer in whole or in part from Section 12(g) or from Sections 13 or 14, "upon such terms and conditions and for such period as [we deem] necessary or appropriate," if we find that "by reason of the number of public investors, amount of trading interest in the securities, the nature and extent of the activities of the issuer, income or assets of the issuer, or otherwise, that such action is not inconsistent with the public interest or the protection of investors."

Following a hearing, the hearing examiner issued an initial decision in which he concluded it would not be consistent with the public interest and the protection of investors to grant an exemption from the registration, reporting and proxy requirements as requested, but that an exemption from the requirements of Rule 13a–13 under Section 13(a)(2) of the Act to file quarterly reports would be appropriate if other requirements are complied with. On the petition of our Division of Corporation Finance ("Division"), we undertook review of the examiner's grant of the limited exemption, and briefs were filed by the Division and applicant. Our findings are based upon an independent review of the record.

Applicant is incorporated in Maryland as a guaranty stock savings and loan institution with two classes of stock: free shares represented by the withdrawable savings accounts of the holders of such shares; and guaranty stock, which provides a secondary reserve for the payment of losses. Upon liquidation the guaranty stockholders are entitled to the undivided profits and reserves after required payments have been made to the free shareholders. Applicant is subject to regulation by the Maryland Department of Licensing and Regulation ("Department") and by the Maryland Savings-Share Insurance Corporation ("Insurance Corporation"), a quasi-public nonprofit corporation created under Maryland law to insure the free-share accounts of member savings and loan associations. As of February 28, 1970, applicant had assets of $8,023,235, liabilities of $7,317,698 including savings accounts of $6,647,730, and reserves and stockholders' equity of $705,537. For the year ending that date it had gross operating income of $446,888 and net income, after dividends on savings accounts and federal income taxes, of $16,988.

Between March 1968 and September 1969, applicant merged with three mutual savings or building and loan associations which had only free shares that were entitled, upon liquidation, to the undivided profits and reserves. In each merger, the free shares or savings accounts in the mutual associations were exchanged for equal shares or savings accounts in applicant and, as required by the Department, guaranty stock was also issued by applicant for distribution to the free shareholders or accountholders of the mutual associations representing the undivided profits and reserves in such associations. No other guaranty shares have been issued since March 1968. As a result of those mergers 1,360 persons received 46,603 guaranty shares in applicant, which prior to March 1, 1968 had only 85 guaranty stockholders. As of July 1, 1970 applicant had outstanding 113,145 guaranty shares which were held of record by 1,376 stockholders, of whom 878 held up to 25 shares each, 329 from over 25 to 100, 146 from over 100 to 500, and 23 over 500 shares each, with officers and directors as a group owning 40,598 shares or 36 percent of such shares.

The guaranty shares of applicant are not listed on any exchange nor are they regularly traded in the over-the-counter market. The National Stock Summary lists only four bid and one ask quotations for such stock for the period October 1, 1969 to October 1, 1970. Quotations for the stock published in a Baltimore newspaper were discontinued at the request of applicant which felt that because of a lack of transactions such quotations did not reflect the value of the stock. From March 1968 through June 1970 a total of 107 sales, involving 12,117, shares, were effected.

Registration under Section 12(g) entails the filing of specified information and certified financial data in compliance with our Regulation S-X consisting of a balance sheet and statements of profit and loss and of source and application of funds. Such information is required to be kept current by the filing of various reports provided for by Section 13 of the Act and our rules thereunder. Annual reports, on Form 10–K, include up-dated certified financial documents, and a report, on Form 8–K, is required with respect to events specified in that Form within ten days after the month in which they occurred, and requires certified financial statements for any business acquired by registrant representing a significant amount of assets. A further quarterly report, on Form 10–Q, which is the one the examiner would exempt applicant from filing, was recently adopted to replace a semi-annual report (Form 9–K) and to provide more detailed financial information, as part of a program to improve disclosure under the Act.[1] That report calls for the disclosure of financial information, which need not be certified, with respect to, among other things, gross sales, operating revenues, costs and expenses, income, debt, stock, retained earnings and dividends.

[1] See Securities Exchange Act Releases Nos. 8683 and 9004 (September 15, 1969 and October 28, 1970).

Applicant urges that compliance by it with the quarterly reporting requirements would be unduly burdensome particularly in view of its small net income, and that its activities are subject to regulation under Maryland law which affords investors in its quaranty stock protection through, among other things, requirements for the disclosure of financial information of the type provided by the Form 10–Q reports. We have considered the application for exemption in the light of the public interest in having publicly held companies make prompt and accurate disclosure of information to securityholders and the investing public.[2] While a broad exemption from the requirements imposed by virtue of Section 12(g) would not be warranted, we have concluded under the special circumstances it would not be inconsistent with the public interest and the protection of investors to exempt applicant from filing quarterly financial reports under Rule 13a–13 under Section 13(a) (2) of the Act. In reaching this conclusion, we have considered, among other factors, the absence of a regular market for the quaranty stock, the relatively small number of transactions effected, the origin and nature of a substantial portion of the public investor interest, applicant's limited income and the state regulation to which it is subject. We have also taken into consideration that the granting of this limited exemption will not deprive applicant's existing and potential guaranty shareholders of the principal protections provided through registration under Section 12(g) of the Act.[3]

Applicant will still be subject to the reporting requirements of Rules 13a–1 and 13a–11, and must therefore file an annual report on Form 10–K which includes certified financial statements, and current reports of specified events on Form 8–K including a certain situations certified financial statements. In addition, as noted above, the registration of the guaranty stock under Section 12(g) subjects applicant to the proxy provisions of Section 14. Our proxy rules and regulations thereunder require an issuer soliciting proxies from its stockholders to make disclosure to them, through a proxy statement which is filed with us and examined by our staff prior to its use, of relevant facts to insure a vote on an informed basis. In general, if the solicitation relates to the election of directors, a proxy statement must be accompanied or preceded by an annual report containing certified financial statements reflecting the issuer's financial position and results of operations.

[2] See, *e.g.*, Securities Exchange Act Release No. 8995 (October 15, 1970).

[3] *Cf. The National Dollar Stores, Ltd.*, 43 S.E.C. 881 (1968).

Prior to any stockholders' meeting as to which an issuer does not solicit proxies, it must transmit to its stockholders and file with us a statement containing substantially equivalent information to that required in a proxy solicitation statement, and, if directors are to be elected, an annual report containing the certified financial statements referred to above with respect to the solicitation of proxies.

In addition, the regulation and examination by Maryland regulatory authorities to which applicant is subject includes requirements that it submit a statement of its financial condition in a prescribed form at its annual shareholders' meeting, file a certified copy of such statement with the Department, and deliver a statement of condition to any shareholder upon request; and file a certified statement with the Department, which is available to free shareholders upon request, relating to the salaries, fees and expenses paid to its officers and directors.

While Section 12(g) (2) (C), in exempting from registration any security issued by a savings and loan association supervised by any Federal or State authority, excepts guaranty stock or other similar certificate evidencing nonwithdrawable capital, we do not consider this rejection of an automatic blanket exemption for guaranty stock of such institutions to preclude the grant of a specific exemption to an individual association in a particular case pursuant to the broad authority in Section 12(h) to exempt any issuer in whole or in part from the provisions of Sections 12(g), 13 or 14. At the same time, we emphasize that our decision in this case is strictly limited to the facts and circumstances presented by the record herein.

Our order will require applicant to inform us annually of all sales that have been effected in its guaranty stock and to advise us promptly of any material change in the facts recited in this opinion, and we will reserve jurisdiction to reconsider the exemption in the event of such a change, or in the event that changes take place in our rules and regulations relating to disclosures by Section 12(g) companies.

An appropriate order will issue.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM and HERLONG), Commissioner LOOMIS not participating.

In the Matter of

FIRST MULTIFUND OF AMERICA, INC.

and

FIRST MULTIFUND ADVISORY CORPORATION

File No. 3-2260. Promulgated August 26, 1971

Investment Company Act of 1940—Section 17

APPLICATION FOR DECLARATORY ORDER

Capacity of Affiliate of Investment Company in Executing Portfolio Purchases of Mutual Fund Shares

Retainability and Computation of Concessions on Portfolio Purchases of Mutual Fund Shares

Where registered investment company's investment advisor, which is also registered broker-dealer, effects purchases for company's portfolio of mutual fund shares of other investment companies on which it receives concessions from underwriters of selling companies not exceeding 1 percent of purchase price, *held*, adviser acts as broker for affiliated investment company within meaning of Section 17(e) (2) of Investment Company Act of 1940, notwithstanding selling agreements between it and underwriters of selling companies characterizing it as a dealer, and is entitled to receive and retain such concessions, computed on basis of aggregate purchases without regard to intervening redemptions; but where purchases are effected in which concessions exceed 1 percent limitation in Section 17(e) (2) of Act, *held*, adviser breaches its fiduciary duty to investment company and must pay entire concession to such company, unless purchases are effected in good faith belief that breakpoint resulting in concession not exceeding 1 percent would be reached, in which event excess over 1 percent must be returned to principal underwriter of portfolio fund shares.

Excessive Portfolio Turnover

Where portfolio transactions of registered investment company which invests solely in shares of other investment companies showed high turnover rate, but evidence failed to establish that investment adviser, who as registered broker-dealer effected transactions, induced turnover for purpose of generating concessions for itself, *held*, adviser was not shown to have breached fiduciary duty to investment company and is entitled to retain concessions which were otherwise permissible.

Practice and Procedure

Contentions by applicants that they were entitled to formal responsive pleading by staff, and that Commission's order for hearing was improperly based on *ex parte* communication from staff and raised issues not posed by application for declaratory order, *rejected.*

APPEARANCES:

Simon H. Rifkind, *Paul J. Newlon*, and *Leonard H. Becker*, of Paul, Weiss, Goldberg, Rifkind, Wharton & Garrison, for First Multifund of America, Inc.

Kenneth J. Bialkin, *Louis A. Craco*, and *Richard Darsky*, of Willkie Farr & Gallagher, for First Multifund Advisory Corp.

Lloyd J. Derrickson, *Frank J. Wilson*, *John F. Mylod, Jr.*, and *John J. McCarthy, Jr.*, for the National Association of Securities Dealers, Inc.

Solomon Freedman, *Sydney H. Mendelsohn*, *Gerald Osheroff*, and *Stephen K. Wiseman*, for the Division of Corporate Regulation of the Commission.

FINDINGS AND OPINION OF THE COMMISSION

First Multifund of America, Inc. ("Fund"), which is registered as an open-end diversified investment company under the Investment Company Act of 1940 and invests solely in shares of other open-end investment companies, and its affiliate, First Multifund Advisory Corp. ("Adviser"), which is Fund's investment adviser, a registered broker-dealer, and distributor of Fund's shares,[1] filed a joint application for a declaratory order pursuant to Section 5(d) of the Administrative Procedure Act.[2] They seek an order declaring that it is lawful, in accordance with Section 26 of Article III of the Rules of Fair Practice ("Rule 26") of the National Association of Securities Dealers, Inc. ("NASD"), for members of the NASD who are underwriters of the shares of open-end investment companies ("mutual funds") to grant concessions to members who act as brokers for purchasers of such shares, including brokers who are affiliated persons of such purchasers.[3] We ordered a hearing on the application with respect to certain

[1] The president of Fund is also the president and majority stockholder of Adviser.

[2] 5 U.S.C. 554(e). That Section provides that "The agency, with like effect as in the case of other orders, and in its sound discretion, may issue a declaratory order to terminate a controversy or remove uncertainty."

[3] Rule 26(c) permits a broker or dealer who is an NASD member to purchase mutual fund shares at a discount from the public offering price from an underwriter who is also a member, provided that a sales agreement setting forth the concession to be received is in effect between the parties.

matters presented for consideration by our Division of Corporate Regulation ("Division"). A public hearing was held at which the NASD was granted leave to be heard. An initial decision by the hearing examiner was waived, briefs were filed by applicants, the NASD, and the Division, and we heard oral argument. Our findings are based upon an independent review of the record.

The application alleges that at November 21, 1969, Fund had 1,814,607 shares outstanding and net assets of $17,559,964; that Adviser, in purchasing mutual fund shares for Fund from principal underwriters of those shares, receives concessions of not more than 1 percent of the purchase price; and that a controversy had developed between applicants and the Division with respect to the capacity in which Adviser acts in effecting such purchases, the provisions of the Act that are applicable, and whether Adviser or Fund is entitled to the concessions paid on those purchases.

Where a sales load is charged by a mutual fund whose shares Fund proposes to acquire for its portfolio, Fund's practice is to execute a "letter of intent" for the principal underwriter of the selling fund stating an intention to purchase the dollar amount of such shares, generally ranging from $200,000 to $1,000,000, required to qualify it for the minimum sales load, usually 1 percent of the purchase price.[4] Adviser enters into a selling agreement with the underwriter under which it is entitled to receive as a concession or commission an amount normally somewhat less than 1 percent of the purchase price if Fund fulfills its letter of intent. Pending resolution of the dispute between applicants and our staff as to the disposition of those commissions, they have been placed in escrow, and by November 30, 1969, totalled about $279,000.

Adviser's Capacity in Portfolio Transactions

Applicants assert that Adviser acts as a broker for Fund in effecting purchases of mutual fund shares for Fund's portfolio, while the Division contends that Adviser acts as a dealer and thereby violates Section 17(a)(1) of the Act unless it obtains an exemption from that Section.[5] The Division stresses that Ad-

[4] The letters of intent permit the aggregation of purchases of redeemable securities during a maximum period of 13 months in determining the amount of sales load. There is no obligation to purchase, and, if the letter of intent is not fulfilled, the sales load applicable to the lesser aggregate amount of securities purchased is payable in accordance with a scale of reducing loads varying with the quantity of securities purchased.

[5] Section 17(a)(1) of the Act makes it unlawful for an affiliated person of a registered investment company, acting as principal, knowingly to sell any security to such company, with certain exceptions not here applicable.

viser is characterized as a dealer-principal in the selling agreements with the principal underwriters of the selling funds and that Section 22(d) makes no provision for the sale of mutual fund shares to a broker at a discount,[6] and it argues that while Rule 26 states that brokers as well as dealers may obtain concessions, it cannot contravene Section 22(d). The NASD's position is that Adviser acts as a dealer, as stated in the selling agreements, and can properly obtain the concessions since both Rule 26 and Section 22(d) permit dealers to obtain a concession.

We agree with applicants' position that Adviser acts as a broker. The selling agreements with the underwriters, not all of which refer to Adviser solely as a dealer or principal,[7] govern the legal relationship between Adviser and those underwriters and the selling funds, but not that between Adviser and Fund. The agreement forms are prepared by the underwriters to insulate them and the selling funds from liability for any misrepresentations by the broker-dealer to purchasers and to insure payment by him. Applying the classical common law test of intention of the parties in determining whether an agency relationship exists, the testimony of the president of applicants that it was understood that Adviser acted as broker must be given weight. Moreover, the letters of intent, confirmations, and other materials indicate that Fund, not Adviser, is the purchaser, and that Adviser performs only the functions of a broker.[8] Adviser's rights are therefore governed, not by Section 17(a)(1), but by Section 17(e)(2) which permits it to receive compensation for acting as broker, notwithstanding its affiliation with Fund, provided such compensation does not exceed 1 percent of the purchase price.[9] And Section 17(e)(2) recognizes, in permitting a 1 percent concession, that the performance of certain functions by an affiliated broker may

[6] Section 22(d) of the Act provides in pertinent part that no principal underwriter shall sell mutual funds shares "to any person except a dealer, a principal underwriter or the issuer, except at a current public offering price described in the prospectus."

[7] Two of the selling agreement forms in the record recognized that the purchaser from the principal underwriter may be either a broker or dealer. In one the underwriter states: "You agree to purchase shares through us at the offering price then in effect as agent for your customers or for resale to your customers as principal." In the other it states: "You agree not to purchase as principal, or to participate as broker in the purchase of, any Fund shares except through or from us or from investors . . ."

[8] According to the president of applicants, the confirmations from underwriters to applicants showed Fund to be the purchaser. An official of a company which managed a number of the portfolio funds also testified that when Fund executed a letter of intent, the principal underwriter knew that Fund was the ultimate purchaser and that, "in a sense," the sale was by the underwriter to Fund.

[9] Section 17(e) (2) (C) of the Act makes it unlawful for an affiliated person of a registered investment company "acting as broker" in connection with the sale of securities to such company, to receive from any source a commission or other remuneration which exceeds 1 percent of the purchase price.

be in the interests of the fund despite inherent conflicts of interest.[10]

Our conclusion that Adviser acts as broker is not precluded by the absence of any reference to brokers in Section 22(d) of the Act. That Section, which is primarily concerned with price maintenance, did not need to mention the broker because, if a broker is involved, the sale, as recognized by Section 17(e)(2), is effected through him to the customer (in this case, Fund) who pays the current public offering price as required by Section 22(d). The exception as to a dealer was necessary because, like a customer, he purchases for his own account, and it was intended that he not be required to pay the offering price. Rule 26, which expressly deals with concessions, makes explicit with respect to a broker what is implicit in Section 22(d), namely, that a broker may receive a concession, and, therefore, we see no inconsistency between the two provisions.

We disagree with the Division's further contention that, assuming Adviser is not a dealer, it is not "acting" as a broker within the meaning of Section 17(e)(2), and that Rule 26 cannot validate violations of that Section. The Division asserts that the only function performed by Adviser is telephoning the underwriter and ordering the number of shares requested by Fund at the effective offering price, there being no opportunity to shop for best price and execution, and it points out that Adviser is already compensated for its investment advisory function of selecting suitable investments and that Fund could order the shares directly. However, Adviser's functions include arranging for the letters of intent, sending confirmations to Fund, Fund's custodian, and the underwriter, arranging for prompt payment by the custodian and for receipt by it of the certificate from the underwriter, and record-keeping. Adviser's role as a broker is no different from that of a non-affiliated broker who is asked by a mutual fund to purchase specified mutual fund shares or that of any broker, affiliated or not, who effects a transaction in a listed security for such fund in an ordinary stock exchange transaction. Accordingly, no different characterization should be applied to the functions performed by Adviser because it is affiliated with Fund, or because

[10] In our *Report on the Public Policy Implications of Investment Company Growth*, H. Rep. No. 2337, 89th Cong., 2d Sess., p. 190 (1966), we stated: "The Act deals with these problems [resulting from close affiliation between a broker-dealer and an investment company] by placing some limitations on the type and amount of compensation that broker-dealers may obtain from executing profolio transactions for their affiliated comapnies. In addition, and even more important, are the basic fiduciary standards incorporated in the Act which govern relationships between investment companies and affiliated broker-dealers."

mutual fund shares rather than listed shares are involved and selling agreements are used for the protection of the selling underwriter and issuer.

COMPUTATION AND RETAINABILITY OF CONCESSIONS

The Division next asserts that even if Adviser be considered to be acting as broker within the meaning of Section 17(e)(2), its commissions in fact exceeded in the case of purchases of some of the portfolio fund shares the 1 percent limitation specified in that Section because succeeding purchases, redemptions, and repurchases of shares of the same funds within the period of a letter of intent had the effect of increasing the true commissions paid to Adviser in relation to the net number of shares purchased.[11] We are of the view that, aside from any breach of Adviser's fiduciary obligation to Fund involved in assertedly excessive redemptions and repurchases to generate commissions, which is discussed below, it is not appropriate to calculate the commissions paid to Adviser on the basis of net purchases. Section 17(e))2) states the permissible commission in terms of the price in each transaction. Moreover, Rule 22d–1(a)(3) under the Act permits the aggregation of purchases during the period of a letter of intent, without deduction of redemptions, in determining eligibility for a reduced sales load.[12] Accordingly, it would appear that the computation of commissions on the basis of each purchase is equally permissible. The Division's formula for computing commissions would create uncertainty in achieving compliance with the 1 percent limitation and could discourage redemptions that might be dictated by legitimate market considerations. It could, for example, have the unwarranted result of requiring Adviser to relinquish all commissions received with respect to purchases of shares of a fund which were thereafter redeemed for sound reasons during the period of the letter of intent.

We are also not persuaded by the Division's contention that Adviser must pay over to Fund all the commissions it receives on the ground that their retention is inconsistent with Adviser's fiduciary obligation to Fund to obtain the best price and execution. In the face of Section 17(e)(2) as well as Section 22(d), we do not consider that Adviser has any fiduciary

[11] Although the Division analyzed transactions in shares of 11 portfolio funds, its argument is not pertinent with respect to at least five of such funds, as to which it appears that Fund effected a series of consecutive purchases, without any intervening redemptions, sufficient to qualify it for a 1 percent load under the letters of intent.

[12] The general practice of the industry is for selling funds to permit the aggregation of purchases without deducting redemptions in determining whether the letter of intent has been fulfilled.

obligation to turn such commissions over to Fund.[13] As pointed out by Adviser, and recognized by Fund, retention of the commissions paid to Adviser "affords a benefit to the Adviser which the Fund may properly take into account in bargaining with the Adviser concerning its advisory fee." We would anticipate that substantial recognition would be given to the commissions retained by Adviser, with of course appropriate allowance being made for the expenses incurred in executing portfolio transactions for Fund.[14]

The record discloses several instances, however, where Adviser's commission exceeded 1 percent of the purchase price, in violation of Section 17(e)(2). On four purchases of the shares of First Investors Fund for Growth, Adviser's concessions amounted to 1.15 percent of the purchase price, and on at least two purchases of the shares of Hartwell and Campbell Leverage Fund, Adviser's concessions amounted to 1.2 percent and 1.6 percent of the purchase price. In those instances Adviser must be considered to have breached its fiduciary duty to Fund to the extent that it effected transactions at commissions which exceeded 1 percent; and, therefore, it must pay the entire amount of such commissions to Fund, no exemption from Section 22(d) is necessary for this purpose, and Section 24 of Article III of the NASD's rules, which prohibits concessions to anyone other than a broker or dealer, is not pertinent.[15] With respect to two purchases of Oppenheimer Fund shares pursuant to Fund's letter of intent expiring in November 1968, it appears that Adviser effected purchases in good faith belief that the breakpoint resulting in a concession to Adviser not exceeding 1 percent would be reached; in fact, the letter of intent was not fulfilled and the concession exceeded 1 percent. We would consider the provisions of Section 17(e)(2) satisfied if the excess commission over 1 percent in each of these two

[13] See *Kurach* v. *Weissman*, 49 F.R.D. 304, 307 (S.D.N.Y. 1970).

In view of our conclusion, we reject the Division's ancillary argument which applicants and the NASD opposed that we should exempt Adviser from Section 22(d) pursuant to Section 6(c) so as to enable it to effect the payment to Fund.

[14] In our Investment Company Report (*supra*, at p. 190), we recommended that brokerage commissions paid to broker-dealers with which investment company managers are affiliated be taken into account for the purpose of reducing management cost. We stated: "If Congress accepts this recommendation, affiliation between investment companies and broker-dealers should in the future produce significant benefits to investment companies and their public shareholders in the form of reduced management costs." See Section 36(b), added by 1970 Amendments and effective June 1972 (Public Law 91-547, Sec. 20, 84 Stat. 1429).

[15] *Cf. Provident Management Corporation*, 44 S.E.C. 440, 445 n. 14 (1970).

transactions were returned to the principal underwriter of the selling fund.[16]

ALLEGED EXCESSIVE PORTFOLIO TURNOVER

The Division contends that once Adviser commenced receiving concessions on transactions for Fund, it increased the rate of such transactions excessively in order to generate concessions. It notes that a significant number of dealer agreements (permitting the payment of concessions to Adviser) were signed by Adviser late in 1968 and throughout 1969, and that for the year ended November 30, 1969, Fund reported a portfolio turnover rate of 253.1 percent, as compared to 76.8 percent reported for the previous year.[17] The Division alleges that Adviser followed a practice of purchasing, redeeming, and repurchasing shares of the same funds, and of redeeming all or a large part of the investment in a fund shortly before and after expiration of the letter of intent and re-using the proceeds to purchase shares in other funds. It urges that to redeem shares in one fund and repurchase shares in another "virtually simultaneously" affords little benefit to the investor since each fund is itself invested in a large number of companies, and that Adviser's practice was to switch to funds with substantially similar investment objectives.

In our opinion the record does not establish by a preponderance of the evidence that Adviser induced the turnover in Fund's portfolio for the purpose of generating commissions. We note at the outset that the Division's charge of excessive transactions was based on an analysis of only 11 of Fund's 70 portfolio securities, which were not claimed to be representative of all the others but rather selected as showing "particularly heavy" trading. As previously mentioned, purchases sufficient to qualify for the 1 percent load were effected in at least five of the 11 portfolio funds without any intervening redemptions.[18] Moreover, there appears to be no material difference in

[16] Under the investment advisory agreement between Adviser and Fund, Adviser was required to reimburse Fund for any sales load in excess of 3½ percent (now 2½ percent) of the purchase price. It appears that reimbursements were made, pursuant to this guarantee, in an amount that applicants' president states has been insignificant, which may involve questions under Section 22(d). We note that no reimbursements were necessary with respect to Fund's purchases of the protfolio funds selected for analysis by the Division.

[17] Of the approximately $279,000 in escrow at November 30, 1969, $249,158 was credited to Adviser during the year ending on that date.

Under the instructions in Form N-1R filed by Fund, the portfolio turnover rate is calculated by dividing the lesser of the dollar amounts of the purchases and the sales of portfolio securities for the fiscal year, by the monthly average of the value of the portfolio securities owned by registrant during the year computed according to a specified formula.

[18] In three of the remaining six portfolio funds, over 75 percent of the qualifying amount had been invested before any redemptions.

the pattern of transactions as between those five funds and the remaining six, or between those purchases on which Adviser received concessions and those on which it did not. We also note that, whatever significance with respect to the volume of commissions Fund's 1969 turnover rate might have in the case of a conventional mutual fund which pays a commission on both the purchase and sale of its portfolio securities,[19] the computation of the turnover rate here did not exclude transactions entailing no commissions to Adviser, including sales (redemptions), transactions in no-load funds in which about a third of Fund's assets were invested, and those involving a switch between funds in the same management complex which similarly were made at no sales load.[20]

As we analyze Fund's repurchases following redemptions in the 11 selected funds, they do not establish that Adviser was seeking increased commissions. For example, Fund, to qualify for a 1 percent sales load on purchases from L. M. Rosenthal Fund, had to purchase $500,000 of its shares. In January and February 1969, Fund purchased 34,000 shares at offering prices ranging from $10.87 to $11.13 per share for a total of $372,920. Ten days later, Fund redeemed 31,000 shares at about $9.85 per share for a total of $305,620. About a year later, within the 13-month period of the letter of intent, Fund purchased 18,000 shares, at $7.43 per share, for $133,740. Assuming no redemptions or repurchases had been made, since the $372,920 of purchases were below the breakpoint for a 1 percent load, Fund would have had to pay a sales load of 2.03 percent or $7,570 and Adviser's concessions under the selling agreement would have been 1.71 percent or $6,377. By making the repurchase in the amount of $133,740 following the redemptions, the total sales load paid by Fund on the aggregate purchases of $506,660 amounted to $5,067, and the commissions actually payable to Adviser amounted to $4,509. Similarly, in connection with Fund's transactions in the shares of Boston Common Stock Fund, where $1,000,000 in aggregate purchases was required to qualify for the minimum sales load of 1 percent, Fund first effected purchases of $843,750 on which, absent further purchases, a sales load of 2.25 percent or

[19] In 1969, about 8 percent of 370 conventional mutual funds which submitted reports to us had turnover rates higher than Fund, and in 1968 about 35 percent of 404 reporting funds had higher rates than Fund.

[20] Of the 148 transactions reflected in the Division's analysis with respect to the 11 portfolio securities. 91 were purchases and 57 were redemptions. No commissions were generated by the redemptions and 23 of the purchases. Thus, no commission was available to Adviser in about 54 percent of those transactions. We note that in fiscal 1970, when the turnover rate was 200.1 percent, the concessions amounted to only $94,685.

$18,984 would have been payable by Fund, and a concession of 1.5 percent or $12,656 would have been payable to Adviser. Following redemptions in the amount of $333,600 (at the rate of $11.12 per share compared to the prior purchase prices of $10.95 and $10.98 per share), Fund effected a purchase four months later at $7.66 per share for a total of $229,800, which brought it above the 1 percent breakpoint (to $1,073,550). The sales load and Adviser's concession were accordingly each reduced to $10,735.50.[21]

The Division points out that three months after the repurchases of Rosenthal Fund shares, and two months after the expiration of the period of the letter of intent, Fund redeemed the 21,000 shares of that fund remaining in its portfolio. We note, however, that the net asset value of that fund's shares had declined to about $6.50 per share and that such redemptions were consistent with the exercise of business judgment and did not necessarily indicate that the purpose of the prior transactions was to generate commissions for Adviser.

The record shows, as asserted by applicants, that a substantial amount of Adviser's commissions resulted from the investment of net capital received from the sale of Fund's shares to the public in 1969.[22] Applicants further assert that substantially all the redemptions of the shares of the 11 selected portfolio funds were effected as a defensive measure in three periods in 1969 when the stock market was particularly unstable. Applicants note that in 1969 the Dow Jones Industrial average declined from 953 to 903 between February 13 and March 6 and from 965 to 815 between May 15 and July 31 and fluctuated between 830 and 803 from September 25 to October 16. They state that each successive decline in the market confirmed their fears that the market had not yet bottomed out and that Fund's management, like many other portfolio managers, liquidated "perilous" investments to preserve Fund's assets in liquid form (cash and cash equivalents) or to reinvest the proceeds in funds deemed safer.

[21] We recognize, as previously indicated, that to the extent Adviser's concession on the Rosenthal and Boston purchases prior to the redemptions exceeded 1 percent of the purchase price, and assuming no further purchases during the period of the letter of intent, Section 17(e) (2) would have required Adviser to return the excess to the principal underwriter. On this record, however, it is doubtful that applicants were aware of such requirement. It should also be noted, with respect to the sales load, that Adviser would under certain circumstances have a fiduciary duty to effect the additional purchase necessary to qualify Fund for the minimum sales load and the resulting savings in sales charges to Fund. See *Russell L. Irish*, Securities Exchange Act Release No. 7687, p. 7 (August 27, 1965), *aff'd* 367 F.2d 637 (C.A. 9, 1966), *cert. denied* 386 U.S. 911.

[22] For the year ended November 30, 1969, Fund issued 1,718,063 shares for $19,450,338. Assuming two-thirds of all the proceeds were invested in load funds, the concessions to Adviser, at the average rate of .8 percent which it received in transactions in such funds, would have amounted to approximately $104,000.

Fund's liquidity ratio or proportion of liquid assets to net assets during the first two periods of substantial market decline in 1969 indicates that many of its redemptions were motivated, at least in part, by its desire to take a defensive position.[23] The ratio, which was less than 3 percent at the beginning of the year, rose to about 58 percent by the end of February and to more than 75 percent by the end of March and from less than 5 percent at the end of May to about 33 percent at the end of June. A significant portion of Fund's high turnover rate in 1969 can be attributed to these high liquidity ratios since, under the turnover rate formula, the divisor (monthly average value of portfolio securities) would be smaller to the extent a proportion of the proceeds of the redemptions was not immediately reinvested in portfolio securities. Although the Division argues that there was little justification for Fund to go defensive since the portfolio funds would also follow that course, we cannot presume that Fund's business judgment was improper. Nor was any evidence offered by the Division to support its assertion that shifts from one diversified portfolio to another afforded little benefit to Fund's shareholders. The fact that funds have diversified holdings does not mean that their holdings or investment results are the same. Changes in the net asset values of the funds in conjunction with other factors such as the quality and policies of their particular managements may impel a business decision to switch to a particular fund notwithstanding that it may have substantially similar basic investment objectives.

Without expressing any opinion on the actual merits of the business judgment exercised in effecting the transactions in the 11 funds analyzed by the Division, we conclude in light of the above factors that the 1969 turnover rate reported by Fund is not sufficient of itself to establish a breach by Adviser of its fiduciary duty to Fund. Accordingly, Adviser is entitled to receive and retain the commissions up to 1 percent except in those instances where, as discussed above, they exceeded the 1 percent limitation in breach of Adviser's fiduciary duty.

Other Matters

The NASD contends that we have no power to issue the declaratory order requested by applicants because, apart from the matters raised in our order for hearing, the requested order relates solely to Rule 26 as to which there is no actual controversy or uncertainty in these proceedings. We do not

[23] No information with respect to Fund's liquidity was available for July or October.

agree that, merely because the application requested a declaratory order in terms of Rule 26, we are limited to a consideration of that Rule. This is particularly true when, as evidenced by our order for hearing, the record, and applicants' own briefs and previous correspondence with our staff, various provisions of the Act are relevant to a settlement of the controversy with respect to the commissions held in escrow and future commissions paid to Adviser.

We also reject the NASD's contention that we should exercise our discretion to refuse to issue a declaratory order covering the matters raised in our order for hearing on the grounds that the provisions for such orders in the Administrative Procedure Act (5 U.S.C. 554(e)) does not apply to "a matter subject to a subsequent trial of the law and facts de novo in a court," and that the declaratory order device is intended to inform persons whether or not certain proposed conduct is lawful, whereas applicants have already engaged in conduct deemed objectionable by the Division. Our order herein will be completely effective without the necessity for judicial retrial or decision, and the commissions in question have been and continue to be deposited in escrow. Nor do we find any substance to objections by Adviser that it was entitled to receive a "responsive" pleading by the Division and that we, on the basis of an allegedly improper *ex parte* communication from the staff, raised issues in our order for hearing not posed by the application.[24]

CONCLUSION

On the basis of the foregoing, we will enter an order declaring that Adviser acted as broker for Fund and, no excessive trading in Fund's portfolio to generate commissions having been shown, is entitled under the terms of Section 17(e)(2) of the Act to receive and retain commissions (limited to 1 percent of the purchase price except where a breach of fiduciary duty otherwise appears) paid and to be paid by the principal underwriters of selling funds on purchases from them of mutual fund shares for Fund.

An appropriate order will issue.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM and HERLONG), Commissioner LOOMIS not participating.

[24] *R. A. Holman & Co.* v. *S.E.C.*, 366 F.2d 446, 455 (C.A. 2, 1967), *amended on reh'g* 377 F.2d 665 (1967), *cert. denied* 389 U.S. 991.

In the Matter of

WESTON AND COMPANY, INC.

WALTER DAVID WESTON

File No. 3-2397. Promulgated August 30, 1971

Securities Exchange Act of 1934—Sections 15(b), 15A and 19(a)(3)

BROKER-DEALER PROCEEDINGS

Grounds for Remedial Action

Failure to Disclose Inability to Meet Current Obligations

Net Capital Deficiencies

Improper Maintenance of Proceeds of Offering

Late Filing of Financial Report

Where registered broker-dealer followed practice of issuing checks against insufficient funds without disclosing registrant's inability to meet current obligations, and failed to comply with net capital requirements, to maintain properly the proceeds of an underwriting, and to make timely filing of financial report, *held*, willful violations of securities acts, and in public interest to revoke registration of broker-dealer, expel it from membership on stock exchange and in registered securities association, and to suspend president.

APPEARANCES:

Joseph F. Krys and *John E. Jones*, of the Denver Regional Office of the Commission, for the Division of Trading and Markets.

Norman S. Johnson, of Gardiner & Johnson, for respondents.

FINDINGS, OPINION AND ORDER

These are proceedings instituted pursuant to Sections 15(b), 15A and 19(a)(3) of the Securities Exchange Act of 1934 ("Act") to determine what, if any, remedial action is appropriate in the public interest with respect to Weston and Company, Inc., a registered broker-dealer and member of the Salt Lake Stock Exchange and the National Association of Securities Dealers, Inc., and Walter David Weston, a director, president and a principal stockholder of registrant. Following hearings, the parties waived an initial decision by the hearing examiner, proposed findings and briefs were filed, and we heard oral argument with respect to Weston.[1] On the basis of our independent review of the record, we make the following findings.

FAILURE TO DISCLOSE INABILITY TO MEET OBLIGATIONS

During the period November 1969 through March 27, 1970, registrant followed a practice of issuing checks against insufficient funds in its bank account. During this period, over 150 checks, some of which were issued to customers of registrant, were returned by registrant's bank, and payees were forced to redeposit them, in some cases for a second time, before collecting the money that was due them from registrant. No disclosure of this practice was made to registrant's customers aside from those who found it necessary to redeposit checks. Weston asserts that the return of checks by registrant's bank because of insufficient funds was largely caused by the delay in transferring funds to that bank from an account registrant maintained in an out-of-state bank.

In effecting transactions and accepting customers' funds and securities, registrant impliedly represented that it was able to discharge its liabilities as they came due, a representation that was false in view of registrant's undisclosed inability to meet current obligations in the ordinary course of business.[2] The asserted late transfer of funds from another bank would neither explain nor justify the continuance of registrant's practice of issuing checks against insufficient funds over a five-month period. Nor are respondents excused because, as they further assert, customers' checks were generally given priority treatment and all dishonored checks were eventually cleared, although such factors may be considered in mitigation. We think it clear, in view of its check practices, that registrant willfully violated the antifraud provisions of Section 10(b) of the Act and Rule 10b–5 thereunder, and that Weston, who was aware of such practices, willfully aided and abetted such violation.

NET CAPITAL DEFICIENCIES

In February 1970, registrant's independent auditors determined that registrant had had a net capital deficiency as of December 31, 1969 of about $148,000. From financial statements submitted by registrant, our staff made calculations

[1] After these proceedings were instituted, the firm was adjudicated a bankrupt and the trustee in bankruptcy waived oral argument.

[2] See *Finchley Investors Corporation*, 42 S.E.C. 336, 338 (1964).

which showed a deficiency as of that date of about the same amount and also net capital deficiencies on six other occasions between October 31, 1969 and February 28, 1970,[3] during which period registrant was engaging in business.

Respondents contend that our staff, in computing registrant's net capital for the dates in question, undervalued various over-the-counter securities held by the firm. In our opinion the staff's method of valuation[4] was reasonably calculated to determine the value at which the securities could be readily converted into cash, consistent with the net capital rule's basic objective of liquidity.[5] But even if we were to accept respondents' valuations, rather than the staff's, registrant would still have had substantial net capital deficiencies on six of the seven dates in question.[6] Moreover, respondents do not attack or dispute the independent auditors' calculation of a $148,000 net capital deficiency as of December 31, 1969. Under the circumstances, quite apart from the differences in methods of valuation of registrant's securities, it seems clear, and we find, that registrant willfully violated the net capital provisions of Section 15(c)(3) of the Act and Rule 15c3-1 thereunder.

On the basis of this record, however, we are unable to find that Weston willfully aided and abetted registrant's net capital violations.[7] Although Weston was president of registrant, responsibility for net capital compliance had been delegated to and Weston reasonably relied on the firm's comptroller who was a certified public accountant with training and experience in net capital computation. When such a computation by the comptroller as of December 19, 1969 showed registrant to be out of ratio, Weston closed registrant's business for a brief period until net capital was obtained in an amount which, according to the comptroller's calculations, was sufficient to put registrant in compliance with net capital requirements. There is no evidence in the record that, aside from the instance

[3] Rule 15c3-1 under Section 15(c) (3) of the Act provides, insofar as here relevant, that no broker or dealer shall permit his aggregate indebtedness to exceed 2,000 percent of his net capital computed as specified in the rule. The staff's calculations showed net capital deficiencies ranging from a high figure of $440,651 on January 31, 1970 to a low of $87,520 on February 28, 1970.

[4] The staff used the average of bid quotations in the daily pink sheets published by the National Quotation Bureau, Inc. to value the securities held, and the average of ask quotations in those sheets for securities in short positions. Where there were no quotations in those sheets the staff consulted quotations in two local publications.

[5] Securities Exchange Act Release No. 8024, pp. 1-2 (January 18, 1967).

[6] On that basis, deficiencies would have existed ranging from a high of $158,378 on December 19, 1969 to a low of $7,240 on February 24, 1970; on February 28, 1970, registrant would have been in compliance with net capital requirements.

[7] Weston is not charged with a failure of supervision.

cited, Weston knew or should have known prior to February 1970 that registrant was or had been operating out of ratio.

As noted above, during February 1970, the firm of independent accountants hired by Weston to make a year-end audit of registrant and prepare a financial report for filing with this Commission reported to him that its audit indicated that a substantial net capital deficiency had existed as of December 31, 1969. At a February 24 conference attended by Weston, registrant's comptroller, and members of our staff, the staff, after being informed of the auditors' report, requested a copy of registrant's January 31, 1970 trial balance and net capital computation. The staff then stated that the firm appeared to have had a net capital deficiency as of January 31, and advised Weston to suspend registrant's business "until [the firm's] capital situation satisfied the requirements of the Rule." Weston thereupon obtained a current net capital report from registrant's comptroller, which indicated that registrant was then in compliance with net capital requirements, and also an opinion of the independent auditors that changes since December 31 had cured the deficiency which had existed at that date. Under the circumstances, we are unable to conclude that Weston's failure to suspend registrant's business in February 1970 made him a willful aider and abetter of the firm's net capital violations.

Improper Maintenance of Offering Proceeds

Rule 15c2–4 under Section 15(c)(2) of the Act requires in pertinent part that a broker or dealer who participates in a distribution of securities which contemplates that payment is to be made to the issuer only when a certain contingency occurs, place funds received from sales in escrow or deposit them in a separate bank account as agent or trustee "for the persons who have the beneficial interest therein" until the contingency has occurred.

On August 27, 1969, registrant, as underwriter, commenced an offering of securities of Minerals Exploration and Mining Company ("Minerex"). The offering was contingent on registrant effecting gross sales of at least $200,000 at which time the proceeds were to be turned over to the issuer. If registrant failed to meet the required sales level, the proceeds were to be refunded to subscribers. The record shows that registrant did not deposit the initial proceeds from the Minerex underwriting in a bank account until September 26, 1969, when it made three such deposits totalling $44,400 in an account opened in the name of the issuer in care of registrant's vice-president in charge of the underwriting. Prior to the opening of the account, the vice-president had kept checks representing underwriting proceeds in his locked desk drawer. Withdrawals from the bank account could only be made on the joint signatures of registrant's vice-president and an officer of the issuer, although registrant was obligated to return the funds to subscribers unless $200,000 worth of the offering was sold.

Respondents argue that there was no violation of Rule 15c2–4, that the delay in the initial deposits was merely "technical" since no losses resulted, that the fact that the issuer had joint control of the bank account was "of little importance" since it could not unilaterally withdraw funds, and that the funds were not withdrawn or used by the issuer or registrant improperly and were transmitted to the issuer within two days after completion of the required gross sales of $200,000.

Respondents' arguments are without merit. The circumstance that apparently no funds were lost or misappropriated in the present instance[8] lends no support to respondents' conclusion that the requirements of the rule are merely "technical". They constitute important specific safeguards which must be strictly followed. It is clear, and we find, that registrant willfully violated Section 15(c)(2) of the Act and Rule 15c2–4 thereunder. The record, however, does not support a finding that Weston himself willfully aided and abetted that violation. Weston is not charged with a failure of supervision. Registrant's vice-president, who had responsibility for underwritings including that of Minerex, did not inform Weston that he was accumulating checks received from the Minerex offering before depositing them. When this practice came to the attention of Weston, the firm's executive committee immediately instructed the vice-president to make prompt deposits, and there is nothing in the record to indicate that Weston knew or should have known of the manner in which the vice-president set up the Minerex bank account.

Late Filing of Financial Report

Rule 17a–5 under Section 17(a) of the Act requires in pertinent part that every broker-dealer file a report containing certified financial information as of a date within each calendar year, the report to be filed not more than 45 days after the

:ord shows that $400 was withdrawn from the account on September 30, 1969 but fails to .ıe circumstances surrounding the withdrawal.

date selected. Registrant's financial report as of December 31, 1969 was not filed until April 1, 1970, after its request for an extension of time pursuant to subsection (d) of the rule had been denied on February 13.

Respondents argue that the violation of the rule was not willful. Weston testified that the national independent accounting firm he engaged to prepare the report represented that its audit would be completed within the required 45-day period. He became concerned in the latter part of January 1970 that the report would not be filed on time and complained to the auditors, who again assured him that the audit would be completed on schedule and that, in any event, they had never had any difficulty in securing an extension of time from this Commission. His further inquiry in early February elicited the same response. Both Weston and the accountant with primary responsibility for the audit testified to the substantial effort made by the accounting firm and by registrant's own staff to comply with the filing requirement.

A finding of willfulness within the meaning of Section 15(b) of the Act does not require a finding of intention to violate the law.[9] Nor can respondents' violation be viewed as merely technical, as they argue. As we have previously pointed out, annual reports are an important part of the scheme of regulation and surveillance of brokers and dealers under the Act,[10] and any delay in submitting required information could result in harm to those dealing with a firm in the interim that could otherwise have been avoided. We conclude that registrant, willfully aided and abetted by Weston, willfully violated Section 17(a) of the Act and Rule 17a–5 thereunder. In light of the circumstances set forth above, however, we consider it unnecessary in the public interest to impose any sanctions for this violation.[11]

PUBLIC INTEREST

As noted above, we have determined not to assess any sanctions for registrant's late filing of its financial report for 1969. In view of the serious nature of registrant's other violations, however, and the fact that it is presently in bankruptcy,

[9] See *Haight & Co., Inc.*, 44 S.E.C. 479, 505 (1971) Securities Exchange Act Release No. 9082, p. 22 and cases there cited.

[10] *Samson, Roberts & Co., Inc.*, 42 S.E.C. 612, 613 (1965).

[11] The record does not sustain the allegations in the order for proceedings that registrant, aided and abetted by Weston, violated the record-keeping provisions of Section 17(a) of the Act and Rule 17a–3 thereunder by failing to maintain properly records of trial balances and customer ledger accounts.

we have concluded that it is appropriate in the public interest to revoke registrant's broker-dealer registration and expel it from membership on the Salt Lake Stock Exchange and in the National Association of Securities Dealers, Inc. As to Weston, we have found that he violated the antifraud provisions because of registrant's practice of issuing checks against insufficient funds. We consider this a serious matter justifying the imposition of a sanction. Under all the circumstances, however, we have concluded that a bar of Weston is not required. The public interest will be adequately served by suspending him from association with any broker or dealer for a period of 30 days and, in view of the managerial nature of his violation, providing that for a further period of 6 months he may not be associated with any broker or dealer in a managerial or supervisory capacity.

Accordingly, IT IS ORDERED that the registration as a broker and dealer of Weston and Company, Inc. be, and it hereby is revoked; that Weston and Company, Inc. be, and it hereby is, expelled from membership on the Salt Lake Stock Exchange and in the National Association of Securities Dealers, Inc.; and that Walter David Weston be, and he hereby is, suspended from being associated with any broker or dealer for a period of 30 days, and, for a period of 6 months thereafter from any such association in a managerial or supervisory capacity. The suspension of Weston shall commence as of the opening of business on September 7, 1971.

By the Commission (Chairman CASEY, Commissioners OWENS, NEEDHAM and HERLONG), Commissioner LOOMIS not participating.

In the Matter of

NORRIS GRAIN COMPANY

File No. 3-3161. Promulgated August 31, 1971

Investment Company Act of 1940—Section 6(c)

MEMORANDUM OPINION AND ORDER

Norris Grain Company ("Norris") has filed an application pursuant to Section 6(c) of the Investment Company Act of 1940 ("Act") for an order exempting from the provisions of Section 17(a) of the Act the purchase by Norris (a) from New England Merchants National Bank of Boston, (acting on behalf of Waltham Resources Corp. ("Resources") pursuant to an irrevocable power of attorney under a pledge agreement) of 690,000 shares of common stock of Waltham Industries Corporation ("Industries") for the price of $2,518,500 ($3.65 a share), and (b) from Chemical Bank of New York (acting on behalf of Resources pursuant to an irrevocable power of attorney under a pledge agreement) of 10,000 shares of common stock of Industries for the price of $36,500 ($3.65 a share). The terms of the various agreements between the parties are described in the notice of the filing of the application issued by the Commission in this proceeding (Investment Company Act Release No. 6659). The purchases by Norris were consummated without first obtaining an exemptive order under Section 17(b) of the Act after the parties requested and obtained a "no-action" letter from our staff and in accordance with conditions specified therein.

Our primary concern with respect to the Section 6(c) application was the adequacy of the sale price in view of the fact that prior to and around the time of the negotiations the market price of Industries stock on the American Stock Exchange was considerably higher than the negotiated price. The record shows that the sale price of $3.65 a share was arrived at in arm's length negotiations between the bank and Norris. The application indicates that at the time of the negotiations Industries was a financially troubled concern. About ten months later Industries filed a voluntary petition for reorganization under Chapter X of the Bankruptcy Act. We note that Norris owned 12 percent of the outstanding common stock of Industries prior to the negotiations and was represented on the board of directors of Industries and that the parties were aware that Industries was in financial difficulty. Under these circumstances, and in the light of the financial information relating to Industries contained in the record, and in view of the fact that Norris is a privately owned corporation, we conclude that the transactions as negotiated are fair and should be exempted as requested. In reaching this conclusion, we do not determine the value of Industries common stock. The question of the value of such stock will be considered by the Chapter X court if and when a plan of reorganization is filed.

The Commission finds, pursuant to the provisions of Section 6(c) of the Act, that the granting of the requested exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act.

IT IS HEREBY ORDERED, pursuant to the provisions of Section 6(c) of the Act, that the transactions as described in the application are exempted from the provisions of Section 17(a) of the Act, effective forthwith.

By the Commission.

IN THE MATTER OF

HAGEN INVESTMENTS, INC.

and

EDWARD J. HAGEN

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

File No. 3–2638. Promulgated September 7, 1971

Securities Exchange Act of 1934—Sections 15A(g) and 15A(h)

REGISTERED SECURITIES ASSOCIATION—REVIEW OF DISCIPLINARY PROCEEDINGS

Violations of Emergency Rules of Fair Practice Regarding Fail Items

In proceedings for review of disciplinary action of registered securities association, association's findings that member and its president violated emergency rules of fair practice prohibiting transactions in security in which member had fails to deliver at least 120 days old and requiring fails to deliver or receive of that age to be cleared within 30 days, and sanctions consisting of suspensions, fine and censure of member and president, *sustained.*

Validity of Emergency Rules of Fair Practice

Emergency rules of fair practice of registered securities association designed to reduce large fails balances carried by broker-dealers, *held*, validly adopted pursuant to by-law provisions permitting adoption of rules without submission to membership in case of emergency.

APPEARANCES:

George F. Saunders, of Saunders & Dotson, for applicants.

Lloyd J. Derrickson, *Frank J. Wilson*, and *Andrew McR. Barnes*, for the National Association of Securities Dealers, Inc.

FINDINGS, OPINION AND ORDER

Hagen Investments, Inc., a member of the National Association of Securities Dealers, Inc. ("NASD"), and Edward J. Hagen, its president, seek review, pursuant to Section 15A(g) of the Securities Exchange Act of 1934 ("Act"), of action by the NASD suspending the firm's membership for 3 days, suspending Hagen from associating with any member for the same period, fining applicants $3,000 jointly and severally, censuring them, and assessing costs against them.[1] Applicants and the NASD filed briefs with us. On the basis of our review of the record, we make the following findings.

The NASD's action was based on its findings that applicants had failed to comply with restrictions and requirements imposed by its Emergency Rules of Fair Practice 68–4, 69–2 and 69–4 and had thereby violated Section 1 of Article III of the Fair Practice Rules.[2] Those emergency rules were part of a series of rules adopted by the NASD beginning in June 1968 which were designed to deal with the back-office problems resulting from the high volume of securities transactions, including particularly the problem of the large number and dollar amount of "fails to deliver" and "fails to receive" carried in the accounts of broker-dealers.[3] The first three such rules curtailed trading hours. Rule 68–4, which was adopted in November 1968, effective for the period from December 2, 1968 through January 30, 1969, in pertinent part prohibited a member from selling a security for its own account or buying a security for a customer if it had any fail to deliver in that security 120 days old or older. The rule specified that conduct inconsistent with its provisions would be deemed a violation of Section 1 of Article III. In January 1969, that rule was reenacted as Rule 69–2, effective from January 31 through April 1, 1969. Rule 69–4, which was also adopted in January 1969 and was to be effective from February 15 through April 15, 1969, declared it to be a *per se* violation of Section 1 of Article III and of Rule 69–4 for a member to have a fail to deliver or a fail to receive on its books which was not cleared by it within 30 days after reaching 120 days in age.

[1] During the pendency of the proceedings, we issued an Order, in proceedings instituted by us pursuant to Sections 15(b) and 15A of the Act, revoking the registration of Hagen Investments as a broker and dealer and barring Hagen from being associated with any broker or dealer. Securities Exchange Act Release No. 8859 (April 3, 1970). Applicants consented to entry of that Order without admitting the allegations in the order for proceedings, which included allegations of violations of the registration and antifraud provisions of the securities acts. Following issuance of the Order, applicants submitted their resignations as member and representative, respectively, to the NASD. They were advised that such resignations could not be accepted because of the pending proceedings, and that upon conclusion of the proceedings the membership and registration would be terminated on the basis of our Order.

[2] Section 1 of Article III requires observance of "high standards of commercial honor and just and equitable principles of trade."

[3] "Fail to deliver" means the failure of a broker-dealer to deliver a certificate in proper form at the agreed settlement date to another broker-dealer, and the "failed to deliver" account of a broker-dealer indicates the dollar amount receivable for securities which he has not delivered at settlement date. The "securities failed to receive" account, conversely, indicates the dollar amount of purchased securities which have not been delivered to him at the settlement date by other broker-dealers. See *Report of the Special Study of Securities Markets*, H. Doc. No. 95, 88th Cong., 1st Sess. (1963), Part I, page 416.

Applicants contend that the cited rules were not properly enacted by the NASD and were therefore invalid; that many of the violations found by the NASD did not involve fails items and therefore did not fall within the scope of the rules; and that the penalties imposed by the NASD are excessive.

VALIDITY OF EMERGENCY RULES

During the period when the rules in question were adopted, the NASD's by-laws provided, as they do now, that rules of fair practice adopted by the Board of Governors must be submitted to the membership and become effective only if they are approved by a majority of the members voting and are not disapproved by us.[4] They further provided, however, that when the Board found an emergency to exist, rules adopted by a two-thirds vote of the Board and not disapproved by us would become effective without submission to a membership vote, "provided, however, that no such rule of fair practice. . . shall be effective for more than sixty days or the duration of the emergency as declared by the Board of Governors, whichever is the less."[5] Applicants urge that this provision in effect limited the duration of an emergency to 60 days and precluded successive promulgations of the same or similar rules without submission to the membership, and that, at the time the rules in question were adopted, there was no sudden or unexpected "emergency" but rather a relatively permanent condition which could properly have been dealt with through the normal rule-making procedures.

In our view, departures from the requirement of the by-laws calling for submission of rules to the membership can be justified only in the case of a true "emergency" situation. And we consider that if a situation which is initially of an emergency character persists for an extended period, notwithstanding enactment and enforcement of emergency rules, so that it assumes the nature of a permanent condition, the NASD may be obliged, consistent with its by-law requirement, to obtain membership approval for the continuation or adoption of those and other rules designed to cope with the situation.

Under the circumstances presented here, however, we do not believe that it was improper for the NASD to deal through its

[4] Section 15A(b)(6) requires that the rules of a registered securities association assure its members fair representation in the adoption of its rules.

[5] Article VII, Section 1. Subsequent to the period under consideration, the provision relating to emergency rules was amended so as to provide that an emergency found by the Board may continue for up to six months, and that the Board, upon reassessment of the circumstances which gave rise to the emergency, may declare the emergency to continue to exist for successive six-month periods.

emergency rule procedures with the back office situation that it initially found to exist in June 1968. We also consider that the need for flexibility of action justified the NASD in determining periodically thereafter, at least until it could be ascertained what the conditions that existed required on a long-range basis, whether extraordinary restrictions on members' activities were still needed rather than undertaking to incorporate such restrictions into its permanent rule structure.[6]

The back office problems in the securities industry not only failed to recede after June 1968, but increased to more alarming proportions during the period November 1968-January 1969,[7] and in recognition of that situation action of an emergency nature was taken or continued in effect not only by the NASD, but by the stock exchanges and by this Commission.[8] We cannot say that the NASD was not justified in its determinations incident to the enactment of the rules here under consideration that the emergency originally found to exist still persisted. Nor do we read the by-law provision under which the Board acted as limiting the duration of an emergency to a maximum of 60 days. In our view, that provision merely represented a limitation on the life of the particular rule, and did not preclude the NASD from re-enacting the same rule for another 60-day period, or adopting a new rule designed to cope with the same emergency, provided only that it made a new determination that the emergency conditions still existed.

VIOLATIONS OF RULES

1. The NASD found that during the period from December 2, 1968 to at least February 13, 1969, the member, acting through Hagen, entered into 94 transactions in nine securities in which

[6] The cases referred to by applicants, involving the striking down of legislative enactments which would have dispensed with the normally required submission to or right of review by the electorate on the basis in one case of a purported emrgency and in the other a purported need of action "for the immediate preservation of the public peace, health, or safety," do not in our view require a conclusion that the NASD was not warranted in finding the existence of an emergency under the circumstances presented here. The conditions to which those enactments were directed had existed for an extended period.

[7] In December 1968, fails to deliver reached a record high of $4.1 billion. See S.E.C. 35th Ann Report, p. 2.

[8] For example, in January 1969 we amended our net capital rule to impose a graduated percentage deduction from market value of securities in fails to deliver accounts of broker-dealers. Securities Exchange Act Release No. 8508 (January 30, 1969). In the release accompanying the amendment, reference was made to the "great concern" which this Commission had expressed over the acute delivery backlogs confronting the securities industry, and to the serious nature of the existing back office problems. It was pointed out that the length of time for which amounts due were carried in failed to deliver accounts exposed broker-dealers to undue risk of market fluctuations and to the possibility of financial difficulties of brokers on the other side of transactions, and that major stock exchanges had amended their net capital rules in similar respects.

it had fails to deliver at least 120 days old, in disregard of the restrictions imposed by Rules 68–4 and 69–2. Applicants do not question the NASD's findings that as to two of the securities (Pan American Resources and Wyoming Nuclear)[9] the member in fact had fails to deliver of the specified age, and, with the exception of five transactions noted in the margin, we affirm its findings respecting transactions in those securities.[10]

As to the remaining securities, we reject applicants' contentions that they did not involve fail items. Applicants urged in that connection that in some instances there was no contractual relationship with the broker-dealer on the other side of the transaction (the "contra-broker") or a dispute regarding the terms of the contract; and that in others the member had tendered delivery of the securities, but such tender was rejected. They claimed that they could not properly be required to clear such transactions in a specified time, and thereby to abandon rights which may have accrued by virtue of such tender or arising from doubts as to the existence of a contract.

The record shows, with respect to the underlying transactions in the securities (i.e., the transactions in which the initial fails were found by the NASD), that in two instances (the securities of Great Yellowstone and Mayflower Corp.) the contra-broker did not immediately confirm the transaction and did not respond to written requests for confirmation, but did eventually confirm, subsequent to the alleged restriction date, and that the transactions were then consummated. With respect to another security (Mid-Continent Mining Corp.) the record indicates that prior to the period under consideration the shares were tendered to the contra-broker, apparently following the exchange of confirmations,[11] but were returned to the member with a "DK" ("Dont't Know") notation, and that in February 1969 the member received a "buy-in" notice from the contra-broker and thereupon re-delivered the shares. Similarly, in two other instances (Naturizer and Sharin'O' The Green) confirmations were exchanged, but the original delivery was rejected, apparently because of some confusion arising in one case out of the fact that the confirmations did not

[9] The names of these issuers and others named below are given in the abbreviated form in which they appear in the NASD record submitted to us.

[10] The member's treasurer testified that the Wyoming Nuclear transaction which gave rise to the restriction was completed by delivery of the securities on January 27, 1969. Accordingly, we set aside findings of noncompliance with Rules 68–4 or 69–2 with respect to 5 transactions in the security entered into on or after that date.

[11] Applicants were unable to produce pertinent documents regarding this transaction at the NASD hearings. However, Hagen testified that generally the member did not attempt to deliver stock until it had established that there was a "good trade."

specify which of the two classes of the issuer's stock were the subject of the transaction, and in the other out of a change in the issuer's name following the trade date. In both cases, however, the shares were eventually accepted by the contra-broker. With respect to another security (Southwest Factories), confirmations were also exchanged, but shares tendered by the member were refused because the contra-broker, although it had confirmed the same number of shares, apparently entered a lesser number on its records. This transaction was eventually cancelled by agreement subsequent to the period under consideration.

In our judgment, the NASD was warranted in concluding that there were fails to deliver arising out of the underlying transactions described above. Although these were not the most usual type of fails items,[12] it appears that in each instance not only did the member consider that a valid transaction existed, but the contra-broker also recognized it as such, as reflected in the confirmations issued and in some of the cases in utilization of the "buy-in" procedure which presupposes a good contract. Moreover, particularly in light of the emergency situation, we find nothing improper or unreasonable in a requirement that transactions in which the tender of securities has been rejected because of misunderstanding or confusion be cleared after an extended period has already elapsed, or, as more pertinent to the rules under consideration, that no further transactions in the security be entered into until the earlier transaction has been cleared. It would not appear that the clearing of those transactions through any of the recognized methods of liquidation would defeat any existing legal claims.

We accordingly affirm the NASD's findings regarding fails in the above six securities, although we find that in the case of Naturizer securities, delivery was effected on about January 16, 1969 and that 5 transactions subsequent to that date which the NASD found improper were in fact permissible. We also set aside its findings of violations with respect to 7 transactions in securities of U.S. Silver Mining Corp. which were effected after the fail to deliver was eliminated by the contra-broker's execution of a "buy-in."

In sum, we affirm the NASD's findings of violations with

[12] The NASD acknowledged that applicants might have been granted exemptions, pursuant to the exemptive provisions of Rules 68-4 and 69-2, with respect to many of the transactions had such exemptions been sought.

respect to 77 of the questioned transactions and set aside its findings with respect to the remaining 17.

2. The NASD found that the member failed to clear or settle 69 transactions resulting in 38 fails to deliver items and 31 fails to receive items which were at least 150 days old on February 15, 1969 or became that old by February 28, 1969,[13] and that each such item constituted a violation by applicants of Rule 69–4 and Section 1 of Article III.[14] Applicants' arguments respecting these findings are essentially the same as those presented with respect to the violations discussed above: that many of the transactions in question did not involve fails, because, among other things, the existence or terms of the contract were in dispute, or tendered delivery had been rejected, and that the NASD could not properly require such transactions to be cleared up within a specified time.

However, aside from 5 violations found by the NASD that we do not find to be supported by the record,[15] we sustain the findings of the NASD. In all those instances confirmations had been exchanged and the transactions were recognized as valid.[16]

PUBLIC INTEREST

While we have set aside certain of the NASD's findings, a large number of violations remains and we concur in the NASD's characterization of the extent of the violations as "extremely serious." We also note that the District Committee had fined applicants $5,000, but had not imposed suspensions. The Board, stating it considered that penalty inadequate, added censure and the 3-day suspensions, but reduced the fine to $3,000. In view of the disciplinary action taken by us with respect to applicants during the pendency of these proceedings, which in effect excludes them from the securities business, the suspensions imposed by the NASD will have no practical effect, so that the remaining sanctions are in fact less severe than those imposed by the Committee. Under all the circumstances, we find no basis for concluding that such

[13] It appears from the NASD's decision, although it is not entirely clear in this respect, that 23 alleged violations arising out of transactions in Dumont Corporation stock were dismissed.

[14] While the effective date of Rule 69–4, as noted, was from February 15 through April 15, 1969, and the rule allowed 30 days to clear fails which had reached 120 days, the notice to the membership transmitting the rule, which was dated January 15, 1969, specified that a member which had not eliminated any fails over 120 days old by February 15 would be in violation. It thus appears that it was the intent of the NASD to require members to clear by February 15 those fails which were at least 120 days old on January 15.

[15] In 4 transactions the contra-broker did not confirm and there is no other indication in the record that a contract in fact existed, and a fifth transaction was concludedon January 30, 1969.

[16] The record shows that in a majority of the of the above transactions, buy-in notices were issued eithr by the member or by the contra-broker.

sanctions are excessive or oppressive, having due regard to the public interest.[17]

Accordingly, IT IS ORDERED that the proceedings for review of the disciplinary action taken by the National Association of Securities Dealers, Inc. against Hagen Investments, Inc. and Edward J. Hagen be, and they hereby are, dismissed.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM, HERLONG and LOOMIS).

[17] Applicants requested permission to introduce additional evidence before us, consisting of Emergency Rules 68-1 through 69-5, together with related NASD resolutions and transmittal letters to the NASD membership. We do not deem it necessary, however, to have such material incorporated into the record. The rules and regulations are part of our official records, having been submitted to us by the NASD pursuant to Section 15A(j) of the Act, and we have officially noticed them. No showing has been made that the transmittal letters, other than those submitted by applicants as exhibits to their brief, are relevant to the issues before us.

In the Matter of

BOHN-WILLIAMS SECURITIES CORPORATION

(now known as Don Williams Securities Corporation)

RAY G. BOHN

DONALD J. WILLIAMS

File No. 3-1916. Promulgated Septemeber 8, 1971

Securities Exchange Act of 1934—Sections 15(b) and 19(a)(3)

BROKER/DEALER PROCEEDINGS

Grounds for Remedial Sanctions

Offer and Sale of Unregistered Securities

Bids and Purchases While Engaged in Distribution

Fraud in Sale of Securities

Failure to Disclose Additional Remuneration

Failure to Comply with Record-Keeping Requirements

Improper Extension of Credit

Failure of Supervision

Where registered broker-dealer offered and sold unregistered securities and engaged in fraud in their sale, bid for and purchased stock while engaged in a distribution of such stock, failed to disclose to customers additional remuneration received from issuer's officer in connection with sales of stock, failed to comply with record-keeping requirements, and improperly extended credit to customers, in willful violation of Securities Act of 1933 and Securities Exchange Act of 1934, and failed to exercise reasonable supervision with a view toward preventing such violations, *held*, in public interest to revoke broker-dealer's registration and expel it and associated person from membership in national securities exchange and to bar associated persons from association with any broker-dealer.

APPEARANCES:

J. Donald Sullivan and *Joseph J. Carr*, for Bohn-Williams Securities Corporation (now known as Don Williams Securities Corporation), Ray G. Bohn and Donald J. Williams.

Francis N. Mithoug, for the Division of Trading and Markets of the Commission.

FINDINGS AND OPINION OF THE COMMISSION

Following hearings in these private proceedings pursuant to Sections 15(b) and 19(a)(3) of the Securities Exchange Act of 1934 ("Exchange Act"), the hearing examiner issued an initial decision in which he concluded that the registration as a broker and dealer of Bohn-Williams Securities Corporation (now known as Don Williams Securities Corporation) ("registrant") should be revoked, that registrant and Donald J. Williams, who was secretary-treasurer of registrant, should be expelled from membership in the Spokane Stock Exchange, and that Williams and Ray G. Bohn, who was president of registrant, should be barred from association with a broker or dealer. We granted a petition for review of the initial decision filed by respondents, briefs were filed by them and our Division of Trading and Markets ("Division"), and we heard oral argument. On the basis of an independent review of the record and for the reasons set forth herein and in the initial decision, we make the following findings.

Registrant became registered as a broker-dealer in April 1968, and during the relevant period Bohn and Williams occupied the positions with registrant noted above, and each beneficially owned 50 percent of its common stock and controlled its operations.[1]

OFFER AND SALE OF UNREGISTERED SECURITIES, AND BIDS AND PURCHASES DURING DISTRIBUTION

The record establishes that in August 1968 respondents willfully violated the registration provisions of Sections 5(a) and 5(c) of the Securities Act of 1933 in the offer and sale of the common stock of Champion Oil and Mining Company ("Champion"), a Nevada corporation, when no registration statement had been filed or was in effect under that Act with respect to such securities.

In July 1968 Allan F. Zalk, David E. Hoover and another person acquired control of Champion, a corporate shell which had been formed in 1924 and had a small number of shareholders and whose stock had no quoted market, through their purchase for $20,000 of over 1/3 of the approximately 1,470,000

[1] Bohn ceased active participation in the operations of registrant about April 1, 1969, shortly after the institution of these proceedings, and was replaced by Williams as president around July or August. As of December 1969 Bohn had no official position with registrant, and negotiations have taken place for the sale of his ownership interest in registrant to Williams and employees of registrant. In January 1970 registrant filed an amendment to its broker-dealer registration application to show its name had been changed to Don Williams Securities Corporation.

outstanding Champion shares. Zalk arranged with Bohn and Williams, whom he told Champion was a corporate shell he had acquired and who knew Zalk and Hoover were its president and treasurer, to make available to registrant 100,000 shares of Champion stock for sale by it for the benefit of Champion through an account in Hoover's name. In addition, Bohn and Williams obtained 10,000 Champion shares from Zalk as a bonus or additional compensation in connection with the sale of Champion stock. Between August 1 and August 23, 1968, registrant sold a total of 69,100 shares for the Hoover account in about 80 transactions.

Respondents assert that they believed the Champion stock could properly be sold because Zalk stated it was exempt from registration under the so-called "grandfather" clause of the Securities Act applicable to securities issued prior to the passage of that Act,[2] Champion's counsel on Williams' inquiry verified the free-trading status of the stock under that clause, and the Secretary of State of Nevada, whom Williams also contacted, advised that Champion had been in good standing since 1925. They further assert that they did not know that Zalk's group were the sellers.

We find that respondents sold shares for an issuer in connection with a distribution and were accordingly underwriters as defined in Section 2(11) of the Securities Act.[3] Where, as here, control persons seek to dispose of a block of shares they have acquired in a shell, a "new offering" is involved which is expressly excluded from the exemption from registration provided by the "grandfather" clause of Section 3(a)(1) of the Securities Act for securities sold or offered to the public prior to or shortly after passage of that Act.[4]

The technique used in this case fits in general the classic pattern of an unlawful distribution of unregistered securities of an essentially assetless corporation of which control has been acquired for a small sum. A company formed prior to the passage of the Securities Act is selected where possible so as to give an appearance of the availability of a "grandfather" clause exemption, and the device has been used to unload

[2] Section 3(a) (1) of the Securities Act exempts from registration a security which was prior to or within sixty days after passage of that Act "sold or disposed of by the issuer or bona fide offered to the public" but does "not apply to any new offering of any such security by an issuer or underwriter subsequent to such sixty days."

[3] Section 2(11) of the Securities Act includes within the definition of an "issuer" a person controlling the issuer.

[4] *Cf. U.S.* v. *Schwenoha*, 383 F.2d 395 (C.A. 2, 1967), *cert. denied* 390 U.S. 904; *S.E.C.* v. *North American Research and Development Corp.*, 424 F.2d 63, 70–71 (C.A. 2, 1970).

essentially worthless stock on public investors without the protections afforded by the registration provisions of the Act. The new owners typically engage in activities designed to quickly increase the market value of the company's stock. Among other things, a program of acquisitions financed by the sale or issuance of securities may be initiated, and frequently it is accompanied by activities violative of the antifraud provisions of the securities acts, including false and misleading statements designed to stimulate investor interest in and artificially raising the market price for such securities.[5] As discussed below, such activities were present in this case.

Where sale of securities of a shell corporation is involved, it is incumbent on a broker-dealer to exercise especial care so as to be reasonably assured that no violation of the securities laws is involved.[6] As stated above, respondents knew that Champion was a shell and that Zalk and Hoover, respectively, were its president and treasurer. We think it clear that under the circumstances they were not entitled to rely on the self-serving statements of Zalk and Champion's counsel that the securities were exempt from registration under Section 3(a)(1).[7] That they may not have known, as they have asserted, of the arrangements relating to the acquisition of stock in and control of Champion by the Zalk group cannot excuse their actions. The facts known to them called for further and more direct inquiry. They did not seek the advice of their counsel prior to the sales and did not consult him until advised to do so by our investigator when on August 22 he questioned the legality of the sales. In view of the fact that respondents knew that they were offering and selling unregistered securities, it is also clear that their violations were willful.[8]

Respondents also willfully violated Section 10(b) of the Exchange Act and Rule 10b–6 thereunder in that registrant bid for and purchased Champion stock during August 1968 while engaged in the distribution of such stock.

[5] *Cf. S.E.C.* v. *North American Research and Development Corp., supra* at 66–70; *U.S.* v. *Schwenoha, supra*. See also Securities Act Release No. 4982 (July 2, 1969) dealing with the application of the securities acts to trading in the securities of shell corporations.

[6] See Securities Act Release No. 4982, *supra*.

[7] See *S.E.C.* v. *Culpepper*, 270 F.2d 241, 251 (C.A. 2, 1959); *A. G. Bellin Securities Corp.*, 39 S.E.C. 178, 184 (1959). See also Securities Act Release Nos. 4445 and 4982 (February 2, 1962 and July 2, 1969) relating to the standards of conduct expected of a broker-dealer in connection with the distribution of substantial blocks of unregistered securities, particularly in situations where relatively obscure and unseasoned issuers are involved and where all the circumstance surrounding the proposed distribution are not known to the broker-dealer; and with respect to the sale of securities of a little-known inactive issuer.

[8] It is well established that a finding of willfulness does not requre an intent to violate the law; it is sufficient that the person charged with the duty intentionally commits the act which constitutes the violation. See *Tager* v. *S.E.C.*, 344 F.2d 5, 8 (C.A. 2, 1965), and cases there cited.

FRAUD IN SALE OF SECURITIES

The record establishes that in connection with the sale of Champion stock between August and October 1968 respondents willfully violated the antifraud provisions of Section 10(b) of the Exchange Act and Rule 10b–5 thereunder in various respects.

1. Fraudulent and Manipulative Trading Activities

Respondents dominated and controlled the market for and artificially raised the price of Champion stock. Zalk arranged to have registrant start selling shares at 80c and attempt to move the price up to $3 as expeditiously as possible because of Champion's agreements to make certain acquisitions on the basis of stock selling for around $3. Starting with a sale at 80c per share on August 1, 1968, registrant effected transactions at generally increasing prices which reached a level of around $1.90 on August 22, generally remained at that level for about one month, and reached a high of $2.10 on October 14 in a sale by registrant for Williams. Between August and October 1968 registrant effected transactions involving 178,725 shares.

The record contains instances in which registrant purchased Champion shares for Bohn and Williams at prices far below those at which it effected contemporaneous purchases as agent for customers. Such transactions not only aided respondents' mainipulative activities by removing from the market stock obtainable at lower prices but also produced substantial profits for Bohn and Williams by giving them the benefit of those prices in preference to customers. For example, on September 24, registrant purchased shares for Bohn at $1.50 and for customers from his account at $1.89 in execution of the customers' purchase orders, two of which had been placed with it prior to Bohn's purchase. Similarly, on September 26, registrant bought shares for Williams at $1.50 and the following day effected the purchase for a customer at $1.90 of shares from his and Bohn's accounts.[9] Again on October 10, despite existing purchase orders of customers, registrant purchased shares for Williams at $1 and for those customers at $1.60. On the same day it also effected a transaction involving a sale for Williams and purchase for a customer at $1.90, without disclosing that the seller was Williams or that he had earlier that day purchased Champion shares at $1. On October 11 registrant purchased Champion shares for Bohn, Williams and an employee

[9] Around the end of September Bohn purchased from Zalk 10,000 shares at $1 per share in a transaction not handled by registrant.

at $1 and for a customer at $1.60 and effected the sale of shares at $1.90 for Williams and the employee to customers for whom it also acted as agent.

Respondents claim that Bohn and Williams were able to purchase stock below the trading price because it was offered in a block at that price. The fact that an entire block had to be purchased to obtain an advantageous price would not, however, afford any justification for the preferential treatment which was accorded Bohn and Williams.[10] In situations in which registrant had on hand customer purchase orders, respondents were required to fill those orders first and, in the case of a block offering which they accepted, to limit any purchases for themselves to any shares of the block that remained after filling such orders. In one of the instances noted above, registrant was in receipt of three customer orders, two of which were each for amounts equal to the number of shares bought for Williams at the preferential price. Respondents did not disclose to customers Bohn's and Williams' personal transactions and the activities described were both manipulative and a fraud on the customers.

2. Dissemination of False and Misleading Sales Literature

Champion provided registrant with a large number of copies of a stockholder letter dated July 24 and signed by Zalk, which registrant made available to customers at its office in Spokane and furnished in response to inquiry concerning Champion. The letter recited that a mining program was being activated by means of acquisitions and projects which were being negotiated and for which certain contracts had been acquired and referred to three specified mining projects. It stated that Champion had contracted to acquire the Curlew Mine for $1,650,000, to be paid through the issuance of convertible preferred shares and that the company intended to market 200 tons or more per day and within six months would install a 200-ton per day mill and a smelter. It also referred to negotiations to purchase the Lost Lode Mine for $220,000, to be paid out of a 10 percent royalty override, and stated that the assay values from 27 assays furnished Champion from that mine's developed ore body showed over $120 per ton average. It further recited that an agreement had been signed to acquire for $1,675,000 the Cavalli-Hughes claims and the operator's 120-ton per day mill which was currently processing at capac-

[10] Bohn testified that "if we get an offer [to buy Champion stock] at a price that is attractive, we purchase it personally."

ity and producing concentrates from ore that was assaying 5.8 percent copper, over 34 ounces of silver and a small amount of free gold. The letter was materially false and misleading.

As has been seen, Champion was a recently acquired corporate shell, and it had no cash or assets immediately after Zalk took control. The stockholder letter, however, made no disclosure of the acquisition and operation problems Champion faced in view of its lack of cash resources. The arrangements to issued preferred stock for the Curlew Mine had been made with the lessees of the mine; its owners required cash. A proposed "250 ton" per day mill for that mine was estimated to cost between $300,000 and $400,000. The Lost Lode Mine was acquired for stock and cash consisting of $20,000 down and minimum payments, with respect to which Champion is presently delinquent, of $5,000 a month. The Lost Lode Mine assays were furnished by the seller, and Champion did not verify them, and no shipments have been made from that mine since July 24, 1968. Champion never acquired the Cavalli-Hughes claims, which were to be paid for with cash and stock, and the mill referred to in the letter was not producing ore from those claims but was engaged in custom milling for other mines.

Respondents cannot excuse their use of the fraudulent literature by their assertions that the investors in Champion stock were principally sophisticated investors and that the record does not show that any purchases were made in reliance upon it. It is sufficient that such literature was used by registrant in connection with the sale of securities.[11] Although respondents were aware that Champion was a recently acquired shell and had no financial information with respect to it, they did not make any adequate inquiry to verify the company's statements in the letter concerning its financial condition and contractual arrangements and the value of the properties acquired or to be acquired by it.

FAILURE TO DISCLOSE ADDITIONAL REMUNERATION

As stated above, Bohn and Williams obtained from Zalk 10,000 shares of Champion stock as additional compensation in connection with the sale of the stock.[12] However, such additional remuneration was not disclosed to customers for whom registrant thereafter effected transactions from August 9 to 23, 1968. Under the circumstances, registrant, willfully aided

[11] *Cf. N. Sims Organ & Co., Inc.*, 40 S.E.C. 573, 575 (1961), *aff'd* 293 F.2d 78 (C.A. 2, 1961), *cert. denied* 368 U.S. 968.

[12] The shares were issued on August 2, 1968 in the name of registrant's bookkeeper.

and abetted by Bohn and Williams, willfully violated Section 15(c)(1) of the Exchange Act and Rule 15c1–4 thereunder.[13]

FAILURE TO COMPLY WITH CREDIT-EXTENSION AND RECORD-KEEPING REQUIREMENTS AND FAILURE OF SUPERVISION

The record shows that between May and October 1968, registrant in about 30 instances failed to promptly cancel or liquidate purchases in cash accounts of customers who did not make payment within seven business days or the extended period of time granted for payment. We find that by such failure, registrant, willfully aided and abetted by Bohn and Williams, willfully violated the credit-extension provisions of Section 7(c) of the Exchange Act and Regulation T promulgated by the Board of Governors of the Federal Reserve System.

In addition, between August and October 1968, many of registrant's memoranda of agency orders did not show the times of entry and execution of the orders, as required by Section 17(a) of the Exchange Act and Rule 17a–3 thereunder. Those omissions constituted willful violations of that Section and Rule by registrant, willfully aided and abetted by Bohn and Williams.

We further find that registrant, and Bohn and Williams, who owned and controlled registrant, failed to exercise reasonable supervision with a view toward preventing the violations found by us.

PUBLIC INTEREST

Respondents urge that lesser sanctions should be imposed than ordered by the hearing examiner. They assert, among other things, that certain violative activities took place shortly after registrant began business and that those violations were unintentional, that they took prompt corrective action and made full disclosure to our staff, that registrant has adopted procedures to prevent future violations, that they were deceived by Zalk, and that Bohn, who had the principal dealings with Zalk and made the Champion stockholders' letter available to customers, is no longer actively associated with registrant. They also claim that no financial losses were suffered by investors.

[13] Rule 15c1–4 requires, among other things, that a broker furnish his customer, at or before the completion of a transaction, written notification disclosing the source and amount of any commission or other remuneration received or to be received by him in connection with the transaction.

In light of the serious and pervasive violations found, the factors presented by respondents do not in our opinion justify reduction of the sanctions the examiner considered appropriate. Those violations demonstrated an inability or unwillingness to engage in the securities business in conformance with applicable requirements. Moreover, even after the legality of the Champion stock sales had been questioned by our investigator on August 22, registrant sold around 9,000 shares for the Hoover account on August 23 and engaged or continued to engage in fraudulent and manipulative conduct.[14] It is also clear that not only Bohn but also Williams, who with Bohn owned and operated registrant, is culpable. Although Zalk's initial contact with registrant was made through Bohn, Williams met Zalk shortly thereafter and participated in the agreement relating to the distribution and market manipulation of the unregistered Champion stock. And the claim that customers suffered no losses is unacceptable. As seen, customers were denied the more favorable prices which should have been available to them but which were given to Bohn and Williams and were made to pay higher manipulated prices. Even assuming customers could on a resale obtain a price equal to or more than they paid, they would, of course, realize less than they would have had they paid the lower proper prices.[15]

Finally, we note that although violations began shortly after registrant had commenced business, Bohn and Williams had previous securities selling experience, assertedly with respect to intra-state issues; and, in any event, the misconduct we have found, particularly with respect to market manipulation and preferential price treatment, is of such a nature that its impropriety was or should have been obvious to respondents irrespective of prior securities experience.

Under all the circumstances we conclude, as did the hearing examiner, that the public interest requires that registrant's registration be revoked, that registrant and Williams be expelled from membership in the Spokane Stock Exchange, and that Bohn and Williams be barred from association with any broker or dealer.[16]

[14] In February 1969 the United States District Court for the Eastern District of Washington, Northern Division, entered a decree of permanent injunction, on the basis of a complaint filed by us and with the consent of respondents who did not admit the allegations of such complaint, enjoining them from offering, selling or delivering unregistered securities of Champion. Civil Action File No. 3229.

[15] *Cf. Atlantic Equities Company*, 43 S.E.C. 354, 368 (1967).

[16] The exceptions to the initial decision of the hearing examiner are overruled to the extent that they are inconsistent with our decision and sustained to the extent that they are in accord.

An appropriate order will issue.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM, HERLONG and LOOMIS).

IN THE MATTER OF

THE BEN ZENOFF COMPANY, INC.

GERTRUDE ZENOFF

File No. 3–2885. Promulgated December 13, 1971

Securities Exchange Act of 1934—Section 15(b)

BROKER-DEALER PROCEEDINGS

Grounds for Remedial Action

Failure to Comply with Examination Requirement and to File Personnel Forms

Failure to Comply with Net Capital, Record-Keeping and Reporting Requirements

Where broker-dealer not member of registered securities association conducted securities business although associated persons had not passed required general securities examination, and failed to file personnel forms with respect to such persons and to comply with net capital, record-keeping and reporting requirements, *held*, in public interest to suspend broker-dealer's registration subject to certain conditions, and to suspend its president from association with any broker-dealer.

General Securities Examination

Rule 15b8–1 under Section 15(b)(8) of Securities Exchange Act of 1934, which prohibits broker-dealers who are not members of registered securities association from conducting business unless certain associated persons have passed a general securities examination, is not in conflict with provisions of Section 15(b)(8), and does not deprive broker-dealer who conducts securities business which is limited in scope of due process of law.

APPEARANCES:

William D. Goldsberry and *Samuel S. Duffey*, of the Chicago Regional Office of the Commission, for the Division of Trading and Markets.

John F. McCarthy, of McCarthy and Levin, for respondents.

FINDINGS, OPINION AND ORDER

These are proceedings instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Act") to determine what, if any, remedial action is appropriate in the public interest with respect to The Ben Zenoff Company, Inc. ("registrant"), a registered broker-dealer, and Gertrude Zenoff, its president, treasurer and sole shareholder. Hearings and an initial decision by a hearing examiner were waived, respondents and our Division of Trading and Markets entered into a stipulation of the pertinent facts, and we heard oral argument. On the basis of our independent review of the record, we make the following findings.

Registrant became registered as a broker-dealer in November 1966. Its sole business has been the solicitation of deposits for federally insured savings and loan associations and, infrequently, for federally insured banks. Registrant has never been a member of the National Association of Securities Dealers, Inc. ("NASD"), the only securities association registered pursuant to Section 15A of the Act. Gertrude Zenoff's husband was registrant's president, treasurer and sole shareholder until his death in June 1969 and she assumed those positions in January 1970.

Failure to Comply with Securities Examination Requirement

Rule 15b8–1 under Section 15(b)(8) of the Act prohibits broker-dealers who are not members of a registered securities association from effecting over-the-counter securities transactions unless every associated person engaging in certain activities, including selling and rendering investment advice, has successfully completed a general securities examination as specified. Registrant admittedly has not complied with the Rule and respondents do not contest that their activities involve the offer and sale of securities. They argue, however, that application of the Rule to registrant would violate the terms and purpose of Section 15(b)(8) which assertedly recognizes that broker-dealers and their associated persons should be divided into classes for examination purposes based on the nature of their securities activities.[1] Respondents assert that the examination required by that Rule was designed to test qualifications for the usual type of general dealing in the over-

[1] Section 15(b) (8) provides in relevant part as follows: "No [registered] broker or dealer . . . shall, during any period when it is not a member of a [registered] securities association . . . effect any transaction in . . . any security . . . unless such broker or dealer and all [its associated] persons . . . meet such specified and appropriate standards with respect to training, experience, and such other qualifications as the Commission finds necessary or desirable. The Commission shall establish such standards by rules and regulations, which may —(A) appropriately classify brokers and dealers and [their associated] persons . . . (taking into account relevant matters, including types of business done and nature of securities sold). (B) specify that all or any portion of such standards shall be applicable to any such class. (C) require persons in any such class to pass examinations prescribed in accordance with such rules and regulations.

the-counter market, which they argue is considerably more demanding than the limited activity conducted by them. They further contend that application of the Rule to them would violate due process because it would require them to establish qualifications for a business in which they are not engaged.

Respondents' contentions are without merit. Section 15(b)(8), set forth in relevant part in the margin above, directs this Commission to establish "standards with respect to training, experience, and such other qualifications as [it] finds necessary or desirable." While that Section authorizes us to classify broker-dealers and their associated persons for examination purposes, it does not require such a classification.[2] The Section was part of the Securities Acts Amendments of 1964, which were the product of legislative proposals submitted to the Congress by this Commission as a result of our 1963 Report of Special Study of Securities Markets.[3] That Report pointed out that experience had shown the impossibility of effectively regulating the conduct of those in the securities industry unless would-be members were adequately screened at the point of entry; that there was a distinct tendency on the part of new broker-dealers to become involved in serious securities violations more often than experienced firms; and that if the public were to be protected from the perils of incompetent and irresponsible broker-dealers, there should be erected uniform, minimum standards of competence, experience and character. The Report recommended the establishment of a standard examination that would "cover a core of basic subjects for salesmen, supervisors and principals."[4] It was that recommendation which we followed in adopting Rule 15b8–1.[5]

With respect to respondents' due process argument, it is established that "the guaranty of due process . . . demands only that the law shall not be unreasonable, arbitrary or capricious and that the means selected shall have a real and

[2] We note that the original version of Section 15(b) (8) would have required all broker-dealers subject to the Act to become members of a registered securities association. Although the requirement of compulsory membership was eliminated, the section was amended "to insure that the Commission [had] the necessary authority to provide regulation of nonmember brokers and dealers comparable to that imposed by [such] associations on their membership." H.R. Rep. No. 1418, 88th Cong., 2d Sess. 12 (1964). The NASD, whose By-Laws, adopted pursuant to Section 15A(b) (5) of the Act, contain language nearly identical to that of Section 15(b) (8) (Article I, Section 2(d)), currently requires, with exceptions not relevant here, that all principals and registered representatives take and pass general qualification examinations.

[3] H. Doc. No. 95, 88th Cong., 1st Sess.

[4] Special Study, *supra*, Pt. 1, pp. 150, 152, 153, 160–61.

[5] Securities Exchange Act Release No. 7697, p. 3 (September 7, 1965).

substantial relation to the object sought to be attained."[6] We consider that the general examination requirement of Rule 15b8–1 is reasonably directed towards the goal of establishing minimum standards of competence in the securities industry for the protection of the investing public. While all of the topics covered by the examination are not directly pertinent to registrant's present business, at least one of them, the provisions of the Act pertaining to the conduct of broker-dealers and their associated persons and the rules thereunder, is highly relevant. The value of the examination requirement in that area is demonstrated, as shown below, by registrant's numerous violations of Commission rules apart from Rule 15b8–1. In addition, while registrant's business has been limited in scope, its solicitation of savings and loan deposits embodies at the least implied advice to customers concerning the merits of that type of investment as opposed to others, and, in the nature of such a solicitation, it is to be expected that the advice would take express form as well. We consider it necessary that such advice be based on a knowledge of securities notwithstanding the narrow area in which registrant operates. Finally, we note that registrant's broker-dealer registration carries with it the right to engage in other areas of the securities business.

We conclude that registrant, willfully aided and abetted by Mrs. Zenoff, willfully violated Section 15(b)(8) of the Act and Rule 15b–1 thereunder by failing to comply with the examination requirement. We also find that respondents committed additional willful violations of the Rule by their failure to file personnel forms (SECO–2) for associated persons.[7]

OTHER VIOLATIONS

The stipulation entered into by the parties shows that registrant, willfully aided and abetted by Mrs. Zenoff, willfully violated Section 15(b) of the Act and Rule 15b–1 thereunder in that registrant did not amend its registration application until March 1970 to reflect a May 1969 change of address and Mrs. Zenoff's assumption of her present positions in January 1970; Section 15(c)(3) of the Act and Rule 15c3–1 thereunder in that registrant transacted business in February 1970 without the required minimum net capital of at least $2,500 and with a net

[6] *Nebbia* v. *New York*, 291 U.S. 502, 525 (1934); *American Power and Light Co.* v. *S.E.C.*, 141 F.2d 606, 624 (C.A. 1, 1944), *aff'd*, 329 U.S. 90 (1946).

[7] In 1968, registrant filed Forms SECO–2 for Mr. Zenoff and an employee of registrant. However, the forms were returned by our staff because they did not contain the required certification that those individuals had passed the general securities examination.

capital deficiency; and Section 17(a) of the Act and Rules 17a–5 and 17a–a10 thereunder in that registrant failed to file a timely financial report for 1970 and did not file its 1969 report of income and expenses and related financial and other information until April 1971. Registrant committed additional willful violations of Section 17(a) of the Act and Rules 17a–3 and 17a–5 thereunder in that it failed to prepare monthly computations of aggregate indebtedness and net capital from March 1967 to October 1969, and to file timely financial reports for 1968 and 1969.

Respondents stress that most of the violations occurred during Mr. Zenoff's final illness and the ensuing period of dislocation, and argue that they were not willful. However, although the conditions referred to may be considered in mitigation, they do not affect the willfulness of respondents' violations. It is well established that a finding of willfulness within the meaning of Section 15(b) of the Act need not be based on a finding of intention to violate the law.[8]

PUBLIC INTEREST

The Division urges that respondents' activities show a pattern of violations requiring in the public interest the revocation of registrant's broker-dealer registration and a bar of Mrs. Zenoff from association with any broker-dealer. Respondents assert, as noted above, that the violations we have found, apart from the failure to comply with Rule 15b8–1, were in part the result of Mr. Zenoff's illness and conditions following his death, and they state that all of those infractions have been cured. It further appears that, in failing to comply with the examination requirement of Rule 15b8–1, respondents relied on advice of counsel.

Under all the circumstances, we do not think the public interest requires the revocation of registrant's registration or a bar of Mrs. Zenoff. As to registrant, if it were in compliance with Rule 15b8–1, we would consider a 30-day suspension of its broker-dealer registration an adequate sanction in the public interest. However, registrant is not in compliance and cannot be permitted to engage in its business until it is. We shall accordingly enter an order suspending its broker-dealer registration for one year with the provisos that if, after 30 days but within the one-year period, the associated persons of registrant have passed the required examination and the requisite

[8] See, *e.g.*, *Tager* v. *S.E.C.*, 344 F.2d 5, 8 (C.A. 2, 1965); *Haight & Co., Inc.*, 44 S.E.C. 479, 505 (1971), *aff'd per curiam*, C.A.D.C. (June 30, 1971).

Forms SECO–2 have been filed, the suspension shall then terminate, but, if registrant has not complied with those requirements by the end of the one-year suspension period, an order will be entered revoking its broker-dealer registration.

As to Mrs. Zenoff, we consider that the public interest will be adequately served by suspending her from association with any broker-dealer for 30 days. Thereafter she would be free to become associated with registrant or another broker-dealer upon passing any requisite examination.

Accordingly, IT IS ORDERED that the registration as a broker and dealer of The Ben Zenoff Company, Inc. be, and it hereby is, suspended for a period of one year subject to the conditions set forth above; and that Gertrude Zenoff be, and she hereby is, suspended for a period of 30 days from being associated with any broker or dealer. The suspensions of the firm and Mrs. Zenoff shall be effective as of the opening of business on December 20, 1971.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM, HERLONG and LOOMIS).

IN THE MATTER OF

THOMAS D. CONRAD, JR.

MARGARET J. CONRAD

ROLAND L. GONZALES, JR.

CONRAD & COMPANY, INC.

File No. 3-2338. Promulgated December 14, 1971

Securities Exchange Act of 1934—Section 15(b)

BROKER-DEALER PROCEEDINGS

Grounds for Remedial Action

Offer and Sale of Unregistered Securities

Failure to Furnish Required Information

Failure to Comply with Net Capital, Record-Keeping and Reporting Requirements

Improper Extension of Credit

Misappropriation of Funds

Failure of Supervision

Where president of registered broker-dealer authorized and participated in offer and sale of unregistered bonds and was responsible for a failure of supervision with respect thereto, failed to have bond sales recorded on registrant's books and to have registrant make copies of confirmations and send purchasers required written information, and, together with registrant's executive vice-president, failed to exercise proper supervision to prevent misappropriation effected by branch manager of funds paid registrant by customers for securities purchases, failed to have registrant comply with net capital, record-keeping and reporting requirements, and allowed improper extension of credit; *held*, in public interest to bar president and branch manager from association with any broker-dealer and to suspend executive vice-president from any such association for one year.

APPEARANCES:

Alexander J. Brown, Jr., *William R. Schief*, and *David P. Doherty*, for the Division of Trading and Markets of the Commission.

Jeremiah D. Lambert, of Peabody, Rivlin, Cladouhos & Lambert, for Thomas D. Conrad, Jr. and Margaret J. Conrad.

Roger W. Titus, of Chadwick & Titus, for Roland L. Gonzales, Jr.

FINDINGS, OPINION AND ORDER

Following hearings in these proceedings pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act"), the hearing examiner filed an initial decision in which he concluded, among other things, that Thomas D. Conrad, Jr., president of Conrad & Company, Inc. ("registrant"), then a registered broker-dealer,[1] should be barred from association with any broker-dealer, that his wife, Margaret J. Conrad, registrant's executive vice-president, should be suspended from such association for one year, and that Roland L. Gonzales, Jr., a former branch manager, should be barred from such association with the proviso that, after a year, he might apply for permission to become so associated upon a satisfactory showing that he would be properly supervised. We granted a petition for review filed by the Conrads which took exception to the sanctions imposed on them and to certain of the examiner's findings against Conrad. We also ordered review, pursuant to Rule 17(c) of our Rules of Practice, of the examiner's decision with respect to the issues which were before him concerning Gonzales. Respondents and our Division of Trading and Markets ("Division") filed briefs and we heard oral argument. On the basis of our independent review of the record with respect to the matters before us, we make the following findings.

VIOLATIONS RELATING TO SALES OF BONDS OF SVANHOLM RESEARCH LABORATORES

The examiner found that, in May and June 1969, Conrad willfully violated the securities acts in connection with the offer and sale of bonds of Svanholm Research Laboratories ("SRL") by Gary Booker,[2] who at that time was an assistant branch manager of registrant, in willful violation of registration and antifraud provisions of the securities acts.

SRL, whose activities the examiner aptly characterized as "bizarre", was incorporated in 1968 as a "non-profit" company, and, according to its president, Johann K. V. Svanholm, en-

[1] No review was sought of the hearing examiner's order revoking registrant's broker-dealer registration.

[2] Booker, a respondent in these proceedings, did not appear or answer the allegations in the order for proceedings, and was barred from association with any broker or dealer. Securities Exchange Act Release No. 9002 (October 21, 1970).

gaged primarily in research and consultation to assist the government and industry groups in areas in which they could not themselves achieve progress. It had no employees, and its office and "laboratory" were located in the basement of Svanholm's home. A balance sheet included in a brochure given to customers by Booker listed as SRL assets $14,700 worth of office and laboratory equipment and a $2,000 automobile.

However, although Svanholm testified he had transferred those assets to the corporation, he admitted he had not executed any documents evidencing transfers of title. The remaining assets listed on the balance sheet consisted of "receivables good" in the amount of $7,626 and "corporate programs in progress" with an estimated value of $90,650. However, those items represented neither money actually due SRL nor work performed by it under contract.[3]

Booker sold nine unregistered SRL bonds at $1,000 each to unsophisticated investors who were unaware of SRL's lack of assets or prospects for success. In addition to the brochure referred to above which falsely represented that SRL had contracts and receivables, customers were given a subscription agreement which falsely stated that the bonds were guaranteed. In addition, Booker variously represented to customers that the bonds were backed by the Government, that they were guaranteed, and they they were better than U.S. Government bonds.

Conrad has not sought review of the examiner's finding that he failed to exercise reasonable supervision over Booker with a view to preventing Booker's registration and antifraud violations. As to the examiner's finding that Conrad himself violated the antifraud provisions in connection with the SRL bond sales, Conrad correctly points out that the order for proceedings herein did not charge him with such violation, and that finding must accordingly be set aside. As to the remaining findings of the examiner which Conrad challenges, that in connection with the SRL sales he willfully violated the registration provisions of the Securities Act and willfully aided and abetted registrant's violations of certain provisions of the Exchange Act and rules thereunder, we sustain the examiner.

We cannot accept Conrad's contentions that Booker's offer and sale of the SRL bonds were unauthorized and that Conrad

[3] For example, Svanholm testified that one of the items carried as a receivable was a plan for "the complete reorganization of the U.S. Government" which he had submitted to the Department of Defense entirely on his own initiative but for which he asserted the Government became obligated to pay, in the approximate amount of $2,300, when the Defense Department opened the envelope containing it after reading a covering letter which stated that an invoice was enclosed.

was not aware of Booker's activities until some months after the SRL transactions had occurred. On the basis of our examination of the record, we find that Conrad played a principal role in causing the SRL bonds to be offered and sold by his conduct authorized the transactions.

In May 1969 Svanholm telephoned Conrad stating that he wished to raise capital for SRL through bonds which would be exempt from registration because the corporation was nonprofit. Conrad told Svanholm that registrant had not previously engaged in any underwriting but that he would be willing to meet with him. When Svanholm came to registrant's office, however, Conrad stated that he was unable to see him, and Svanholm talked with Booker. The latter then sought Conrad's permission to sell the SRL bonds and asked him what registrant would charge Svanholm for selling them and what his own compensation would be. Conrad stated that registrant would charge an 8 percent commission, the amount it received on sales of mutual fund shares, and that Booker's commission would be $27 on each $1,000 bond sold, but that before Booker could begin to sell Conrad would have to check out the legal aspects. Conrad then instructed an employee who acted as a trader for registrant, a young man about 21 years old without prior experience in the securities business who had been hired a few months previously and admittedly knew very little about the responsibilities of underwriters with respect to new issues, to call our staff to ascertain if the SRL bonds were exempt from registration as Svanholm claimed. When Booker again asked Conrad for permission to sell the bonds, Conrad referred him to the trader, stating that he had delegated to the latter the responsibility to supervise the bond transactions and that if sales could be legally effected it would be "all right". The trader called our staff and without mentioning SRL asked general questions respecting exemptions from registration. He was told of the various criteria for determining whether or not a private offering exemption is available, but was cautioned that those criteria merely provided guidelines and not a definite formula and that such availability depended on the facts of each case. On the basis of that call, the trader told Booker that it would appear "just on the face of it" that the bonds were exempt from registration since Booker was only planning to sell them to a very small number of investors for investment purposes. He also relayed that opinion to Conrad. Thereafter, as noted above, Booker proceeded to offer and sell the bonds.

We concur with the examiner's conclusion that Booker acted with Conrad's expectation or knowledge that offers or sales of the SRL bonds would be made. From what he had been told by Conrad and the trader, Booker would reasonably have concluded that he was authorized to proceed with the SRL offering. In fact, it appears that Conrad, while seeking to avoid the appearance of responsibility in the event questions were raised, fully intended Booker to reach that conclusion. Under the circumstances, it is clear that by his conduct Conrad authorized the SRL offering, and that he participated in Booker's violation of the registration provisions.[4] Conrad's actions subsequent to the bond sales lend support to that finding. In June or July 1969, he initialled his approval of a "memorandum of order" describing the bond sales which was drawn up by the trader in order that the appropriate commissions would be paid by registrant,[5] and, in July 1969, he made a correcting entry on Booker's commission statement reducing Booker's commission on the SRL sales.

We reject Conrad's further arguments that the SRL offering was a "private" one exempt from registration, and that any violation by him was not willful because he believed, on the basis of the information the trader received from our staff, that registration was not required. The SRL bonds were offered to persons who clearly did not have access to the same kind of information that registration would have supplied. Under such circumstances, the facts that the number of offerees was small and the bonds were by their terms non-transferable did not suffice to make the offering private.[6] And not only would any reliance by Conrad on the opinion of the inexperienced trader be wholly unjustified, but on the record before us we cannot credit Conrad's claim of reliance. His delegation to the trader of the responsibility for determining the need for registration can only be viewed as part of a deliberate effort to avoid responsibility for the SRL sales. We conclude that the examiner correctly found that, in connection with the offer and sale of SRL bonds, Conrad willfully violated and willfully aided and abetted violations of the registration provisions of Sections 5(a) and 5(c) of the Securities Act.

We also affirm the examiner's findings that Conrad willfully aided and abetted registrant's willful violations of Sections

[4] See *System Investment Corp.* v. *Montview Acceptance Corp.*, 355 F.2d 463, 466 (C.A. 10, 1966); Restatement (Second), Agency § 26 (1958).

[5] The trader received an override on Booker's commission for sale of the bonds.

[6] See *S.E.C.* v. *Ralston Purina Co.*, 346 U.S. 119 (1953); *Gilligan, Will & Co.* v. *S.E.C.*, 267 F.2d 461 (C.A. 2, 1959), *cert. denied* 361 U.S. 896.

15(c) (1) and 17(a) of the Exchange Act and Rules 15c1–4 and 17a–3 thereunder, in that the SRL transactions were not recorded on registrant's books, copies of confirmations were not made, and bond purchasers were not furnished with written notification of registrant's capacity in connection with the sales and the amount of its commissions. Our rejection, as set forth above, of Conrad's defense of lack of knowledge of the transactions is equally applicable with respect to these findings. Nor is there any merit in his further contention that the bond purchasers' subscription agreements with SRL constituted the required confirmations. Those agreements made no reference to registrant or to the commissions it was receiving on the sales.

MISAPPROPRIATIONS BY GONZALES

During the period from about March 1 to October 31, 1968, Gonzales willfully violated the antifraud provisions of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b–5 thereunder in that he converted to his own use over $26,000 paid to registrant by customers for securities purchases. In June 1968, after Gonzales had misappropriated about $2,000, Mrs. Conrad discovered his conversions and notified her husband. Gonzales apologized for his misconduct and was allowed to retain his position as branch manager[7] and to charge off the money he still owned the firm to his commission account. However, Gonzales thereafter misappropriated an additional $24,000.

The Conrads were found by the examiner to have failed to exercise reasonable supervision over Gonzales with a view to preventing his violations and they have not sought review of such finding. As the examiner noted, Gonzales was permitted to continue to sell securities and receive customers' money after discovery of his first misappropriations in June 1968, and there was no evidence that procedures were adopted to prevent a recurrence. Even following discovery by Mrs. Conrad of Gonzales' additional misappropriations in December 1968 she and her husband did nothing, Gonzales having by then repaid the money he had taken, until late in January 1969 after Gonzales had informed Conrad that he was leaving the firm to work for a competitor, at which time Conrad notified regulatory agencies of Gonzales' misappropriations.

[7] Gonzales was also permitted to retain his membership on registrant's "Board of Consultants and Overseers," a successor body to its board of directors.

OTHER VIOLATIONS

The examiner further found, and the Conrads have not challenged on review, that Conrad and Mrs. Conrad willfully aided and abetted willful violations by registrant of:

1. Section 15(c) (3) of the Exchange Act and Rule 15c3–1 thereunder in that registrant effected securities transactions with net capital deficiencies of $3,514 as of January 31, 1969 and $16,817 as of February 28, 1969.

2. Section 7(c)(1) of the Exchange Act and Sections 4(c)(1), 4(c)(2) and 4(c)(8) of Regulation T adopted thereunder by the Board of Governors of the Federal Reserve System in that registrant failed to cancel 51 transactions when customers did not make payment within the required time, and improperly continued to effect securities purchases for three accounts.

3. Section 17(a) of the Exchange Act and Rules 17a–3, 17a–4 and 17a–5 thereunder in that registrant failed to maintain accurate ledger accounts for customers and brokers and security position records, to retain copies of certain communications, and to file a timely financial report for 1968.

4. Section 15(b) of the Exchange Act and Rule 15b3–1 thereunder in that registrant failed to amend its application for broker-dealer registration promptly to correct information with respect to its officers and directors, its membership in a national securities exchange, and the issuance of a cease and desist order against registrant in September 1969 by the Maryland Securities Commission based on registrant's sale of the SRL bonds.

PUBLIC INTEREST

The Conrads contend that the public interest does not warrant the sanctions imposed on them by the examiner. They claim that the examiner gave insufficient weight to the fact that substantial restitution was made to the SRL bond purchasers through registrant's insurance company, that most of the violations found against them relate to supervisory deficiencies which should not bar them from association with a broker-dealer in a non-supervisory capacity, and that Mrs. Conrad was completely under Conrad's control and had no independent responsibility.

We are of the opinion that the sanctions imposed by the examiner on the Conrads are fully warranted. The record amply demonstrates not only Conrad's unfitness for assuming any proprietary or supervisory role with a broker-dealer, but for engaging in the securities business in any capacity. The numerous violations and the supervisory failures found with respect to him are compounded by the lack of candor he displayed in these proceedings.[8] As the examiner found, his testimony was in large part "utterly incredible," and directly contradicted by his own prior sworn testimony and statements. As to Mrs. Conrad, she was not merely a figurehead in registrant's business but exercised substantial managerial functions. She was responsible for registrant's back office, an area in which, as can be seen from the many violations found, serious deficiencies existed. Moreover, as noted above, after Mrs. Conrad first discovered Gonzales' misappropriations she did nothing to institute supervisory procedures that could have prevented a recurrence of his misconduct. In assessing a lesser sanction against her than her husband, the examiner took into account her subordinate role to Conrad. Finally, under the circumstances, the fact that the SRL bond purchasers were able to recover some of their money from registrant's insurance company does not constitute a significant mitigative factor.

Gonzales argues that the same or a lesser sanction than that assessed by the examiner should be imposed on him. He points to the fact that he has already been suspended for 18 months by Maryland and the District of Columbia for the same misconduct, and states that, since the suspension expired on July 21, 1970, he has voluntarily refrained from re-entering the securities business pending the outcome of these proceedings. He further asserts that no customer loss resulted from his misappropriations, that the Conrads condoned his actions, and that he has cooperated with all regulatory agencies.

In the light of Gonzales' serious misconduct, we consider that, despite the factors advanced in mitigation, his unqualified exclusion from the securities business is required. As has been seen, even after his first misappropriations had been discovered, and he had been given a second chance, Gonzales engaged in additional conversions of funds. We do not believe that giving him yet another chance is consistent with the protection of investors and the public interest.

Accordingly, IT IS ORDERED that Thomas D. Conrad, Jr. and Roland L. Gonzales, Jr. be, and they hereby are, barred from being associated with any broker or dealer; and that Margaret J. Conrad, be and she hereby is, suspended from any

[8] *Cf. Financial Counsellors, Inc.*, 42 S.E.C. 153, 157 (1964); *John G. Abruscato*, 43 S.E.C. 209, 214 (1966).

such association for a period of one year. The suspension of Margaret Conrad shall commence as of the opening of business on December 20, 1971.

By the Commission (Chairman CASEY and Commissioners OWENS NEEDHAM, HERLONG and LOOMIS).

IN THE MATTER OF

POLARAD ELECTRONICS CORPORATION

File No. 1-4258. Promulgated December 15, 1971

Securities Exchange Act of 1934—Section 12(d)

STRIKING OF SECURITY FROM LISTING AND REGISTRATION

Net Losses

Where, on the basis of latest audited financial statements available at time exchange determined to seek delisting of issuer's security, issuer had large net tangible asset deficit and net losses in last three fiscal years and thus came within exchange's delisting guidelines which provide that delisting will be considered where issuer with net tangible assets of less than $3 million has net losses in three of four most recent fiscal years, and exchange has considered unaudited projected figures for latest fiscal year indicating that issuer, which had recently emerged from proceedings under Chapter XI of Bankruptcy Act and had combined with another company, would have a small net profit but net tangible assets still substantially below $3 million, application by exchange to delist security, *granted*, and issuer's request for hearing by Commission, *denied*, the Commission finding among other things that exchange was not required to defer seeking delisting until audited statements for latest fiscal year could be submitted.

APPEARANCES:

Bernard H. Maas, Vice-President, for American Stock Exchange.

Golenbock and Barell, for Polarad Electronics Corporation.

FINDINGS, OPINION AND ORDER

The American Stock Exchange filed an application, pursuant to Section 12(d) of the Securities Exchange Act of 1934 ("Act") and Rule 12d2-2(c) thereunder, to strike from listing and registration on the Exchange the common stock, 50c par value, of Polarad Electronics Corporation.[1] Trading in the stock was suspended by the Exchange on April 29, 1970. Polarad filed a memorandum in opposition to the application and the Exchange filed a reply.

The application is grounded principally on the Exchange's policy to consider delisting where, in its opinion, an issuer's financial condition or operating results appear to be unsatisfactory and do not warrant continued listing.[2] In furtherance of that policy, the Exchange has adopted certain guidelines, including ones which specify that delisting will be considered where an issuer which has net tangible assets of less than $3 million has sustained net losses in three of its four most recent fiscal years.[3] The application states that as of June 30, 1970, the date of Polarad's latest audited financial statements,[4] it had a net tangible asset deficit of $1,947,300, and that it had net losses in each of the preceding three fiscal years, amounting to $1,500,000, $408,000 and $3,690,000, respectively.

Polarad does not question these figures nor the fact that these losses bring it squarely within the delisting guidelines. It urges, however, that, considering the fact that trading in its securities is suspended, the Exchange should have deferred delisting action pending Polarad's submission of audited statements for its fiscal year ended June 30, 1971 which to the best of its knowledge would have shown a substantial net worth as

[1] Section 12(d) of the Act and Rule 12d2—2(c) provide in pertinent part that, upon application by a national securities exchange, a security registered with such exchange may be stricken from listing and registration in accordance with the rules of the exchange upon such terms as we may deem necessary to impose for the protection of investors. The Rule also provides that we may order a hearing to determine whether the application has been made in accordance with the rules of the exchange or what terms should be imposed.

[2] American Stock Exchange Company Guide, § 1002.

The application also adverts to the Exchange's so-called "backdoor" listing policy (*Id.* § 334) not to list additional shares of a listed company issued in connection with a combination of such company with an unlisted company that in effect acquires it unless the unlisted company meets all original listing standards except those as to share distribution and number of stockholders or the combined company's net worth, earnings and share distribution meet approximately one half of the original listing standards. That policy is deemed applicable because, pursuant to an arrangement with Polarad's creditors in May 1971 under Chapter XI of the Bankruptcy Act, 80 percent of Polarad's common stock, following a 1-for-6 reverse split and a reduction in par value, was issued to Rodale Electronics, Inc. in exchange for Rodale's business and substantially all of its assets. The Exchange is of the view that Rodale in effect acquired Polarad, even though Polarad was the surviving company, and since Rodale and the combined company fail to meet the applicable "backdoor" standards, it will not list the new Polarad shares. We consider that if we conclude the Exchange was warranted in finding that Polarad does not meet standards for continued listing that Polarad does not meet standards for continued listing of its securities, that determination will encompass the new as well as the old common stock. In this connection, it would appear that the new common stock, while not approved for listing, is registered under the Act since Rule 12d-1(a) provides that registration of a class of security covers additional shares or amounts of such class then or thereafter authorized, upon their issuance.

[3] American Stock Exchange Company Guide, § 1003.

[4] Polarad's audited financial statements for the fiscal year ended June 30, 1971, have not as yet been filed with us even though they were required to be filed by September 28 and Polarad requested an extension to November 1, 1971.

of that date and a net profit for that year exceeding $150,000. It contends that the delisting standards were not meant to apply to an unusual situation such as is present here, involving Polarad's recent emergence from proceedings under Chapter XI of the Bankruptcy Act pursuant to an arrangement which preserved the interests of its stockholders and unsecured creditors and left them in a position to benefit from the operations of a viable company. It urges that its stockholders, including the old stockholders and former creditors who received new common stock under the plan of arrangement, should be entitled to a market for their securities at a time when it can be shown by audited statements that it is a viable company. Polarad requests that we order a hearing to determine whether the application was made in accordance with the rules of the Exchange or what terms should be imposed for the protection of investors.

We find no merit in Polarad's contentions. The Exchange, which had deferred action during the pendency of the Chapter XI proceedings, was clearly warranted in not delaying further. It points out that before it determined to seek delisting of Polarad's common stock, it did in fact consider up-to-date information submitted by Polarad indicating improvements in its financial condition and prospects, including a projection, on June 28, 1971, of a net profit for fiscal 1971 of about $135,000. The Exchange further states that at a hearing held before its Committee on Securities, representatives of Polarad focused primarily on unaudited figures for fiscal 1971 and on the prospects of Polarad as a result of its combination with another company in connection with the Chapter XI arrangement. Polarad did not suggest that the audited figures would differ materially from the unaudited figures. On the basis of the figures submitted by Polarad, it was clear that even from the vantage point of June 30, 1971, its net tangible assets would still be below $3 million[5] and it would thus continue to fall squarely within the applicable delisting guidelines.

Where, as here, an issuer comes within those guidelines, there is no adequate basis for requiring the Exchange to afford continued listing and registration to its securities pending the

[5] Polarad advised the Exchange on June 28 that at December 31, 1970, it and Rodale had a combined net worth, *pro forma*, of $2,097,162. Net tangible assets represent net worth minus intangible assets. See Donaldson, *Corporate Finance*, p. 133 (1957).

results of further operations.[6] And we cannot agree with Polarad that standards normally applied are inapposite under circumstances such as those involved here.

While delisting may have adverse effects on present investors, the primary concern is to protect possible future investors who rely on the fact of exchange listing as an indication that the securities meet the qualifications which such listing suggests.[7] Moreover, Polarad's shareholders were advised in April 1971 that delisting of the stock was under consideration.[8]

We therefore conclude that the Exchange has complied with its delisting rules and that no useful purpose would be served by a hearing. If and when Polarad is in a position to meet the Exchange's then current standards for original listing, it may of course reapply for listing.

Accordingly, IT IS ORDERED that the application of the American Stock Exchange be, and it hereby is, granted.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM, HERLONG and LOOMIS).

[6] *Cf. Fotochrome, Inc.*, 43 S.E.C. 151 (1966); *Magic Marker Corporation*, 43 S.E.C. 500 (1967).

[7] *American Electronics, Inc.*, 43 S.E.C. 687, 690 (1968), and cases cited in note 10.

[8] The proxy statement furnished to Polarad's shareholders in connection with the agreement with Rodale and the changes in Polarad's common stock pointed out that the Exchange had advised Polarad that it did not meet standards for continued listing and that the Exchange was considering the delisting of the common stock whether or not the transaction with Rodale was consummated, and that it "is anticipated that such shares may be delisted in the foreseeable future."

In the Matter of

SECURITY PLANNERS ASSOCIATES, INC.

HOWARD SMOLAR

File No. 3–2267. Promulgated December 17, 1971

Securities Exchange Act of 1934—Sections 15(b) and 15A)

BROKER-DEALER PROCEEDINGS

Failure to Comply with Records Requirements

Improper Extension of Credit

Failure to File Timely Report of Financial Condition

Where registered broker-dealer failed to comply with records requirements, improperly extended credit to customers, and failed to file report of financial condition within prescribed period, in willful violation of the Securities Exchange Act of 1934 and rules thereunder, and where president of broker-dealer failed to exercise reasonable supervision to prevent certain of credit violations, *held*, under circumstances, in public interest to suspend broker-dealer's registration and membership in registered securities association and to suspend president from association with broker-dealer.

APPEARANCES:

Willis H. Riccio and *Edward P. Delaney*, of the Boston Regional Office of the Commission, for the Division of Trading and Markets.

Sumner H. Woodrow and *Harold R. Fisher*, of Balliro and Woodrow, for respondents.

FINDINGS AND OPINION OF THE COMMISSION

Following hearings in these proceedings pursuant to Sections 15(b) and 15A of the Securities Exchange Act of 1934, the hearing examiner issued an initial decision in which he concluded that the broker-dealer registration of Security Planners Associates, Inc. ("registrant") should be revoked, and that registrant should be expelled from membership in the National Association of Securities Dealers, Inc. ("NASD"). He further concluded that Howard Smolar, president and treasurer of registrant, should be barred from association with a broker-dealer except that, after thirty days, he may become so associated upon an appropriate showing that he will be adequately supervised. We granted respondents' petition for review of the initial decision, and they and our Division of Trading and Markets ("Division") filed briefs. Our findings are based upon an independent review of the record.

Registrant became registered with us in November 1960. During the period covered by the allegations of the order for proceedings as amended, September 1968 to August 1970, L. Dexter Faunce was president and Smolar executive vice-president of registrant until December 1, 1969, when Smolar succeeded Faunce as president. Registrant was charged with violations of our record-keeping provisions while Faunce was president, of the credit-extension regulations while Faunce and then Smolar were president, and of our financial reporting requirements while Smolar was president. Smolar, as well as Faunce, was charged with a failure to exercise reasonable supervision with respect to the record and credit violations.[1]

Failure to Comply with Record-Keeping Requirements

The record supports the examiner's finding that registrant willfully violated Section 17(a) of the Act and Rule 17a–3 thereunder in failing to make or keep current or accurate certain required books and records as set forth below.

An inspection by our staff on June 13, 1969, disclosed that registrant's general ledger had not been posted since April 30, 1969, and the dividend record not since May 31, 1969, and no position record was kept. The last available trial balance of customer and broker-dealer accounts was as of April 30, 1969. In addition, there was a difference of $74,600 between subsidiary records of customers' accounts and the control account. Although after being notified of those deficiencies Faunce advised the staff that registrant had taken steps to correct them, another inspection on July 17, 1969, disclosed that the general ledger had not been posted since May 31, the customer ledger accounts did not show receipts and deliveries of securities or dividends, long positions in the securities ledger did not have offsetting short positions, and the balance in the subsidiary accounts for customers and broker-dealers as of May 31, 1969, exceeded the amount shown in the general ledger control account by $76,239. The deficiencies and the lack of progress in

[1] Pursuant to an offer of settlement, Faunce was censured subject to certain conditions and undertakings by him. Securities Exchange Act Release No. 9191 (June 4, 1971).

curing them were discussed with Faunce and other representatives of registrant, but a further inspection on September 29, 1969, disclosed that customer ledger accounts had not been posted since September 17, and that, on the basis of an examination of a small part of the securities ledger (accounts under letters A through part of C), 34 stock-record cards were out of balance.

Respondents do not dispute the above findings in so far as they relate to the requirements that certain records must be kept and must be accurate. They contend that the Division failed to prove that registrant's books and records were not "current" within the meaning of Rule 17a–3. In our opinion, however, it is clear that a general ledger which has not been posted for 44 or 47 days, a dividend record that has not been posted for 13 days, and customer ledger accounts that have not been posted for 12 days cannot be considered current[2] and delay the preparation of trial balances which, under the Rule, are required at least once a month.[3] Unless records are maintained on a current basis, a broker-dealer is not in a position to know whether he is meeting our net capital requirements, or to demonstrate compliance with the various statutcry and rule provisions which we are charged with enforcing, or to answer inquiries of customers in respect of their accounts.

IMPROPER EXTENSION OF CREDIT

The record establishes that registrant willfully violated Section 7(c)(1) of the Act and Section 4(c)(2) of Regulation T promulgated thereunder by the Board of Governors of the Federal Reserve System in that a random sampling of about 275 transactions of registrant between January 1969 and August 1970 disclosed 93 transactions for which full payment was not received within seven business days after the date of purchase and which were not promptly cancelled or otherwise liquidated. These violations involved delinquencies of 1 to 216 days.[4]

Respondents assert that 12 of the transactions involved new issues, and that the Division failed to sustain the burden of

[2] See *David Joel Benjamin*, 38 S.E.C. 614, 619–20 (1958); *cf. Wanda O. Olds*, 37 S.E.C. 23, 24 (1956).

[3] It is unnecessary to make findings with respect to various additional violations of the record-keeping provisions found by the hearing examiner but not listed in the Division's more definite statement of specified matters of fact and law to be determined, which purported to include all the violations it intended to prove. *Cf. U.S.* v. *Neff*, 212 F.2d 297, 309 (C.A. 3, 1954).

[4] In determining the number of violations and the extent of the delinquencies, we have taken into account the fact that our staff was led to believe that all the dates shown for transactions posted in the customer ledger were settlement dates, rather than trade dates, and deducted 7 days to arrive at the trade date, when in fact only those posted after August 1, 1969, showed the settlement date.

showing, pursuant to an exception from the date-of-purchase provision in Section 4(c)(2), the date when the security was made available by the issuer for delivery to the purchaser.[5] We agree with the examiner, however, that respondents, by claiming the exception from Section 4(c)(2), had the burden of showing not only that new issues were involved but also when the securities became available for delivery.[6]

Respondents further contend that 13 of the transactions did not violate Section 4(c)(2) because the customers had funds available for payment in other unspecified accounts with registrant. In our opinion, the presence of funds in another account presumably controlled by the customer does not constitute payment within the meaning of Section 4(c)(2) absent written authorization of the account holder for the transfer of such funds within the 7 business-day period.[7] No such authorizations were produced by respondents in those 13 instances.[8]

Late Filing of Financial Report

Respondents do not dispute and we find that registrant's report of financial condition as of November 30, 1969, which was due by January 14, 1970 pursuant to Rule 17a–5 under Section 17(a) of the Act, was not filed until February 26, 1970, in willful violation of those provisions. They contend, however, that the violation was only technical. They note that on January 13, 1970, registrant's accountant pursuant to Rule 17a–5(d) requested an extension of time to February 15, 1970, on the ground that an "exceptionally heavy workload" prevented completion of the required audit procedures by the due date, but the request was denied by our staff although similar requests for extensions by registrant with respect to the two preceding annual reports had been granted.

We do not consider the requirement that annual financial reports be filed on time to be merely technical. Such reports not only inform investors but provide a source of information essential to our regulatory functions.[9] Moreover, the fact that

[5] Section 4(c) (2) as pertinent here requires that, where full cash payment for purchases in special cash accounts is not made within 7 business days, the broker-dealer shall promptly cancel or otherwise liquidate the purchase "except as provided" in Section 4(c) (3). Section 4(c) (3) provides that where an unissued security is purchased, the applicable period is 7 business days after the date on which the security is made available by the issuer for delivery to purchasers.

[6] *Cf. S.E.C.* v. *Sunbeam Gold Mines Co.*, 95 F.2d 699, 702 (C.A. 9, 1938); *Schlemmer* v. *Buffalo, Rochester and Pittsburg Railway Company*, 205 U.S. 1, 10 (1907).

[7] See *Coburn and Middlebrook, Incorporated*, 37 S.E.C. 583, 586–87 (1957).

[8] It is noted that a staff investigator had eliminated from his list of prima facie violations those transactions as to which proper authorizations were produced.

[9] See *Weston and Company, Inc.*, 44 S.E.C. 690, 695 (1971); *W. E. Leonard & Co., Inc.*, 39 S.E.C. 726, 727 (1960); *Wesley S. Swanson*, 41 S.E.C. 697, 698 (1963).

extensions had to be requested in the two preceding years should have called for extra efforts to avoid the necessity of a third request.

Failure of Supervision

The hearing examiner concluded that Smolar, as executive vice-president until December 1, 1969 and president thereafter, a director and major stockholder, and the officer in charge of sales, public relations and the training of salesmen, was under a duty to use reasonable care to see to it that the everyday operations of registrant's business were properly performed.

On the record before us, we cannot agree that Smolar was under such a duty before December 1, 1969. Until that date, Faunce had the exclusive responsibility of supervising the back-office personnel, and while Smolar may have been made generally aware, through his attendance at meetings of registrant's officers, that registrant had back-office problems, they were not discussed in detail in his presence, and he was also aware that Faunce was taking steps to solve them.

Under the circumstances we make no adverse finding as to Smolar with respect to the charge that he failed to exercise reasonable supervision with a view to preventing violations of the record-keeping provisions and, until December 1, 1969, of the credit provisions.[10] However, after he became president, he had the responsibility of supervising the back office.[11] Accordingly, we conclude that he failed to exercise reasonable supervision to prevent or terminate the unlawful extension of credit with respect to 57 transactions after December 1, 1969.

Other Matters

Respondents contend that the hearing examiner improperly granted the Division's motion to amend the order for proceedings to extend the period of the credit violations and to add the charge with respect to the late filing of the financial report. They note that the motion to amend was filed by the Division shortly before it submitted a more definite statement with respect to the original order for proceedings and assert that the examiner's granting of the motion at the opening of the hearing did not allow them sufficient time within which to request further specifications.

It appears, however, that the Division in its more definite statement did in fact include specifications of the alleged

[10] See *Midwest Planned Investments, Inc.*, 42 S.E.C. 558, 562 (1965).

[11] Smolar was not charged with a failure of supervision in connection with the financial report due after he became president, and we make no finding in this respect.

LIBRARY U. OF I.

credit violations for the period after December 1, 1969, in anticipation of its motion to amend being granted by the examiner. With respect to the added charge of failing to file a financial report for 1969 within the prescribed period, we fail to see how the charge could have been any more specific, and no claim was made by them at the hearing that further specification was necessary.

PUBLIC INTEREST

Respondents urge that the sanctions imposed by the hearing examiner are too severe. They state that registrant is a publicly held corporation and that revocation instead of a suspension would destroy its sale value to the detriment of its approximately 300 innocent stockholders. They further stress that Faunce, during whose tenure as president the major violations occurred, was permitted pursuant to an offer of settlement to continue to act as a principal in his own brokerage firm, and assert that Smolar tried to save registrant's business but would under the examiner's sanctions be precluded from engaging in any securities activities for 30 days and then permitted to occupy only a supervised position.[12]

We agree with the examiner that registrant's violations were serious and extensive. However, we do not think that revocation of registration and expulsion from NASD membership are required in the public interest. Faunce, who had the responsibility of supervising the back office until December 1, 1969, is no longer associated with the firm. Smolar testified that after taking charge of registrant's business on December 1, 1969, he was unable to determine the condition of the company until completion of an audit in March 1970, that more back-office personnel were hired and additional capital was raised, that the deficiencies revealed by the audit were corrected within 90 or 120 days, and that in September 1970 registrant voluntarily ceased doing business and was still not operating as a broker-dealer as of the date of the hearing on December 17, 1970. Under all the circumstances we think the public interest would be adequately served by the suspension for a period of 60 days of registrant's broker-dealer registration and NASD membership.

With respect to Smolar, he is not aided by pointing to the

[12] The examiner noted that the requirement of supervised association in any future employment would not necessarily be permanent.

lesser sanction imposed upon Faunce under the settlement.[13] Offers of settlement are encouraged by the Administrative Procedure Act, and whereas Faunce neither admitted nor denied the charges with respect to him, the record before us established a charge against Smolar. In any event, the remedial action which is appropriate depends upon the facts and circumstances of each particular case and cannot be precisely determined by comparison with action taken against another respondent in the same case or in other cases.[14] However, we have exonerated Smolar of the charge that he failed to exercise reasonable supervision with respect to the credit violations before he became president, and the bookkeeping violations. Under the circumstances, we think the sanction imposed upon him by the examiner should be reduced, and that it is sufficient in the public interest to suspend him from association with a broker-dealer for 20 days.[15]

An appropriate order will issue.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM, HERLONG and LOOMIS).

[13] In addition to the censure, Faunce among other things was required for a two-year period to send to our staff unaudited quarterly financial statements along with affidavits as to his brokerage firm's compliance with Section 17 of the Act and the rules thereunder; and was prohibited for a one-year period from causing his firm, without the prior consent of our staff, to engage generally in underwritings, to purchase or sell over-the-counter securities as agent or principal, or to make a market in any security.

[14] *Dlugash* v. *S.E.C.*, 373 F.2d 107, 110 (C.A. 2, 1967); *Winkler* v. *S.E.C.*, 377 F.2d 517, 518 (C.A. 2, 1967).

[15] The exceptions to the initial decision of the hearing examiner are sustained to the extent that they are in accord with our decision and overruled to the extent that they are inconsistent therewith.

IN THE MATTER OF

BENJAMIN WERNER

doing business as

BENJAMIN WERNER CO

File No. 3-2658. Promulgated December 17, 1971

Securities Exchange Act of 1934—Sections 15(b) and 15A

BROKER-DEALER PROCEEDINGS

Sales of Unregistered Securities

Where broker-dealer sold unregistered stock of issuer on behalf of nominee of issuer's controlling persons and failed to establish availability of claimed exemption from registration provisions of Securities Act, *held,* willful violations of those provisions and in public interest, in view of circumstances and extent of violations and issuance of injunctions against broker-dealer including one based on court findings of serious fraud, to revoke broker-dealer's registration and bar sole proprietor from association with any broker-dealer.

APPEARACES

Marvin G. Pickholz, Edward J. Levitt and *Edward J. Rosner,* of the New York Regional Office of the Commission, for the Division of Trading and Markets.

Stanley Kligfeld, for Benjamin Werner.

FINDINGS, OPINION AND ORDER

These were private proceedings pursuant to Sections 15(b) and 15A of the Securities Exchange Act of 1934 ("Exchange Act") presenting, among others, the issue whether Benjamin Werner, doing business as Benjamin Werner Co. ("registrant"), a registered broker-dealer and a member of the National Association of Securities Dealers, Inc., willfully violated and willfully aided and abetted violations of Sections 5(a) and 5(c) of the Securities Act of 1933 in connection with the offer and sale of common stock of Mastercraft Electronics Corp. Registrant and our Division of Trading and Markets entered into a stipulation of facts and waived a hearing and an initial decision by a hearing examiner. They filed proposed findings and conclusions and supporting briefs, and the Division filed a reply brief. On the basis of our review of the record, we make the following findings.

During the period from February through August 1968, when no registration statement under the Securities Act had been filed or was in effect with respect to Mastercraft stock, 272,700 shares of such stock were sold by 13 broker-dealers, including registrant, for the accounts of control persons and nominees of control persons of Mastercraft in a distribution of such shares on behalf of them,[1] for a total amount of $1,435,831. Registrant sold a total of 20,000 shares, all for the account of one Marvin Kopelman, Mastercraft's accountant, who acted as the nominee of Mastercraft or of control persons of Mastercraft. These sales were effected in 6 transactions between May 10 and June 10, 1968, and realized a total of $113,887. During the same period, 5 other broker-dealers sold a total of 28,000 shares of Mastercraft stock through accounts opened by or on behalf of Kopelman.

The Kopelman account with registrant was opened in a telephone call to Werner by one H. John Gluskin, who was secretary, a director and house counsel of Mastercraft. Gluskin provided Werner only with Kopelman's name and address. Neither Werner nor any other representative of registrant had previously spoken to Gluskin or ever met Gluskin or spoke to Kopelman. No inquiry was made regarding the total number of shares to be sold through the Kopelman account, whether any Mastercraft stock had been sold, was then being sold or would be sold through an account for Kopelman at any other broker-dealer, or whether a control relationship existed between Kopelman and Gluskin or Mastercraft. The only statement made to Werner regarding the propriety of sales of the stock was a statement by Gluskin, in their telephone conversation, that the stock to be sold "was clean."

It is evident that registrant's transactions in unregistered Mastercraft shares were in violation of Sections 5(a) and 5(c) of the Securities Act unless an exemption was available as to them.[2] The burden of proving entitlement to an exemption from the general policy of the Securities Act requiring regis-

[1] A maximum of 6.2 million shares was outstanding during this period.

[2] See, *e.g.*, *Gilligan Will & Co.*, 38 S.E.C. 388, 391 (1958), *affirmed* 267 F.2d 461 (C.A. 2), *cert. denied*, 361 U.S. 896 (1959).

tration rests with the person claiming the exemption.[3] And the terms of an exemption must be strictly construed against the person claiming its benefit.[4] The only exemption claimed by registrant is that provided by Section 4(4) of the Securities Act and Rule 154 thereunder. Section 4(4) exempts "brokers' transactions executed upon customers' orders" but not "the solicitation of such orders." Rule 154 defines certain terms used in Section 4(4) and describes the conditions under which the brokers' exemption is available to a broker offering or selling securities on behalf of a person in a control relationship to the issuer.

On the record before us, it is clear that registrant has not sustained the burden of establishing the availability of the claimed exemption. There is nothing in the record to show that the conditions specified in Rule 154 were met. Among such conditions are that the broker is not aware of circumstances indicating that the transactions are part of a distribution on behalf of his principal,[5] performs no more than the usual broker's function and receives no more than the usual broker's commission; the broker's principal, to the knowledge of the broker, makes no payment in connection with the execution of the transactions to any other person; and neither the broker, nor to his knowledge his principal, solicits or arranges for the solicitation of orders to buy in anticipation of or in connection with such transactions. The facts presented did not address themselves to any of these exemptive factors other than to show that registrant made no inquiry into the question of the existence of a distribution of the Mastercraft stock.

Accordingly, we find that registrant violated Sections 5(a) and 5(c) of the Securities Act. We also find that the violations were willful within the meaning of Section 15(b) of the Exchange Act.[6]

PUBLIC INTEREST

The remaining issue before us concerns the remedial action which is appropriate in the public interest with respect to registrant. The Division, asserting that registrant's conduct

[3] *S.E.C.* v. *Ralston Purina Co.*, 346 U.S. 119 (1953); *S.E.C.* v. *Culpepper*, 270 F.2d 241, 246 (C.A. 2, 1959); *Pennaluna & Co.* v. *S.E.C.*, 410 F.2d 861, 865 (C.A. 9, 1969), *cert. denied*, 396 U.S. 1007 (1970).

[4] *United States* v. *Custer Channel-Wing Corp.*, 376 F.2d 675, 678 (C.A. 4), *cert. denied*, 389 U.S. 850 (1967).

[5] The broker is at least obligated to question his customer to obtain facts reasonably sufficient under the circumstances to indicate whether the customer is engaged in a distribution. Securities Act Release No. 4818 (January 21, 1966).

[6] A finding of willfulness requires merely that we find an intent to do the act which constitutes a violation. See, *e.g.*, *Tager* v. *S.E.C.*, 344 F.2d 5, 8 (C.A. 2, 1965).

evinced a total disregard of the duties of a broker-dealer and pointing out that in May 1970, registrant was permanently enjoined, with his consent, from violating Sections 5(a) and 5(c) of the Securities Act in connection with the offer and sale of securities of another issuer,[7] urges that the public interest requires revocation of registrant's registration and a bar of Werner from association with any broker or dealer. Registrant, on the other hand, urges that any sanctions to be imposed on him should be comparable to those which have been imposed on the other respondents in these proceedings.[8]

The appropriate remedial action as to a particular respondent depends on the facts and circumstances applicable to him and cannot be measured precisely on the basis of action taken against other respondents,[9] particularly where as here the action respecting others is based on offers of settlement which we deemed it appropriate to accept.[10] The record before us shows violations of the registration provisions of a serious nature. As the facts recited above demonstrate, registrant opened the Kopelman account and sold the Mastercraft shares without making the most elementary inquiries, when the circumstances were such as to call for a "searching inquiry."[11] On the basis of the information which Werner had, he was in no position to determine whether any exemption from registration was available for the sale of the shares. Gluskin's naked representation that the stock was "clean" was obviously an insufficient basis for proceeding with the sales. Under the circumstances, the violations found by us, taken together with the fact that registrant has been enjoined against similar misconduct in connection with other securities, would in themselves require imposition of a substantial sanction in order to impress Werner with the need for scrupulous observance of the obligations of a broker-dealer.[12]

[7] *S.E.C.* v. *Dyna Ray Corp.*, S.D.N.Y., 68 Civ. 4622.

[8] We consider as totally devoid of substance registrant's contention that the Division, by urging the imposition of specified sanctions violated his constitutional "due process rights." While it is of course our function to determine the remedial action appropriate in the public interest, it is not only permissible but desirable for the Division, in the same manner as the respondent, to present its views as to the action which it deems appropriate.

[9] See *Dlugash* v. *S.E.C.*, 373 F.2d 107, 110 (C.A. 2, 1967).

[10] See *Cortlandt Investing Corporation*, 44 S.E.C. 45, 53–55 (1969).

[11] See Securities Act Release No. 4445 (February 2, 1962).

[12] We also note that we recently sustained disciplinary action taken against registrant by the National Association of Securities Dealers, Inc., including censure, a $7,500 fine and a suspension from membership for 5 business days. Securities Exchange Act Release No. 9242 (July 9, 1971). The Association found that registrant engaged in conduct inconsistent with just and equitable principles of trade in that, as a member of selling groups for certain securities offerings, he misrepresented to the managing underwriters that he would distribute the securities to the public when in fact he had no intention of doing so and instead sold them to other broker-dealers. An appeal by registrant from our decision is pending in the Court of Appeals for the District of Columbia Circuit.

Moreover, the public interest requires that consideration be given to other misconduct that registrant and Werner have been found to have engaged in. On October 21, 1971, in an action instituted by us against another issuer and various other defendants, including registrant and Werner,[13] the Court, following trial, enjoined registrant, Werner and others from violating antifraud and prospectus provisions of the securities acts in connection with transactions in the common stock of that issuer or any other security. In addition, the Court, after finding that registrant and Werner had in a "willful and blatant" manner violated Rule 15c2–4 under the Exchange Act, which makes it a fraudulent practice for a broker-dealer participating in certain distributions to fail to safeguard funds received from investors, enjoined them from violating that Rule and ordered them and other defendants to disgorge funds and profits received in connection with a public offering of the issuer's stock.

The Court found that although registrant was required to return all funds received by it as underwriter if the entire issue was not sold within a stated period, and the prospectus represented that funds received during the course of the offering would be placed in escrow, undisclosed special compensation arrangements and a purported closing were effected to make it appear that the entire issue had been sold although that was not the case, and registrant deposited funds received partly in its own checking account and partly in an account established in connection with an unrelated offering, and did not return such funds when the issue failed to obtain full subscription.

Under all the circumstances, it is clear that the public interest requires that registrant's registration be revoked and that Werner be barred from association with any broker or dealer.[14]

Accordingly, IT IS ORDERED that the registration as a broker and dealer of Benjamin Werner, doing business as Benjamin Werner Co., be, and it hereby is, revoked and that Benjamin Werner be, and he hereby is, barred from being associated with a broker or dealer.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM, HERLONG, and LOOMIS).

[13] *S.E.C.* v. *Manor Nursing Centers, Inc.*, S.D.N.Y., 71 Civ. 3627.

[14] Registrant contends that he was deprived of due process by our denial, in an earlier order, of his request that the proceedings which we had instituted as private proceedings be made public, and he urges us to reconsider that ruling. No basis has been presented, however, to warrant a change in such ruling.

In the Matter of

PERFORMANCE SYSTEMS, INC.

File No. 3-2968. Promulgated December 20, 1971

Securities Act of 1933—Section 8(d)

Securities Exchange Act of 1934—Section 15(c)(4)

STOP ORDER PROCEEDING

COMPLIANCE PROCEEDING

Material Deficiencies
Financial Statements
Overstatement of Income and Retained Earnings
Interest of Officers and Directors in Transactions
Description of Business

Withdrawal of Registration Statement

Where registration statement filed under Securities Act of 1933 and annual report filed pursuant to Section 13(a) of Securities Exchange Act of 1934 overstated issuer's net income and retained earnings, as a result of improper recognition of revenue on installment notes which were received by issuer in connection with sale of undeveloped franchises and collectibility of which could not reasonably be evaluated, and failed to disclose material interests of officers and directors in transactions to which issuer was party, and registration statement failed to disclose material facts relating to issuer's business, *held*, filings materially misleading.

Where issuer agrees to findings of facts by Commission and to make distribution of Commission's findings and opinion to stockholders, consents to entry of stop order with respect to registration statement found to be misleading but pursuant to which no securities have been sold, and files correcting amendments to cure deficiencies in annual report, *held*, consistent with public interest to issue stop order, permit withdrawal of registration statement, and dismiss compliance proceeding respecting annual report.

APPEARANCES:

Richard H. Rowe, *William Gleeson*, *John S. Bernas* and *Theodore A. Doremus, Jr.*, for the Division of Corporation Finance.

Lewis D. Lowenfels of Goldfeld, Charak, Tolins & Lowenfels, for Performance Systems, Inc.

FINDINGS, OPINION AND ORDER

These are consolidated proceedings pursuant to Section 8(d) of the Securities Act of 1933 ("Securities Act") and Section 15(c)(4) of the Securities Exchange Act of 1934 ("Exchange Act"). The proceeding under Section 8(d) was instituted to determine whether a stop order should issue with respect to a registration statement filed by Performance Systems, Inc. ("PSI") on May 2, 1969, covering a proposed public offering of $15,000,000 of debentures and an undetermined amount of common stock to be sold by shareholders of PSI. The registration statement has not become effective and no securities thereunder have been sold. The proceeding under Section 15(c)(4) of the Exchange Act[1] relates to an annual report on Form 10–K for the fiscal year 1968 ("1968 report") under Section 13(a) of the Exchange Act[2] filed by PSI on April 30, 1969.

PSI submitted an offer of settlement, pursuant to which it waived hearings and post-hearing procedures and, solely for purposes of these proceedings and without admitting or denying the allegations in the orders for proceedings, consented to findings that the registration statement and the 1968 report contained certain misleading statements of material facts as alleged. It also consented to the imposition of a stop order, undertook to file corrective amendments to the report and to distribute copies of our Findings and Opinion herein to its shareholders, and requested leave to withdraw the registration statement. Upon the recommendation of our Division of Corporation Finance we have determined to accept the offer of settlement.

On the basis of the consent contained in the offer of settlement, we make the following findings.

DEFICIENCIES

The registration statement and the 1968 report of PSI, which was organized under the laws of Tennessee in 1967 and until recently was engaged in the business of franchising and operating various businesses, primarily chicken and roast beef fast food outlets, were materially deficient in several aspects.

[1] Section 15(c) (4) of the Exchange Act provides that if we find that any person has failed to comply with the reporting requirements of Section 13 and the rules and regulations thereunder, we may publish our findings and issue an order requiring compliance upon such terms and conditions and within such time as we may specify.

[2] Section 13 (a) of the Exchange Act provides in relevant part that issuer with a class of securities registered pursuant to Section 12 (g) shall file such annual reports as we may prescribe. PSI registered a class of equity securities under Section 12(g) on April 30, 1968.

a. Financial Statements

The financial statements in the registration statement and 1968 report contained material overstatements of net income and retained earnings as a result of PSI's failure to follow generally accepted accounting principles with respect to a series of transactions involving sales of roast beef and chicken fast food franchises in multi-unit blocks ranging from 20 to 100 franchises. Under the terms of the sales, the franchisees paid a portion of their initial franchise fees in cash and the remainder in notes payable in installments over a period of two to four years, usually beginning one year after their issuance. The sales in question were made to seven companies, all of which were newly formed for the purpose of acquiring the franchises. Under the item "sales of franchises" in its 1968 Consolidated Statement of Income and Retained Earnings, PSI included revenues of $3,190,000, representing initial franchise fees paid by the seven franchisees, of which $2,378,500, or over 70 percent, represented the full face amount of notes issued to PSI by those companies in connection with the sales. The principal deficiency stems from the inclusion of revenue related to the notes.

The facts surrounding the franchise sale transactions indicate that there was no reasonable basis for estimating the degree of collectibility of the notes received by PSI. The capital of the franchisee companies, which in some instances consisted in part of personal notes of stockholders, was insufficient both to develop the franchises and to pay the notes issued to PSI, even assuming that the franchisees were able to successfully carry out plans they had to lease land and buildings for development of the franchises. With the possible exception of one company (Minnie Pearl of Canada, Ltd.), none of the franchisees had plans for further financing, and none had firm commitments for such financing. Some were in default on the construction schedule of the franchised units, and PSI had not enforced forfeiture provisions in the franchise contracts in certain of the instances where it had a right to do so. PSI had only limited experience in chicken franchise operations and little in roast beef franchises[3] and that experience had been unprofitable, and the franchisee companies had no significant operating history.

In view of the impossibility under those circumstances of

[3] The franchises purchased by six of the franchisee companies were for roast beef outlets. Only three roast beef franchise units were in operation during 1968.

estimating the collectibility of the notes, revenue recognition related to them in the 1968 PSI financial statements was inappropriate and resulted in an overstatement of the related items. As stated in Accounting Principles Board Opinion No. 10 issued by the American Institute of Certified Public Accountants, while revenue should ordinarily be accounted for at the time a sale transaction is completed, with appropriate provision for uncollectible accounts, where there is no reasonable basis for estimating the degree of collectibility, it is inappropriate to recognize revenue at the time of the transaction and either the installment basis or the cost recovery method of accounting may be used. And in our Accounting Series Release No. 95,[4] we stated that, under generally accepted accounting principles, the recognition of profit at the time of sale is appropriate if it is reasonable to conclude, in light of all the circumstances, that a profit has been realized; that such conclusion is not warranted where the circumstances are such that the collection of the sale price is not reasonably assured; and that recognition of profit is appropriate only to the extent that the consideration received in the transaction can be reasonably evaluated.

Partly as a result of the questions raised by the practices by PSI and other franchisors in accounting for initial franchise fees, generally accepted accounting principles were revised in that initial franchise fee revenue could not be recognized earlier than approximately the time the operating unit had been completed and the franchisee had started operations.[5] The rationale for such deferral of recognition is that until that time the transaction is still executory in that the franchisor and franchisee have not yet substantially performed all the obligations related to the sale of the franchise. Substantial performance is attained when the franchisor has no remaining obligation—by agreement or trade practice—to refund any cash already received or to excuse nonpayment of notes as a result of cancellation or surrender of the franchise by the franchisee, and substantially all of the services to be rendered by both the franchisor and the franchisee have been provided.[6] Thus under this test any valuation of notes received in the sale of the franchise and recognition of revenue are deferred until the operating unit is opened, at which time the accounting and

[4] Securities Act Release No. 4566, Securities Exchange Act Release No. 6982, December 22, 1968.

[5] See "Accounting for Initial Franchise Fee Revenue," *Archibald E. McKay* Journal of Accountancy, January 1970, page 70.

[6] *Ibid.*

evaluation principles referred to above relating to estimating collectibility are to be applied.

As part of the settlement of the compliance proceeding under Section 15(c)(4), PSI amended its annual report on Form 10–K for the fiscal year ended December 31, 1968, and it restated the financial statements on the unit opening basis, which eliminated the initial franchise fee revenue in question from the income statement. The restatement showed Deferred Revenue totalling $10,300,000, consisting of $8,098,000 applicable to notes and $2,202,000 of cash received for franchises where the operating unit had not been opened at the end of 1968. As a result, PSI's reported 1968 net income of $3,156,691, or 67¢ per share of common stock, was changed to a loss of $1,269,000, or 27¢ per share. In 1969, when some of the units began to open, PSI set up an appropriate provision for uncollectible accounts with respect to almost all of the franchise sale transactions in question.

b. Other Deficiencies

In addition to containing inaccurate financial statements, both the registration statement and 1968 report on Form 10–K were deficient and misleading in several other respects.

The registration statement and report failed to make required disclosure of material interests of members of PSI's management in two transactions.[7] In connection with the formation of one of the franchisee companies, Mahalia Jackson's Chicken Systems, Inc., contributions to its capital were made by PSI in the amount of $250,000 and by three individuals in the amount of about $200,000. The individuals obtained their funds through bank loans which were guaranteed by John Jay Hooker, Jr., Chairman of the Board of Directors of PSI, but such guaranty was not disclosed in the PSI filings. Similarly, at the formation of another franchisee, West America Foods, Inc. which purchased 110 franchises from PSI on or about October 31, 1968, that company's president and chairman each contributed $100,000 which together constituted one-third of the total capital, obtaining the funds through bank loans which were guaranteed by the Union Street Investment Company, a partnership composed of John Jay Hooker, Jr. and Henry Hooker, Vice Chairman of PSI. However, those facts also were not disclosed in PSI's filings.

[7] Both Form S–1 and Form 10–K require disclosure of the approximate amount of any material interest, direct or indirect, within a specified period, of, among others, any officer or director in any material transactions to which the registrant or any of its subsidiaries was a party.

The registration statement also was materially misleading in its description of PSI's business. It did not disclose that companies which purchased franchises were formed for that purpose and did not have sufficient assets to both pay the initial franchise fees and develop the franchises into operating units, that a substantial number of chicken franchises had not been profitable in 1968, and that the franchise chicken operations for the first three months of 1969 were below the assumed break-even point for such franchises.

CONCLUSIONS

The publication of this Findings and Opinion, and its distribution by PSI to its shareholders prior to its next annual meeting which PSI has agreed to effect, will inform those shareholders and potential investors concerning the matters set forth above. Under the circumstances, it is consistent with the public interest and with the protection of investors to issue a stop order suspending the effectiveness of the registration statement and to grant PSI's request to withdraw such statement. In addition, in light of PSI's curative amendments to the 1968 annual report filed pursuant to the offer of settlement, we consider it appropriate to dismiss the proceeding instituted under Section 15(c)(4) of the Exchange Act.

Accordingly, IT IS ORDERED that the effectiveness of the registration statement under the Securities Act of 1933 filed by Performance Systems, Inc. with respect to a proposed offering of its securities be, and hereby is, suspended; that the company's request to withdraw such registration statement be, and hereby is, granted; and that the proceeding instituted under Section 15(c)(4) of the Securities Exchange Act of 1934 with respect to that company's annual report for fiscal year 1968 be, and hereby is, dismissed, subject to the condition that the company distribute to its shareholders copies of this Findings and Opinion.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM, HERLONG and LOOMIS).

In the Matter of

NEW ENGLAND ELECTRIC SYSTEM

MASSACHUSETTS GAS SYSTEM

File Nos. 3-2251; 3-3454; 3-3455. Promulgated December 30, 1971

Public Utility Holding Company Act of 1935. Sections 11(b)(1) and 11(e)

MEMORANDUM OPINION

I. INTRODUCTION

This proceeding relates to a Plan ("Plan"), as amended, filed pursuant to Section 11(e) of the Public Utility Holding Company Act of 1935 ("Act") by New England Electric System ("NEES"), a registered holding company, and its subsidiary holding company, Massachusetts Gas System ("Mass Gas"), to effectuate partial compliance with Section 11(b)(1) of the Act, and the Commission's order thereunder of March 19, 1964 (41 S.E.C. 888 and Holding Company Act Release No. 15035). That order, which directed NEES to dispose of all its interests, direct or indirect, in all of its eight gas utility subsidiary companies, was affirmed in *SEC* v. *New England Electric System*, 390 U.S. 207 (1968), and the time for compliance was extended by subsequent orders of this Commission.[1] The Plan proposes the sale, for cash, of the capital stocks of four subsidiary companies: Northampton Gas Light Company ("Northampton"), 24,233 shares; Central Massachusetts Gas Company ("Central"), 54,299 shares; Norwood Gas Company ("Norwood"), 4,215 shares; and Wachusett Gas Company ("Wachusett"), 13,290 shares.

A notice of filing, affording an opportunity to request a hearing, was issued.[2] No hearing was requested by any interested person, and the issuance of an initial decision was waived.

[1] See *New England Electric System*, 44 S.E.C. 226 (1970) and 17066 (March 25, 1971).

[2] Holding Company Act Release No. 17326 (October 20, 1971).

II. THE FOUR SUBSIDIARY COMPANIES

As of June 30, 1971, the gross property, plant, and equipment of Northampton, at original cost, amounted to $4,061,994, and the related depreciation reserve amounted to $1,164,513. Current assets totaled $523,719 and current liabilities, stated at $2,024,707, included notes payable of $1,775,000, of which $1,400,000 was owed to banks, and $375,000 to Mass Gas. Northampton has no long-term debt and its permanent capital consists solely of its capital stock, which had an underlying book value of $1,401,571.

As of the same date the aggregate gross property, plant, and equipment of Central, Norwood and Wachusett, at original cost, was $13,494,981, and the related depreciation reserve was $3,340,122. Their current assets totaled $3,160,201, and current liabilities, stated at $9,041,433, included notes payable of $8,215,000, of which $700,000 was payable to Mass Gas and $7,515,000 was owed to banks. They had no long-term debt, and their permanent capital consisted solely of their capital stocks which had an underlying book value of $4,350,443.

Mass Gas presently owns all the outstanding shares of capital stocks of Northampton, Central, Wachusett and Norwood. Those shares, as well as the capital stocks of the other four gas utility subsidiary companies of NEES, were transferred by NEES to Mass Gas, a Massachusetts business trust which NEES had organized for that purpose as a preliminary step in the required divestitures.[3]

III. THE PROPOSED PLAN AND RELATED TRANSACTIONS

Mass Gas will transfer to NEES the capital stocks of the four subsidiaries, and NEES will effect the transfer and sale to the purchasers. The capital stock of Northampton will be sold for $1,867,000 in cash to Springfield Gas Company ("Springfield"), a nonassociate gas utility company. The stocks of the three other companies will be sold for $5,708,125 in cash to Eastern Gas & Fuel Associates ("Eastern"),[4] a nonassociate exempt holding company whose sole gas utility subsidiary is Boston Gas Company. NEES will invest the proceeds of sale in one or more of their electric utility subsidiary companies as a contribution to capital pursuant to later filings under the Act.

The current debts owing to Mass Gas by the four subsidiary

[3] See Holding Company Act Release No. 16583 (January 19, 1970).

[4] The prices are subject to adjustment for any changes in underlying book values which may occur from December 31, 1970 to the end of the calendar month next preceding the closing.

companies will be discharged by Springfield and Eastern at or prior to the closing. Appropriate arrangements have been made to continue Northampton's bank obligations. In the case of the other three companies, which will be merged into Boston Gas Company simultaneously with the stock acquisitions by Eastern, their bank debts will be either refinanced or continued by agreements with the banks.[5]

The four subsidiary companies, Springfield and Boston Gas are Massachusetts public-utility companies subject to regulation by the Massachusetts Department of Public Utilities. It has approved the acquisition of the capital stocks of the four companies and the proposed merger into Boston Gas Company.

IV. COMPLIANCE WITH STATUTORY STANDARDS

Section 11(e) provides that we shall approve a plan filed thereunder if we find such plan is "necessary to effectuate the provisions of" Section 11(b) and is "fair and equitable to the persons affected" thereby. The transactions proposed by the plan must also satisfy the other applicable provisions of the Act.

It is well established that a plan is "necessary" under Section 11(e) if it provides an appropriate means of achieving the results required by Section 11(b).[6] It is evident that the sale proposed by the Plan in this proceeding satisfies this requirement of Section 11(e).

We also find that the Plan is fair and equitable. In so finding we have considered primarily the relation of the sales prices of the capital stocks to earnings and underlying book values.

Net income of Northampton for the year ended December 31, 1970 was $87,682 and for the twelve months ended June 30, 1971 was $60,596, and the corresponding amounts for Central, Norwood and Wachusett combined were $251,732 and $255,541. On July 27, 1971, all four companies were granted rate increases, and according to applicants, *pro forma* net income for 1970, adjusted to reflect such increases, would be $156,100 for Northampton and $446,332 for the other three companies. On the basis of such adjustment, the sales price of $1,867,000 for

[5] When an exempt holding company acquires the stock of a public utility company and the acquisition is accompanied by a simultaneous merger, we have regarded the transaction as an acquisition of assets and therefore not subject to Sections 9(a) (2) and 10.

Upon acquisition of the Northampton stock, Springfield will be a holding company and exempt under Section 3(a) (1) pursuant to Rule 2. Under order of the State commission they will be merged prior to December 31, 1975.

[6] See *Lahti v. New England Power Ass'n.*, 160 F.2d 845 (C.A. 1, 1947); *Louisiana Gas Service Co.*, 40 S.E.C. 193 (1960); *American Gas and Electric Co.*, 25 S.E.C. 481 (1947); *Electric Bond and Share Co.*, 23 S.E.C. 674 (1946).

Northampton stock is 11.96 times that company's *pro forma* net income for 1970, and the combined sale price of $5,708,125 for the other three subsidiaries is an average of 12.79 times the combined *pro forma* net income of those companies for that year.[7] The proposed sale price for the Northampton stock is equal to 133 percent of its underlying book value at June 30, 1971. The sales price for the capital stocks of the other three companies is 131 percent of their aggregate book value as of the same date. In light of the above comparisons, we have concluded that the prices to be paid for the stock interests of the four gas subsidiaries is in question fall within the range of fairness.

The proposed sale is also subject to Section 12(d) which, among other things, requires "maintenance of competitive conditions" in connection with such sale. We find that this requirement was satisfied. NEES received several proposals from interested purchasers, to whom all pertinent information was supplied.[8] Most of the bids received were for the purchase of more than one subsidiary company. The offers by Eastern and Springfield brought the highest price for the stocks of the four subsidiary companies which NEES received.

We also find that the proposed accounting treatment for the transactions is appropriate. Mass Gas will record the transfer of the capital stocks of the four subsidiary companies to NEES by debiting its paid-in surplus account and by crediting its investment account in the amount of the carrying value of such stocks. Upon sale, NEES will debit its cash account for the aggregate sales price and will credit its investment account for the carrying amount of the stocks of the four subsidiary companies. The excess of the sales price over such carrying amount will be accounted for as ordinary income in amount equal to the undistributed earned surplus of these subsidiary companies since their acquisition by the NEES system. The remainder, representing capital gain, will be credited directly to the earned surplus account of NEES.

No fees or commissions will be paid by NEES or Mass Gas in connection with the sale. Certain services, incident to the transactions, will be performed by New England Power Service Company, the system service company. These services, to be

[7] If the same increments to net income are assumed for the 12 months ended June 30, 1971, the price-earnings ratios would be 12.0 and 12.8, respectively.

[8] Applicants were granted an exception from the competitive bidding requirements of Rule 50. Holding Company Act Release No. 17066 (March 25, 1971).

rendered at cost, are estimated not to exceed $3,750 for NEES and $3,750 for Mass Gas.

V. CONCLUSION

We find the Plan satisfies the requirements of Section 11(e) and the other applicable provisions of the Act.

NEES and Mass Gas have requested that our order entered herein recite that each of the transactions, exchanges, sales and investments proposed in the Plan are necessary or appropriate to effectuate the provisions of Section 11(b)(1) of the Act, in accordance with the requirements of Sections 1081 through 1083 of the Internal Revenue Code of 1954, as amended. This request will be granted.

An appropriate order will issue.

By the Commission

In the Matter of

MUTUAL FUNDS ADVISORY, INC.

File No. 3-2377. Promulgated January 12, 1972

Investment Company Act of 1940—Sections 6(c), 17(a) and 22(d)

EXEMPTIONS

Purchase by Fund Holding Company of Portfolio Fund Shares at Cost to Affiliated Broker-Dealer

Standing to Seek Exemption

Denial of Exemption

Where registered broker-dealer seeks exemption from Sections 17(a)(1) and 22(d) of Investment Company Act to permit it to purchase load fund shares for portfolio of newly formed affiliate, a registered open-end fund holding company, at broker-dealer's cost rather than at public offering price, *held*, under the circumstances exemption denied, it appearing that broker-dealer did not have standing to seek such exemption since in its transactions with fund holding company it would apparently act as broker rather than as dealer and therefore would not come under prohibitions of those Sections.

APPEARANCES:

Frank L. Jones, Jr. and *Barry G. Craig*, of Mershon, Sawyer, Johnston, Dunwody & Cole, for Mutual Funds Advisory, Inc.

David Silver and *Barbara S. Santos*, for Investment Company Institute.

Lloyd J. Derrickson, Frank J. Wilson, and *Frank Formica,* for the National Association of Securities Dealers, Inc.

Paul J. Newlon and *Leonard H. Becker*, of Paul, Weiss, Goldberg, Rifkind, Wharton & Garrison, and *Milton Mound,* for First Multifund of America, Inc.

Louis A. Craco, of Willkie Farr & Gallagher, and *Milton Mound,* for First Multifund Advisory Corp.

John N. Ake, Jr. and *Jerold H. Rosenblum,* for the Division of Corporate Regulation of the Commission.

FINDINGS AND OPINION OF THE COMMISSION

Commissioners OWENS and HERLONG:

Mutual Funds Advisory, Inc. ("applicant"), a registered broker-dealer engaged in the public sale of open-end investment company shares and a member of the National Association of Securities Dealers, Inc. ("NASD"), filed an application for an exemption pursuant to Section 6(c) of the Investment Company Act of 1940 from Sections 17(a)(1) and 22(d) of that Act with respect to certain proposed transactions with its newly formed affiliate, The Fundpack, Inc., a registered open-end investment company operating as a fund holding company. Applicant and Fundpack as well as Fundpack's investment adviser are under common control. The exemption is requested for the purpose of permitting applicant to sell to Fundpack, which presently invests only in no-load funds, load fund shares at applicant's cost (net asset value plus only the concession to the principal underwriter of the selling fund), rather than at the public offering price which would also include a dealer concession to applicant.[1]

A public hearing on the application was held at which the NASD and the Investment Company Institute ("ICI") were granted leave to be heard. We also granted leave to file a brief to First Multifund of America, Inc., a registered open-end fund holding company, and First Multifund Advisory Corp., its investment adviser and a registered broker-dealer, (collectively "Multifund"), because of the similarity of some of the issues herein to those involved in other proceedings concerning them, which have since then been decided by us.[2] An initial decision by the hearing examiner was waived and briefs were filed by applicant and our Division of Corporate Regulation ("Division")in support of the application, and by the NASD, ICI, and Multifund in opposition, and we heard oral argument. Our findings are based upon an independent review of the record.

The application as amended recites that applicant was organized in December 1965 and Fundpack in May 1969, that Fundpack became registered as an investment company in September 1969, that no more than 15 percent of Fundpack's assets or $250,000, whichever is greater, will be invested in a

[1] Section 17(a) (1) of the Act, as here pertinent, makes it unlawful for an affiliated person of a registered investment company, acting as principal, to sell any security to such company. Section 22(d) prohibits a registered investment company, its principal underwriter and dealers from selling its redeemable securities to any person other than a dealer, a principal underwriter or the issuer, "except at a current public offering price described in the prospectus." Section 6(c) authorizes the Commission to exempt any class of transactions from any provisions of the Act if "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of the Act.

[2] *First Multifund of America, Inc.*, 44 S.E.C. —— (1971).

single fund, that Fundpack does not intend to purchase load funds where the cost to it, together with any redemption fee, would exceed 1 percent of the offering price, that an exemption would enable Fundpack to effect purchases of as little as $25,000, in most cases, at a cost limited to the selling underwriter's concession of 1 percent or less, and that the maximum load on the sale of Fundpack's own shares will be 1½ percent of the offering price.

At the outset, it should be pointed out that it does not appear that applicant has standing in the circumstances of this case to seek an exemption from the prohibitions of Sections 17(a)(1) and 22(d) of the Act. Those prohibitions apply to one who sells fund shares as "principal" or "dealer" or principal underwriter. It would seem, in light of our recent decision in *First Multifund,*[3] that applicant would act as a broker for Fundpack in effecting purchases of load fund shares for Fundpack's portfolio, rather than as a principal or dealer. Thus, applicant would not come under the prohibitions in Sections 17(a)(1) and 22(d), and the concessions paid to it would be governed by the provisions of Section 17(e)(2).[4] Indeed, given the close affiliations between the fund, the investment adviser and the broker-dealer in this case, which are similar in nature to those in *First Multifund,* it is difficult to conceive of any situation where applicant would act as a dealer in acquiring other funds' shares from the principal underwriters for Fundpack's portfolio. As we stated in *First Multifund,* "the sale, as recognized by Section 17(e)(2), is effected through [the broker] to the customer [in this case, Fundpack] . . . who pays the current offering price as required by Section 22(d)."[5] Accordingly, an exemption granted to applicant from Sections 17(a)(1) and 22(d) would appear legally impermissible. And while the principal underwriters of selling funds might, if they chose, seek exemption from Section 22(d) to permit a preferential price to Fundpack, not only would the success of such application be doubtful for the reasons discussed below with respect to the instant application, but to the extent that such underwriters chose not to seek an exemption Fundpack would be significantly restricted in the selection of portfolio shares it wished to purchase.

[3] *Ibid.*

[4] Section 17(e) (2) (C) makes it unlawful for an affiliated person of a registered investment company "acting as broker" in connection with the sales of securities to such company, to receive from any source a commission or other remuneration which exceeds 1 percent of the purchase price.

[5] *Supra,* at p. 4 of cited Release.

Even assuming, however, that the circumstances were such that applicant had standing to seek an exemption, the record before us does not in our opinion establish the availability of the exemption sought under Section 6(c). That Section was designed to afford us discretionary authority to deal equitably with situations which are unusual or could not have been foreseen at the time the legislation was enacted, and we must exercise such authority with circumspection so as not to thwart the basic objectives of the Act.[6]

The purposes of Section 22(d) "are to prevent discrimination among purchasers and to provide for orderly distribution of [mutual fund] shares by preventing their sale at a price less than that fixed in the prospectus."[7] The proponents of the exemption stressed that investors in Fundpack, which would hold shares of a number of portfolio funds whose identity could change from time to time, would not be acquiring shares of a specific portfolio fund at a lower price than direct investors in those shares. They urged that the proposed sales to Fundpack would therefore not involve any unfair competition between dealers selling the portfolio fund shares disruptive of the orderly distribution of such shares. ICI, on the other hand, presented expert testimony that dealers would not expend the time, effort and money to sell shares if a fund holding company could purchase them for its portfolio at a lower price and could obtain the benefits of the dealer's sales efforts by emphasizing the availability of the shares to investors in Fundpack (albeit indirectly) at prices lower than obtainable by direct purchasers.[8] We agree that it could be anticipated that Fundpack would use the exemption as a selling tool in precisely such a manner. Compounding the problem, if the exemption were granted, is the probability, recognized by the proponents, that other fund holding companies and perhaps institutional investors would seek and obtain the same exemption, resulting in an increase in the predicted disruption and the further erosion of Section 22(d).

We cannot accept the proponents' further argument that Fundpack should be permitted to acquire a portfolio on more favorable terms than public investors purchase shares because

[6] *The Great American Life Underwriters, Inc.*, 41 S.E.C. 1, 4 (1960); *Variable Annuity Life Insurance Company of America*, 43 S.E.C. 61, 64 (1966); *Transit Investment Corporation*, 28 S.E.C. 10 (1948); *Trust Fund Sponsored by The Scholarship Club, Inc.*, 43 S.E.C. 917, 920 (1968).

[7] Investment Company Act Release No. 2798 (December 2, 1958). See also *Greene, The Uniform Offering Price of Mutual Fund Shares Under the Investment Company Act of 1940*, 37 U. of Det. L. J. 369, 371-3 (1960).

[8] Such prices of course do not reflect the actual cost to the investor in a fund holding company resulting from the layering of advisory fees and other charges.

it is a registered fund holding company sanctioned by and subject to special safeguards under Section 12(d) of the Act as amended in 1970.[9] The proponents noted that Congress rejected this Commission's recommendation that fund holding companies be prohibited because, among other things, they entailed a layering of advisory fees, sales loads and other charges, and lacked utility and a useful investment purpose,[10] but recognized the layering objections by imposing those safeguards. They reasoned that since an exemption would mitigate the remaining layering effects, it would be consistent with the purposes of the Act as amended. The Senate Committee which considered the 1970 amendments to Section 12(d)(1), however, intended to permit investment company securities to continue to be purchased by other investment companies "only within specified limits and subject to the detailed restrictions spelled out in the section."[11] This can hardly be considered a Congressional endorsement of fund holding companies warranting the grant of an exemption to permit them to obtain preferential prices.

The proponents also noted that applicant's purchases for Fundpack would not entail the same service or expense as the sale of mutual fund shares to the public generally, and urged that such factor has been the basis for the grant of exemptions from Section 22(d) by order or pursuant to Rule 22d–1 thereunder.[12] In our opinion, applicant's reduced sales cost does not warrant an exemption. On proponents' reasoning a lower price should be allowed ordinary investors in any unsolicited purchases of fund shares, a result which would clearly be incompatible with the purposes of the Section. Rule 22d–1 was designed not only to codify but also to eliminate or modify exemptions from Section 22(d) previously granted,[13] and we

[9] Under the 1970 amendments (Section 12(d) (1) (F)), a fund holding company cannot own more than 3 percent of a portfolio fund's shares or sell its own shares at a public offering price which includes a sales load of more than 1½ percent, and may be limited by the selling fund to redeeming no more than 1 percent of that fund's outstanding shares in any 30-day period.

[10] *Report of S.E.C. on Public Policy Implications of Investment Company Growth*, H. Rep. No. 2337, 89th Cong., 2d Sess., p. 323 (1966).

[11] S. Rep. No. 91–184, 91st Cong., 1st Sess., p. 30 (1969).

[12] Rule 22d–1 permits reductions in, or eliminations of, the sales load if based on the quantity of redeemable securities purchased by any person (excluding a group of individuals whose funds are combined for such purchase); the reinvestment of dividends or capital gains distributions; the sale to tax-exempt organizations, employee benefit plans, or officers, directors, partners or employees of the investment company, its investment adviser or principal underwriter; the sale to a registered unit investment trust which issues periodic payment plan certificates the net proceeds of which are invested in such redeemable securities; and the private sale to provide initial capital for the issuer.

[13] Investment Company Act Release, No. 2798 (December 2, 1958).

have since materially restricted the class of persons eligible for preferential prices under the Rule.[14]

Nor can we accept the further argument that it is in the public interest to allow Fundpack a reduced sales load because it is at present financially unable to effect purchases of load fund shares large enough to qualify for quantity discounts reducing the sales load to 1 percent.[15] Also insufficient is the argument that the payment of dealer concessions to an unaffiliated dealer would constitute a windfall to the dealer for the mechanical act of placing an order pursuant to the investment decision of Fundpack's adviser.[16] Finally, we do not find persuasive the contention that permitting applicant to forgo its profit would remove any incentive for excessive transactions or purchases of load rather than no-load funds contrary to Fundpack's interests. Section 17(e)(2) in permitting a 1 percent concession to an affiliated broker recognizes that the performance of certain functions by such a broker may be in the interest of the fund despite inherent conflicts of interest,[17] and those responsible for selecting funds for purchase are of course required to act properly.

As previously indicated, Section 6(c) was essentially designed for *ad hoc* exemptions in specific factual situations, whereas an exemption here would doubtless have an industry-wide impact. While we recognize that an exemption would benefit the shareholders of Fundpack as well as of any other fund holding company or institution that might be granted a similar exemption, Section 22(d) seeks to prevent the adverse effect upon investors generally which would result from discriminatory pricing and disorderly distribution.[18] At the request of Congress, the Commission is presently studying whether the retail price maintenance requirements of Section 22(d) should be amended or deleted, and the consequences of such amendment or deletion on the investing public and investment company sales organizations. Pending this study a decision which would restrict the scope of that Section on a broad level would not appear to be appropriate or desirable. Our decision as to the

[14] Investment Company Act Release No. 6347 (February 8, 1971).

[15] ICI's contention that Fundpack is a grouping of investors prohibited by Rule 22d-1 from receiving quantity discounts on purchases of load fund shares is rejected.

[16] *Cf. Midamerica Mutual Fund, Inc.*, 41 S.E.C. 328, 330 (1963), which held that a mutual fund was not entitled to an exemption from Section 22(d) to permit it to sell its shares without the applicable sales load to owners of life insurance policies issued by the company under common control with the fund, notwithstanding the Fund's contention that exacting a sales charge would only result in a windfall to the fund's principal underwriter which did not desire it.

[17] *First Multifund of America, Inc., supra*, at p. 4 of cited Release.

[18] See *Spiro Sideris*, 44 S.E.C. 211, 212 (1970); *Midamerica Mutual Fund, Inc., supra*, pp. 330–331.

best course of action, if any, to follow—whether to institute rule-making procedures as suggested by the opponents of the requested exemption so that comments can be received from all segments of the industry, or to seek an amendment or repeal of the price maintenance provisions—should await the results of the study.

Commissioner NEEDHAM, with whom Chairman CASEY joins:

I concur in the conclusion that the requested exemption should be denied, but I would base such denial solely on the ground that applicants lack standing to seek the exemption for the reasons stated in the opinion of Commissioners Owens and Herlong. I do not consider it necessary to go further and pass upon the question of whether, if an application were properly brought, an exemption of the type requested should be granted. A determination of that nature should be based upon the record developed in such a case.

An appropriate order denying the application for an exemption will issue.

Commissioner LOOMIS, dissenting:

I disagree with the majority in concluding that applicant has no standing to seek an exemption from Section 22(d) of the Act under Section 6(c) thereof and also with the view that, assuming standing, the application should not be granted.[1]

In general, I accept the facts as they have been stated; indeed, I doubt if there is any significant factual dispute in this case. I believe, however, that in its consideration of the facts, the majority has departed somewhat from the analysis in the recent case of *First Multifund of America, Inc.*[2] That case, like this one, involved the activities of an affiliate of a registered fund holding company (the affiliate) in procuring investment company shares for the holding company from the principal underwriter of the issuer of such shares. Insofar as pertinent, the factual situations in that case and in this one seem virtually identical, although the relief sought there was different from that sought here, and consequently, the legal issues are different. In that case, the affiliate sought to collect a dealer's concession upon the acquisition by the fund holding company of fund shares, while in this case, the applicant seeks

[1] I recognize that the concurring opinion, concluding that applicants do not have standing, does not reach the merits.

[2] *First Multifund of America, Inc.*, 44 S.E.C. 678 (1971).

to forego such a concession. In *First Multifund*, we note that, as required by Section 26 of Article III of the Rules of Fair Practice of the National Association of Securities Dealers, Inc. and in accordance with general industry practice, a firm such as the affiliate seeking to acquire fund shares from the principal underwriter of that fund was normally required to, and did, enter into a "dealer agreement" with such principal underwriter, which dealer agreement normally specifies explicitly that the affiliate, at least in its relationship with the fund underwriter, must act as a dealer and not a broker. We concluded, however, that these agreements merely define the relationship between the affiliate and the fund underwriter and that the affiliate was acting as a broker in his relationship with the fund holding company.[3] I accept this analysis.

The majority, however, appears to hold that applicant has no standing to seek an exemption from Section 22(d) because it is acting as a broker throughout the transaction, and Section 22(d) has no application to brokers as distinct from dealers. The majority, however, goes on to conclude that Section 22(d) effectively precludes the applicant from attaining its objective of lower costs to Fundpack and its shareholders because the fund underwriter is regarded as selling directly to Fundpack and Section 22(d) does apply to a transaction so defined. Herein lies my disagreement with the majority on the question of standing. I would conclude that applicant is a dealer in its relationship with the fund underwriter because to do otherwise would require us to ignore or nullify the perfectly lawful requirement in the dealer agreements that applicant act as a dealer. I believe that parties such as a fund underwriter and applicant are entitled to determine by contract whether, as between themselves, they stand in the relationship of principal or agent, unless something in the law prohibits such a contract, and I do not know of anything unlawful about the generally accepted form of dealer agreement used in the investment company industry. If, by reason of the dealer contract, applicant is a dealer in his relationship with a fund underwriter, then Section 22(d) does not apply to the transaction between applicant and the underwriter since Section 22(d) expressly excludes transactions between such an underwriter and a "dealer." It does not follow, however, that Section 22(d)

[3] The law of agency appears to permit a person to act as an agent for a principal and at the same time to have a principal or dealer relationship with the other parties to the transaction. The situation of an agent dealing for an undisclosed principal is a familiar example. See Restatement of Agency 2nd, paragraphs 321 and 322.

is inapplicable to the transaction between applicant and Fundpack. I would conclude that, for purposes of Section 22(d), applicant, whatever its relationship to Fundpack, is to be viewed as a "dealer" because otherwise a major loophole would be opened in Section 22(d). A fund retailer should not be permitted to completely avoid the Congressional policy declared in Section 22(d) by a private contract with his customer governing their relationship, as between themselves, and consequently a fund retailer, which is the function applicant performs in these transactions, should be viewed as a "dealer" for purposes of Section 22(d), whatever his relationship to his customer. If, however, applicant is viewed as a dealer for purposes of Section 22(d), he is the only person in the transaction upon whom the prohibitions of Section 22(d) operate, and he clearly has standing to seek an exemption from that Section.[4]

I will not unduly prolong this opinion by explaining in detail all of the reasons which lead me to conclude that the application should be granted, if we reach the merits. While I recognize that the matter is not free from doubt, several considerations are significant. In the first place, the purpose of Section 22(d) was to avoid price discrimination between investors similarly situated and also to avoid disruption of the distribution mechanism prevailing in the investment company industry. As to discrimination, Section 22(d) clearly does not require that the same sales load be charged in all transactions in the shares of a particular fund. The Commission's Rule 22d-1 departs from the idea in a number of respects. It permits quantity discounts, since those who purchase in large amounts

[4] Regardless of the particular legal relationships between the participants, the conclusion that the applicant lacks standing seems to me overly technical and somewhat unfair. The majority appears to conclude'that the only person having standing to seek an exemption from Section 22(d) is the underwriter of a portfolio fund. It is unlikely, however, that such an underwriter will ever seek an exemption since he has no significant incentive to do so. Indeed, the incentives seem to run the other way, since under the majority view, the principal underwriter of a portfolio fund would be required, and thereby entitled to receive and retain the full sales load rather than merely the principal underwriter's concession described in the prospectus of the portfolio fund. In any event, a principal underwriter of a portfolio fund would probably have no assurance that he could make sufficient sales to Fundpack to justify the expense and effort of an applicant for an exemption. The result, therefore, would be that applicant, who is here the only person injured by the denial of an exemption, would not be permitted to apply for it, while the only person allowed to apply for an exemption would, as a practical matter, not do so. The result seems inconsistent with the recent decisions of the Supreme Court with respect to standing. *Abbott Laboratories* v. *Gardner*, 387 U.S. 136 (1967); *Investment Company Institute* v. *Camp*, 401 U.S. 617 (1971). Without attempting to develop the rather complex and changing status of the law of standing, these decisions appear to hold that a person has standing if he is "aggrieved in fact" and if he is able to present the case without disqualification resulting from conflict of interest or otherwise. Applicant clearly is aggrieved in fact. Section 22(d) prevents him from conducting his business as he wishes to do, either under the interpretation of the majority or under my view. No conflict of interest appears to be present. No underwriter of a portfolio fund has even sought to participate in this case.

are differently situated from those whose purchases are small, and it also exempts from Section 22(d) certain special situations where no selling effort is required, such as the reinvestment of dividends on fund shares and the sale of fund shares to officers and employees of a fund or of affiliates performing services for the fund.[5] I believe that investors in Fundpack are differently situated from direct investors in the underlying fund because they have chosen a significantly different investment medium, which has different advantages, disadvantages, and costs. As to disruption of the distribution system, the principal type of disruption at which Section 22(d) was aimed was the so-called "bootleg market" in fund shares. This involved dealers who purchased fund shares directly from investors at prices somewhat above the redemption price (net asset value) and sold them to other investors at prices somewhat below the public offering price (net asset value plus the prescribed load).[6] This completely bypassed the fund underwriter and subjected dealers who purchased fund shares from the fund underwriter to a serious competitive disadvantage insofar as they were required by contract or otherwise to adhere to the public offering price. No such disruption can occur in this case since applicant will proceed through the conventional distribution channels.[7]

I recognize that Section 6(c), generally speaking, should be invoked only for unusual or unforeseen cases where its application would avoid an inequity. I believe this is such a case. Fund holding companies were unknown when Section 22(d) was enacted and they are still rare. As indicated below in this opinion, investors in fund holding companies may be subject to

[5] I realize that the mere fact that no selling effort is required in a particular situation does not, in and of itself, justify an exemption from Section 22(d). See *Midamerica Mutual Fund, Inc.*, 41 S.E.C. 328 (1963). However, the lack of a need for selling effort is nevertheless relevant, as indicated by Rule 22d-1. In this connection, it is to be noted that the Commission in this 1966 Report to the Congress on Public Policy Implications of Investment Company Growth, recommended that sales loads on the reinvestment of dividends should be prohibited bascially upon the ground that if an investor desired such reinvestment, it occurred automatically without any need for effort on the part of salesmen. Similarly, no sales effort is needed in this case. Applicant would merely execute the investment decision previously made by the management of Fundpack.

[6] See *Greene, The Uniform Offering Price of Mutual Fund Shares Under the Investment Company Act of 1940*, 37 U. of Det. L. J. 369, 371–3 (1960).

[7] The I.C.I. contends that exempting applicant from the requirement that it charge a sales load on portfolio fund shares sold to Fundpack would disturb or discourage retail dealers selling the same portfolio fund to investors. This contention appears speculative, particularly in view of the limitation on the amount of shares of any portfolio fund which Fundpack may purchase pursuant to Section 12(d) (1) (F) of the Act, which would prevent Fundpack from owning more than 3 percent of the shares of the portfolio fund. If, however, the principal underwriter of any portfolio fund believes that sales to Fundpack without a sales load would disturb his retail dealers, he has an entirely adequate remedy. He can simply decline to enter into a dealer agreement with applicant.

a layering of costs and the granting of the requested exemptions would reduce the inequity resulting therefrom.

Finally, I attach considerable significance to the decisions made by the Congress last year when it, for the first time, dealt with the problems created by the emergence of fund holding companies. The Commission, in its 1966 Report, recommended that fund holding companies be prohibited upon the ground that they were not a useful investment medium and because of the layering of costs which resulted from investors in such holding companies having to pay sales loads and management fees attributable to their investment in the holding company and also having to pay, indirectly, sales loads and management fees applicable to the fund shares in the holding company's portfolio. Congress rejected the first reason for the recommendations in that Report and permitted fund holding companies to exist. It, however, saw some validity in the conclusions regarding layering of costs and, in Section 12(d)(1)(F) of the Investment Company Act, as added by the Investment Company Act Amendments of 1970, sharply and uniquely restricted the sales load which fund holding companies may charge to 1$^{1}/_{2}$ percent, as compared to the generally prevailing level in the industry of approximately 8 percent. To grant this application would further mitigate this layering effect and thus further effectuate the most recently declared policy of the Congress and one particularly applicable to fund holding companies such as are here involved.

Furthermore, denial of the application may have anti-competitive effects as between a small fund holding company and a larger one. Large fund holding companies would be able to purchase fund shares in sufficient quantity to take full advantage of the quantity discounts offered by fund managers. On the other hand, new and small fund holding companies such as applicant will not be able to do so. Larger fund holding companies would thereby be able to offer lower costs to investors than small ones.[8]

[8] I recognize that fairly large funds may be able to provide investors with lower costs than small ones because of the economies of scale. I believe, however, that the Act should not be interpreted to intensify this economic disadvantage.

In the Matter of

YALE EXPRESS SYSTEM, INC.

and subsidiaries

Debtors

Promulgated January 14, 1972

ADVISORY REPORT ON PROPOSED PLANS OF REORGANIZATION

This advisory report is filed pursuant to §173 of Chapter X of the Bankruptcy Act[1] on the trustee's amended plan for the reorganization of Yale Express System, Inc. ("Yale Express") and its subsidiaries. It is the Commission's conclusion that the plan is feasible, and would be fair and equitable if amended as suggested herein.

A voluntary petition for reorganization under Chapter X was filed by Yale Express on May 24, 1965, in the United States District Court for the Southern District of New York. A voluntary petition for reorganization was filed on June 1, 1965 by Republic Carloading and Distributing Co., Inc. ("Republic"), then a subsidiary of Yale Express. These petitions were approved on May 28, 1965 and June 2, 1965, respectively. Thereafter all the operating subsidiaries of Yale Express and Republic filed similar petitions, which were approved.[2]

On November 4, 1965, all of these proceedings were consolidated. Following the resignation of the original trustee, F. Ralph Nogg was appointed successor trustee on December 8, 1965, and he has served in that capacity for all debtor corporations.

[1] 11 U.S.C. § 573.
In Title 11 of the United States Code, the numbers of the sections of the Bankruptcy Act comprising Chapter X are higher by 400 than in the Act itself. We shall use the Bankruptcy Act rather than the Code section numbers.

[2] The subsidiaries of Yale Express presently consist of Yale Transport Corp., its principal subsidiary; Nationwide Packing Co., Inc.; Nationwide Packing of Boston, Inc.; Yale Cartage Corp.; and Yale Distribution Centers, Inc. Yale Express and its present subsidiaries will herein be referred to collectively as "debtors". As indicated below, Republic and its subsidiaries were reorganized pursuant to a separate plan to reorganization and are no longer subject to the jurisdiction of the court.

On June 29, 1971, the trustee filed a plan of reorganization, which was amended at the hearing held before Judge Harold R. Tyler, Jr. on September 15 and 16, 1971. The court referred the plan to this Commission for examination and report pursuant to §172 of the Bankruptcy Act.

I. YALE EXPRESS AND SUBSIDIARIES

Yale Express, a New York corporation organized in 1938, directly or indirectly owns all the stock of the other debtors. It is authorized by the Interstate Commerce Commission ("ICC") to control motor carriers and freight forwarders, and it acts as the administrative hub of the transportation companies under its control. Yale Express owns some rolling equipment, a long-term leasehold interest in a building at 460 12th Avenue, New York, New York, a terminal property in Maspeth, New York, and leasehold interests in terminals used by the debtors.

Yale Transport Corp. ("Yale Transport"), the principal subsidiary, is a motor carrier in interstate and intrastate commerce. It operates under certificates granted by the ICC and by the Public Service Commission of the State of New York. Under its certificates Yale Transport carries general and bulk commodities over regular routes covering about 1,000 miles and serving about 1,800 communities in several states, including New York, Connecticut, Rhode Island, Massachusetts, New Hampshire, New Jersey, Pennsylvania, Maryland and the District of Columbia. It also carries general and bulk commodities over irregular routes in most of the same states. A major portion of Yale Transport's business has consisted of shipments to and from New York City, principally to or from the ready-to-wear garment industry.

In May 1963 Yale Express purchased substantially all of the outstanding shares of Republic for $13,208,000. Republic, incorporated in 1939, operated as a forwarder of carload movements of freight to and from various parts of the United States. For the year ended December 31, 1962, consolidated gross revenues and earnings after taxes of Republic and subsidiaries totalled $55,453,000 and $995,700, respectively. For the year ended of the same date, consolidated gross revenues of Yale Express totalled $29 million; net income after federal taxes then was about $1,104,000.

Prior to 1960, Yale Express was a family business. All of its stock was owned by Benjamin Eskow, its founder, and members of his family. In anticipation of a public offering, Yale Express was recapitalized in 1960. At that time it was authorized to issue four million shares of Class A stock and two million shares of Class B stock. The Eskow family exchanged its old Yale Express stock for the new Class A and Class B stocks.

On July 15, 1960, 300,000 shares of Class A stock (150,000 of which was then owned by the Eskow family) were offered to the public. In August 1963, Yale Express sold publicly an additional 400,000 shares of Class A stock and \$6.5 million of 4¼ percent convertible subordinated debentures due August 15, 1983.[3] Part of the net proceeds was used to repay bank borrowings used to acquire the Republic stock in May of that year.

In the 5-year period 1958–1962 consolidated gross revenues increased from about \$11,560,000 to about \$29 million. While motor carrier revenues increased from about \$11 million to about \$20 million, revenues from freight forwarding rose from about \$655,000 to about \$7,659,000. The latter increase in freight forwarding revenues was attributable to the acquisition, in 1959, of American Freight Forwarding Corporation and Nationwide Packing Co., Inc.[4] However, costs during this period increased at a greater rate, and the reported operating ratio (costs to revenues) rose from 90.5 percent to 92.5 percent.

According to the trustee's report, Yale Transport failed to institute measures that other carriers adopted to meet rising costs and lagging rate adjustments. It continued to expand and to concentrate on services to retailers and garment manufacturers in metropolitan New York and adjoining areas, whose merchandise is highly rated for revenue purposes.[5] It also provided services which other carriers declined as uneconomical. To accommodate its customers it did not make the charges prescribed by tariff rates for certain services.

The Republic acquisition in 1963 aggravated the problems which had begun to emerge in the previous years. Freight consolidating services became increasingly expensive while rates remained constant. Maintenance and terminal costs increased. Collections of accounts receivable continued to be neglected, and freight checking ceased with the introduction of computerized billing in the early 1960s. These and other devel-

[3] None of these offerings was registered under the Securities Act of 1933, since an exemption was claimed under § 3(a) (6) thereof, which exempts securities issued by certain common carriers from the registration requirements of the statute.

[4] American Freight was sold by Yale Express in 1967 pursuant to a plan confirmed in that year.

[5] Merchandise is considered highly rated which has a high rate per unit weight, and for which under ICC regulation a carrier receives higher charges.

opments led to a decline in the financial condition of Yale Express and subsidiaries which, as the trustee's report indicates, the reported financial statements obscured.

Yale Express had a consolidated operating loss of $1,492,000 in 1963. For the following year the consolidated operating loss increased to $4,434,000. The seemingly inevitable crisis was averted temporarily by additional bank credit and an accommodation by creditors, but to no avail. Yale Express filed its Chapter X petition on May 24, 1965, and the petitions of the subsidiaries followed in quick succession.

As of June 1, 1965, the liabilities of Yale Express and its subsidiaries aggregated about $35 million. These included $2,127,000 owed by Republic to institutional creditors; $4,730,000 owed by Republic and its subsidiaries to unsecured creditors; and $14,524,000 owed by Yale Express to institutional creditors under agreements by which Republic guaranteed the indebtedness. This latter debt and the guarantee were secured by virtually all of the assets of Yale Express and all its subsidiaries. The remaining liabilities of $13,630,000 included the $6.5 million of the convertible subordinated debentures of Yale Express and trade and other liabilities of the debtors other than Republic and its subsidiaries.

Some months prior to the reorganization proceedings class actions were filed on behalf of security holders who purchased the Yale Express stock or debentures offered to the public in 1963. The defendants included Yale Express the accounting firm that had certified the financial statements used in the offering, the principal underwriters and various officers and directors of Yale Express. The complaints alleged violations of the federal securities laws and of the Interstate Commerce Act as well as common law fraud. The class suits were settled, with approval of the court, for the sum of $1,010,000. The settlement stipulates that Yale Express will not be required to make any contribution to the settlement fund. Pursuant to the settlement, a related derivative suit for the benefit of Yale Express was dismissed and Yale Express is required to execute a release of all claims it may have against any of the other defendants.

II. THE TRUSTEE'S ADMINISTRATION

The trustee, who has had extensive experience in the motor carrier business, effected substantial reductions in the debtors' cost of doing business. He moved the debtors' offices and terminal facilities from the Manhattan building of Yale Express to lower-cost sites elsewhere in the metropolitan area and leased the Manhattan space to unaffiliated tenants. He instituted changes in maintenance practices and introduced an improved freight checking system and economies in pick-up and delivery services. He also devised a program of equipment replacement, required charges for all services rendered, and eliminated unprofitable business. As a result of his efforts, the trustee reported an operating profit of $144,300 for the year 1970.

In the course of the proceedings a plan of reorganization of Republic and its seven subsidiaries was confirmed on November 13, 1968. Under that plan, the creditors of Republic and of its subsidiaries received notes and all the stock of reorganized Republic in exchange for their claims, and Yale Express was relieved of about $14.5 million of liabilities to institutional creditors, which Republic had guaranteed. As a result of this reorganization and the trustee's sale of American Freight Forwarding Corporation, Yale Express does virtually no freight forwarding business.

Upon the reorganization of Republic in 1968, the liabilities of Yale Express were reduced to about $13.3 million, including $6.5 million in convertible subordinated debentures, $1,368,000 owed to insurance companies, and $2,645,000 owed to general creditors.

At present Yale Express's capitalization consists of the publicly-held debentures and of 1,352,328 shares of Class A stock and 828,880 shares of Class B stock. The Class A stock is held by approximately 3,900 persons, and the Class B stock is held by the Eskow family.[6]

The Class A stock and the debentures were listed and traded on the New York Stock Exchange. Shortly after the Chapter X proceedings were begun, these securities were delisted and since then have been traded in the over-the-counter market.

III. THE PLAN OF REORGANIZATION

The trustee's plan assumes that the Yale Express is solvent and hence provides for a participation by present stockholders in the reorganized company. The capitalization will consist of 7 percent 10-year notes and new common stock.

Taxes and other priority claims will be paid in cash. Current liabilities of the trustee will be paid by the reorganized com-

[6] The rights of the Class A and B stocks are identical, except that the Class A is entitled first to a noncumulative annual dividend of $1.50 per share before a dividend of like amount is paid to the Class B. Dividends in excess thereof are payable in the same amount per share to both classes.

pany in the ordinary course of business. The trustee and his counsel have agreed to accept 10-year notes for final compensation.

Mechanics' lien claims, totalling $645,128, plus accrued interest to the date of payment, will be paid in cash up to $10,000. Amounts in excess thereof will be paid 80 percent in cash and 20 percent in 10-year notes. Any such claimant may elect to receive for his entire claim one share of common stock for each $5 in claims.

Holders of chattel mortgage claims, totalling $753,693, plus accrued interest to the date of payment, will receive for their claims 25 percent in cash, 30 percent in 10-year notes, and common stock for the balance at the rate of one share for each $5 in claims.

Unsecured creditors, including the subordinated debenture holders and trade creditors, have claims totalling about $10,674,000, plus interest to the date of payment. Creditors will be paid in cash for claims not exceeding $250. Creditors with claims above this amount may elect to receive (1) $250 in cash in full satisfaction of their claim or (2) 10 percent in 10-year notes and, for the balance of their claims, one share of common stock for each $5 in claims.

The 10-year notes to be received by the creditors (secured and unsecured) will bear interest at 7 percent per annum and will be subject to prepayment without premium or penalty. The indenture will provide for an annual sinking fund equal to 10 percent of the outstanding notes beginning with the third anniversary date, except for the notes to be issued to the trustee and his counsel. The latter notes will be paid over a 10-year period in semi-annual installments, commencing six months after the date of issue. The notes will be secured by a mortgage on the Yale Express building in New York City, which mortgage will be junior only to the mortgage securing the reorganized company's indebtedness to the trustee and his counsel and to working capital loans.[7]

Class A and B stockholders will receive one share of new common stock for each three shares of stock they presently hold. Of the new shares to be allocable to the Eskow family as Class B stockholders, one-half of these shares will, be agreement, be allocated to Employee Benefit Plans. No fractional

[7] Working capital loans exceeding $1 million in principal amount will require the consent of the holders of two-thirds of principal amount of the outstanding notes (other than those issued to the trustee and his counsel) in order to be entitled to the secured status that the plan accords to such loans.

shares will be issued. Those entitled to fractional shares will receive cash at the rate of $5 per share.

IV. VALUATION

For reorganization purposes, the value of a business unit depends on reasonably foreseeable earnings. Prospective earnings are capitalized at a rate appropriate to the business risks of the enterprise. The Supreme Court has said that since a valuation, which is based upon future earnings, requires "a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made. But that estimate must be based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth, including, of course, the nature and condition of the properties, the earnings record, and all circumstances which indicate whether or not that record is a reliable criterion of future performance."[8]

As noted, Yale Transport is the principal operating subsidiary of Yale Express, and it accounts for substantially all of the motor carrier earnings. The elements of value for Yale Express include the capitalized value of such projected earnings, the value of Yale Express's real estate, excess working capital and the present value of the tax loss vary-over.

A. TRUSTEE'S VALUATION OF EARNINGS

In arriving at his valuations, the trustee first analyzed the growth of motor freight revenue for the eastern seaboard, and determind that for 1963–1970 such revenues had "increased at the rate of 13.8 percent per year". He also determined that the revenues of Yale Transport increased from 0.60 percent of the 1969 eastern seaboard revenues to 0.65 percent in 1970, or an increase of 8.3 percent. He then projected aggregate eastern seaboard motor freight revenue at the compound rate of 13.8 percent for the six years 1971–1976 and he increased Yale Transport's share of the market in each of these years by 8.3 percent. As a result of this approach his estimated increases in Yale Transport's revenues ranged from 19 percent to 21.8 percent for these years, as shown in the following table:

[8] *Consolidated Rock Products Co.* v. *DuBois*, 312 U.S. 510, 526 (1939).

TABLE I

(000s omitted)

Year	Eastern Seaboard Motor Freight Revenue	Yale Revenue	Percent Increase	Yale Percentage Share of Market
1971	$1,601,393	$11,209	21.8*	0.70
1972	1,822,385	13,667	20.0	0.75
1973	2,073,874	16,788	21.0	0.81
1974	2,360,064	20,532	20.0	0.87
1975	2,685,757	25,246	19.0	0.94
1976	3,056,391	30,869	19.0	1.01

*This computation not shown in trustee's exhibits.

To determine appropriate operating ratios for 1971–1976, the trustee analyzed such ratios for Yale Transport in the years 1955–1962. The low was 89.3 percent in 1959 and the high was 94.9 percent in 1960. The average for the entire period was 91.6 percent. He noted also that the ratio, which was 108,7 percent in 1969, declined to 98.4 percent in 1970, and that for the six months ended June 30, 1971, the operating ratio had further declined to 95.6 percent.[9] In his opinion, additional improvements may be expected after the reorganization as a result of modernization of the trucking fleet and anticipated economies, some of which he has already initiated.

Revenues, operating ratios and profits before and after taxes, as projected by the trustee, are shown in the following table:

TABLE II

(000s omitted)

Year	Revenue	Operating Ratio	Profit	Net After Taxes
1971	$11,209	94.0	$ 673	$ —*
1972	13,667	94.0	807	420
1973	16,788	93.0	1,139	592
1974	20,532	92.0	1,563	813
1975	25,246	91.5	1,976	1,027
1976	30,869	91.0	2,489	1,294
Total for 5 years				$4,146
Average				$ 829**

*Net profit after taxes not shown in trustee's exhibit.
**$829,299 before rounding off.

[9] The trustee omitted 1963–1968 because this period included Republic and subsidiaries and was not representative.

To the average earnings of $829,299, after taxes and before interest, the trustee applied a multiple of ten and obtained a valuation of $8,292,990.

B. COMMISSION VIEWS ON VALUATION.

We are unable to determine from the record the basis for the trustee's computation of a 13.8 percent annual increase for 1963–1970. The trustee states that it represents revenue increases in the "eastern seaboard". This regional grouping is not identified and from the data supplied at the hearing we cannot ascertain how this regional grouping was determined. Nor can we find support for the trustee's projection that Yale Transport will capture an increasing share of this regional market for the 1971–1976 period, quite apart from the fact that his projected increase is based on a single year's experience. Although, as we shall note, significant growth for Yale Transport after reorganization is probable, we are skeptical about the continuing and sustained annual growth the trustee projects. Projection for a 6-year bottomed a continuing compound growth rate are necessarily conjectural and subject to contingencies, the nature and magnitude of which are extremely difficult to judge even by the well-informed.

Considering the history of the debtor companies we believe that a shorter time span of three years (1972–1974) is more realistic and adequate. In the first five years of the reorganization the trustee reported continuing operating losses. In 1970, the first year in which the trustee reported an operating profit, revenues were $9.2 million, or a 21 percent increase over 1969. Yale Transport revenues for the nine months ended September 30, 1971 totalled $7,837,320, or a 15.9 percent increase over the same period in the prior year. The trustee indicated that but for the maritime strike the percentage increase for 1971 would have been 21.8 percent. Our analysis of the nine months operations indicates that revenues for this year are more likely to be about $10,902,000, or an 18 percent increase over the previous year.

For 1972, we accept the 20 percent growth rate which the trustee projected. In the trustee's judgment, after reorganization Yale Transport should enjoy a surge of new business from customers who heretofore were not willing to deal with the company, whose past operating losses hardly inspired confidence. We think that some such additional momentum may carry over into 1973, for which year we assume a growth rate of 15 percent rather than the trustee's 21 percent.

Our assumption with respect to 1973 is consistent with the historic rate of growth for motor carriers in 1966–1970 for the New England-Middle Atlantic region, within which Yale Transport operates, and for the 20 carriers which the trustee considered comparable to Yale Transport, as shown in the following table:

TABLE III

OPERATING REVENUES 1966–1970

(000s omitted)

Year	New England* Middle Atlantic	Percent Increase	Trustee's 20 Selected Carriers	Percent Increase
1966	$546,578	—	$246,985	—
1967	569,955	4.3	254,135	2.9
1968	606,812	6.5	297,783	17.2
1969	738,974	21.8	331,402	11.3
1970	806,352	9.1	375,433	13.3
Average increase		10.4		11.2

*Source: Trinc's Red Book Of The Trucking Industry, 1971 Edition.

For the year 1974, we would project a growth rate of 11 percent for Yale Transport. Such projected rate is in accord with the data in Table III.

In light of the foregoing and taking estimated revenues for 1971 at $10,902,000, we arrive at projected revenues and rates of growth as follows:

TABLE IV

(000s omitted)

Year	Projected Revenues	Percent Increase
1972	$13,082	20
1973	15,044	15
1974	16,699	11

Applying an operating ratio of 92.0 percent for 1974, as developed by the trustee, we estimate operating profit at $1,336,000, and net income, after taxes but before interest, at $770,000 as shown below:

TABLE V

(000s omitted)

Year	Operating Profit	Projected Interest	Net Profit Before Income Tax	Net Income After Income Tax*
1972	$ 785	$162	$ 623	$324
1973	1,053	159	894	466
1974	1,336	157	1,179	613

*Although no federal income taxes will be payable through 1975 due to the availability of tax loss carry-overs, net income is shown after provision for a 48% tax rate. The value of the tax savings is discussed below.

Net income before interest and after taxes ($770,000) appropriately capitalized would represent the reorganization value of the Yale Transport enterprise.

This is not to say that earnings of the reorganized company may not exceed the 1974 forecast, and in a given year, before or after 1974, earnings may be more or less than presently forecast. Future earnings of the reorganized company, like those of any other business enterprise, will be subject to short-term and cyclical fluctuations, and our 1974 projections represent only an estimated level of earnings on which to construct an approximate value for Yale Transport in light of such factors as may now be reasonably foreseen. That is all that Chapter X requires and all that humanly can be done.

To arrive at an appropriate capitalization rate, we have analyzed six publicly-held motor carriers, which for 1970 had revenues ranging from $23 million to $55 million.[10] This analysis, which is summarized in Appendix A, shows that the average multiple for 1969–1971 for these six companies was 13.9.[11] The range of multiples was 12.8 in 1969, 12.4 in 1970 and a high of 16.4 in 1971. For Yale Transport, we have selected a multiple of 13, taking into account primarily the company's prior history and the fact that we are here concerned with estimates not expected to be attained until 1974. By applying this multiple to projected earnings of 1974, we find for Yale Transport an earnings value of $10,010,000.

The trustee did not provide the basis for the multiple of 10 that he used for capitalizing his estimate of Yale Transport's earnings. His expert witness, an officer of a brokerage and underwriting firm, touched upon this subject in his testimony, but in a rather different context.

[10] Of these six, two are from the trustee's list of companies, and one is from the list of the trustee's expert.

[11] The multiple is derived by dividing the aggregate of the market value of the equity plus principal amount of debt by the related income before interest and after taxes.

He testified that when consulted by a transportation company that wished to make a common stock offering to the public for the first time, he would suggest that it may expect a price of 10 times earnings per share. This is a judgment only as to what price an issuer may expect in a particular market. It was not intended to represent a price-earnings multiple for the common stock as a long-term investment. Besides, we are here concerned not with the price-earnings ratio for the common stock equity, but with an appropriate multiple for earnings after taxes and before interest in order to obtain a value for the total capitalization.

C. OTHER COMPONENTS OF VALUE.

Yale Express, as noted, owns interests in two commercial properties, one in New York City and the other in Maspeth, New York. At present the debtors themselves use very little of the space in these buildings, most of which is leased to tenants unaffiliated with the Yale complex. The debtors' interests in these buildings have been appraised at $6,221,500.

An additional element of value is excess working capital, which the trustee initially estimated at $1.5 million. However, Yale Transport intends in April-June 1972 to purchase new rolling stock for $340,000 in cash. This reduces excess working capital to $1;160,000.

Another element of additional value is the tax loss carry-over. Yale Express and subsidiaries currently have an accumulated tax loss carry-over of about $27 million for 1972–1977, which has value only to the extent that it can be applied to future taxable income of the reorganized company.[12]

Our estimate of future tax savings is based on projected earnings for the years 1972–1974 (Table IV) and, for this limited purpose, for an additional two years (1975–1976), assuming an annual growth in revenues of 11 percent in this two-year period.[13] Accordingly, and using the trustee's projected operating ratios, the tax savings would total $2,655,000. Discounting this amount at 8 percent,[14] the present value of these tax savings would be $2,056,000.

[12] Under the Internal Revenue Code, regulated transportation companies are entitled to carry-over net operating losses for seven years.

[13] Since the remaining tax loss carry-over available for 1977 is only $48,157, this amount was utilized to offset projected taxes for 1976.

[14] The 8 percent discount rate is approximately the reciprocal of the 13 multiple we have used for valuation.

D. TOTAL VALUATION AND SOLVENCY.

Based on the foregoing, the total value of the debtor estates is:

Capitalized value of earnings (Yale Transport)	$10,010,000
Appraised value of buildings	6,221,500
Excess working capital	1,160,000
Present value of tax loss carry-over	2,056,000
Total	$19,447,500

The following tale shows the liabilities of the debtors' estates as recently estimated by the trustee, plus post-petition interest as computed by our staff.[15]

TABLE VI

	Liabilities	Estimated Post-Petition Interest to May 31, 1972	Total
Estimated fee allowances	$ 500,000	$ —	$ 500,000
Taxes	126,808	37,725	164,533
Mechanics' and other liens	668,550*	307,404	975,954
Chattel mortgages	753,693	359,134	1,112,827
Unsecured liabilities (including debentures)	10,673,695	3,767,183	14,440,878
Total	$12,722,746	$4,471,446	$17,194,192

*This includes the claim of Anchor Saving Bank represented by a 6 percent secured note, due 6-1-74, of which $23,422 is unpaid. Under the plan, this note will be assumed by the reorganized company and paid in accordance with its terms.

From the foregoing it appears that the debtors' estates are solvent. The equity for stockholders is $2,253,307, or about 11.6 percent of the total valuation.

The trustee determined that the equity for stockholders amounted to $4,143,293, or about 20.7 percent of his total valuation of $20,037,990, composed of his earnings valuation of $8,292,990 for Yale Transport; an indicated value of Yale Express real estate of $6,345,000;[16] the value of the tax loss carryover of $3.9 million; and excess working capital of $1.5 million. He estimated total liabilities at $15,894,697, which includes principal of $12,699,324, and post-petition interest of $3,195,373.

As noted, our valuation of Yale Transport differs from the trustee's. We accept the appraised value of the real estate. But our estimate of the value of the tax loss savings, unlike the trustee's, is the discounted present value of these savings,

[15] Post-petition interest is estimated to May 31, 1972, the consummation date assumed by the trustee.

[16] The real estate was actually appraised at $6,221,500 as indicated above.

which value is based on earnings projections different from his for 1972–1976. We have reduced his estimate of excess working capital by $340,000 to reflect anticipated expenditures for equipment. And our calculation of post-petition interest is higher than the trustee's for reasons to be noted shortly.

In determining the liabilities we include estimated post-petition interest because when a debtor is solvent, creditors are entitled to interest accruing during the reorganization.[17] The question is the rate at which such interest should be allowed.

In cases of solvency, interest generally will be allowed at the rate specified in the instrument of indebtedness.[18] Where no interest is provided for, as is generally the case with trade claims, which are normally expected to be paid in ordinary course of business,[19] interest is computed at the applicable legal rate.[20] For such claims post-petition interest was computed in Table VI above at the rates prescribed by New York law.[21] This computation, it should be understood, is only an approximation. The actual amount will depend on closer examination of the claims than the present record permits.

We do not suggest that this legal rate must be applied regardless of all circumstances. The allowance for post-petition interest is no more immune from equitable considerations than the claim itself, which under § 57k of the Bankruptcy Act (11 U.S.C. § 93k) may be allowed or disallowed in part or in whole "according to the equities of the case". This is also clearly implied in the "fair and equitable" standard of Chapter X. But the record in this proceeding does not reveal any grounds for departing from the legal rate. The trustee apparently assumed a rate of 4¼ percent because that is the rate fixed in the indenture under which the debentures of Yale Express were issued and is the lowest contractual rate of interest for creditors in this proceeding. We know of no support for this approach.

[17] See *Consolidated Rock Products Co.* v. *DuBois*, 312 U.S. 510, 527–528 (1941); *Ruskin* v. *Griffiths*, 269 F.2d 827, 830–832 (C.A. 2, 1959), *cert. den.*, 361 U.S. 947 (1960); *In re International Hydro-Electric System*, 101 F. Supp. 222, 224 (D. Mass., 1951). *Cf. United States Trust Co. of New York* v. *Zelle*, 191 F.2d 822 (C.A. 8, 1951) *cert. den.*, 342 U.S. 944 (1952).

[18] *Ruskin* v. *Griffiths*, fn. 17 *supra; In re Realty Associates Corp.*, 163 F.2d 387 (C.A. 2, 1947), *cert. den.*, 332 US. 836.

[19] This may also occur when the debt instrument matures by its terms in the course of the reorganization but fails to specify the rate of interest thereafter.

[20] See *In re Muskegon Motor Specialties*, 366 F.2d 522, 528–529, (C.A. 6, 1966); *In re Norcor Mfg. Co.*, 36 F. Supp. 978, 980 (E.D. Wisc., 1941).

[21] Our computation is based on 6 percent rate to June 30, 1968; 7¼ percent thereafter to February 15, 1969; and 7½ percent thereafter. See *Rachlin & Co.* v. *Tra-Mar, Inc.*, 33 App. Div. 2d 370, 374–376, 308 N.Y.S. 2d 153, 157–159 (1st Dep't 1970).

Our valuation and our estimates of liabilities require adjustments in the amounts of cash, notes, and common stock to be distributed to creditors and stockholders.

Liabilities, cash payments to creditors, and the reorganization value of the common stock (assuming a proposed distribution of three million shares)[22] are estimated as follows:

TABLE VII

			Per Share
Total valuation		$19,447,500	
Less:			
Trustee's liabilities	$1,282,700		
Cash payments to creditors	1,433,582		
Notes to creditors	2,349,048		
		5,065,330	
Reorganization value of new common stock		$14,382,170	$4.79
Capitalized value of Yale Transport		$10,010,000	$3.34
Residual value of other assets		4,372,170	1.45
		$14,382,170	$4.79

*Additional value from other assets is $9,437,500 (see p. 18, *supra*) less $5,065,330, or a net of $4,372,170.

V. FAIRNESS, FEASIBILITY AND OTHER REQUIREMENTS

Chapter X requires that before approving and confirming a plan, the judge must find it to be "fair and equitable, and feasible". (§§ 174 and 221(2)). As we show below, the plan is feasible. It would be fair and equitable if amended to reflect adjustments in the light of our preceding discussion. To be approved, the plan must also meet other requirements of Chapter X which we shall note.

A. Fairness.

Under the fair and equitable standard stockholders may participate only if, as here, there is an equity remaining after all creditor claims are satisfied in full. This does not mean that creditors must be paid in cash. It is sufficient if they receive the equitable equivalent of their rights. This equitable equivalent can consist of securities or of cash, or of a combination of the two.

[22] The trustee assumed a distribution of 3,299,932 shares by using a value of $5 per share.

Mechanics' lien claims represent an indebtedness for work done on the Yale Express building in New York City shortly before the reorganization proceeding. For his claim for principal and interest, each such creditor would receive under the plan 80 percent or better in cash and the balance in 10-year notes. These notes, as indicated, are to be part of a larger issue to be distributed to all creditors, and the entire issue will be amply secured by a lien on Yale's leasehold estate in that building.[23] The plan would be fair to these creditors if post-petition interest on their claims were computed at rates we have indicated,[24] and if their option to take stock in exchange for their claims were adjusted to one share for each $4.79 in claims.

Under the plan, holders of claims with chattel mortgages on equipment will receive 25 percent cash, 30 percent in 10-year notes (which, as indicated, are well secured), and 45 percent in common stock at the rate of one share for each $5 in claims for the balance. The treatment of these claims would be fair if post-petition interest were appropriately computed and if the stock distribution were adjusted to provide for the issuance of one share for each $4.79 in claims not satisfied in cash or notes.

The plan provides that unsecured creditors with claims of $250 or less will be paid in cash, and most probably a creditor with a claim somewhat above that amount will elect to take $250 in cash for his entire claim. The plan is certainly fair to them.

Under the plan, debenture holders and other unsecured creditors with individual claims above $250, are offered 10-year notes for 10 percent of their claims, and for the remaining 90 percent thereof one share for each $5 in claims. Although these creditors are reduced to what is almost entirely an equity position, they are offered two main compensating advantages. For 10 percent of their claims they will receive another debt obligation for a like amount but well secured by a lien. In addition, these unsecured creditors as a class will have voting control of the reorganized enterprise.[25]

[23] Notes to be issued, as we have estimated, will amount to $2,349,048. Yale's interest in the building has been appraised at $5,876,500.

[24] It may be noted that a secured creditor is entitled to post-petition interest to the extent of the value of his security even if the debtor is insolvent. *In re Macomb Trailer Coach Co.*, 200 F.2d 611 (C.A. 6, 1952), *cert. den., sub nom., McInnis* v. *Weeks*, 345 U.S. 958 (1953). See also *Coder* v. *Arts*, 213 U.S. 223, 228–229, 245 (1911); *R.F.C.* v. *Denver & Rio Grande West. R. Co.*, 328 U.S. 495, 502–503 (fn 6), 517 (1946).

[25] *Group of Institutional Investors* v. *Chicago, Milwaukee, St. Paul & Pac. R. Co.*, 318 U.S. 523, 569–570 (1943) and *Consolidated Rock Products Co.* v. *DuBois*, fn 17 *supra* at 429–530, indicate that this is a significant factor.

The treatment of the unsecured creditors would be fair if post-petition interest were computed at the legal rate (where there is no contractual rate) and if the distribution of the new common to them were adjusted to reflect an exchange ratio of $4.79 per share.

In view of our previous discussion, we find the plan unfair to creditors in that it allocates to the present common stockholders (Class A and Class B) about 20.7 percent of the trustee's valuation. On our basis, stockholders are entitled to 11.6 percent of the total value of the reorganized enterprise, or $2,253,308 of its common stock equity. At $4.79 per share, the Class A and Class B stockholders would receive 470,419 shares of new common stock, or 15.7 percent of the assumed distribution of three million new shares. Since there are presently outstanding 1,352,328 shares of Class A stock and 828,880 shares of Class B stock of Yale Express, or a total of 2,181,208 shares, the proper exchange ratio would be one new share for 4.64 old shares.

We recognize that an exchange ratio for creditors and stockholders at $4.79 per share may result in an undue number of fractional shares which must be paid in cash. However, when prior to consummation the exact amount of liabilities is ascertained, the precise number of shares to be distributed can be easily adjusted in order to reduce fractional shares to a practicable minimum.[26]

B. FEASIBILITY.

In a Chapter X reorganization feasibility means that the reorganized company should, among other things, have a sound capital structure, adequate working capital and sufficient earnings to service its financial obligations. In our opinion these requirements for the reorganized Yale Express are satisfied.

We note the following tentative pro forma consolidated balance sheet for Yale Express at June 30, 1971, after giving effect to the provisions of the plan, our estimate of liabilities, and the projected cash flow to May 31, 1972:

[26] Our proposed distribution to stockholders, like the trustee's, accords equal rank to the Class A and Class B stock. As we have noted, the rights of both classes are identical except that the Class A has prior right to an annual dividend of $1.50 per share before a dividend of like amount may be paid to the Class B. This priority is non-cumulative even if earned, and the Class B stock, which had effective control of Yale Express, was in a position to control the dividends payable to the Class A. Accordingly, we have given greater weight to the identical liquidating and other rights of both classses and have treated them alike for reorganization purposes.

TABLE VIII

Assets		Liabilities and Capital	
Cash	$ 716,917	Current liabilities	$ 1,282,707
Other assets*	10,277,527	Long-term debt	2,349,048
New equipment	340,000	Total liabilities	3,631,755
Total assets	$11,334,444	Capital	7,702,689
		Total	$11,334,444

*Includes current assets estimated at $1,517,856.

As readily noted, pro forma long-term debt is 23.4 percent of total capitalization. Projected earnings for the foreseeable future appear sufficient to enable the company to:

1. Service this indebtedness; and
2. Raise such additional capital as it may require.

C. *Other Requirements.*

Section 216(11) of Chapter X requires that the plan shall include equitable provisions with respect to the election of directors, and under § 216(12) the charter of the reorganized company must provide "for the fair and equitable distribution" of voting power among the security holders. We have interpreted these provisions as requiring cumulative voting in the election of directors, and the plan in this proceeding should be amended accordingly. The plan should further be amended to provide for pre-emptive rights to stockholders. Without such rights, the interests of the stockholders of the reorganized company would be subject to dilution by a distribution of additional common stock, and the plan would be incompatible with the safeguards for stockholders provided for in §216(11).[27]

The trustee under the indenture, pursuant to which the Yale Express debentures were issued, has proposed an amendment to the plan whereby the indenture trustee would be granted a discharge from any liabilities or obligations thereunder. We think this proposal inappropriate as an amendment to the plan.

This proposed amendment is of interest only to the debenture holders. If the plan, as so amended, is approved by the court, the debenture holders will be faced with the choice of voting either in favor of the entire plan or against it because they do not like the proposed amendment although satisfied with the rest of the plan. The debenture holders should not be faced with this needless choice. We suggest that the indenture

[27] As to both of these requirements, see *Parker Petroleum, Inc.*, 39 S.E.C. 548, 570-571 (1959).

trustee's proposal not be made part of the plan. If it so desires, the indenture trustee may bring on a separate application for discharge on proper notice to the debenture holders.

VI. CONCLUSION

The plan is feasible. But it should be amended, as indicated, to meet the "fair and equitable" standard of Chapter X and other pertinent requirements of that chapter.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM, HERLONG and LOOMIS).

APPENDIX A

(000s omitted)

	Market Value Of Capitalization As Of			*Net Operating Profit After Income Taxes But Before Interest*			*Multiples*		
	12-31-68 [a]	12-31-69 [b]	12-31-70 [c]	1968	1969	1970	1968	1969	1970
Branch Motor Express Co.	$15,119	$14,752	$28,015	$1,894	$1,251	$1,869	8.0	11.8	14.9
Eastern Freightways, Inc.	13,253	12,604	23,693	865	765	1,362	15.4	16.4	17.5
Halls Motor Express, Inc.	23,789	17,471	24,854	2,044	1,310	1,362	12.5	13.3	18.2
Preston Trucking Co., Inc.	24,277	18,270	36,298	1,562	1,792	2,010	15.6	10.2	18.2
Smiths Transfer Corp.	22,841	25,784	61,994	1,894	2,400	3,804	12.0	10.7	16.4
Overnite Trucking Co.	32,386	32,220	55,818	2,449	2,644	4,284	13.1	12.2	13.0
Averages							12.8	12.4	16.4

Mean Between High & Low Sale
Or Bid Prices Of Common Stocks.

[a] For year 1969.
[b] For year 1970.
[c] For period Jan. 1 to Oct. 31, 1971.
Debt at each year end taken at principal amounts.

IN THE MATTER OF

MIDDLE SOUTH UTILITIES, INC.

ARKANSAS—MISSOURI POWER COMPANY

File No. 3-3339. Promulgated February 1, 1972

Public Utility Holding Company Act of 1935—Sections 11(b), 11(b)(2) and 11(e)

SIMPLIFICATION OF HOLDING-COMPANY SYSTEM

Distribution of Voting Power

Where small publicly-held interest exists in common stock of public-utility subsidiary company of registered holding company, *held*, such stock interest constitutes unfair and inequitable distribution of voting power among security holders of subsidiary public-utility company contrary to requirements of Section 11(b)(2) of Public Utility Holding Company Act of 1935.

Plan Under Section 11(e)

Necessity

Plan filed under Section 11(e) of Public Utility Holding Company Act of 1935 which provides for elimination of publicly-held shares of common stock of public/utility subsidiary company of registered holding company through exchange of such shares for common shares of holding company, *held*, necessary to effectuate provisions of Section 11(b) of the Act.

Fairness and Equity

Plan filed under Section 11(e) of Public Utility Holding Company Act for exchange of shares of publicly-held common stock of subsidiary company of registered holding company for shares of common stock of holding company on a fractional share exchange basis, *held*, fair and equitable to persons affected by plan.

APPEARANCES

O. Carlysle McCandless, *Daniel James*, and *Ciro A. Gamboni*, of Cahill, Gordon, Sonnett, Reindel & Ohl, for Middle South Utilities, Inc., and Arkansas-Missouri Power Company.

R. Moshe Simon and *Thomas N. McHugh, Jr.*, for the Division of Corporate Regulation of thè Commission.

FINDINGS, AND OPINION OF THE COMMISSION

Introduction

Middle South Utilities, Inc. ("Middle South"), a registered holding company, has filed a plan pursuant to Section 11(e) of the Public Utility Holding Company Act of 1935 ("Act") providing for the issuance by Middle South of its common shares in exchange for the publicly-held shares of common stock of its public-utility subsidiary company, Arkansas-Missouri Power Company ("Ark-Mo"). We consolidated the proceeding respecting this plan with a proceeding instituted by us pursuant to Section 11(b)(2) of the Act to determine what steps are necessary to ensure that the corporate structure of Ark-Mo does not unfairly or inequitably distribute voting power among its securityholders.

Middle South owned 2,181,983 shares, or 95.2 percent, of the outstanding shares of common stock of Ark-Mo at September 16, 1971. Middle South acquired these shares through a tender offer in exchange for its own common stock.[1] The remaining 110,005 Ark-Mo shares, or 4.8 percent, are publicly held. In our Findings and Opinion approving the acquisition we stated:

> "If not all Ark-Mo shares are tendered, there will remain outstanding a publicly-held minority interest in Ark-Mo, contrary to Sections 10(c)(1) and 11(b)(2) of the Act. [footnote omitted] Middle South has agreed to eliminate such interest by submitting a plan pursuant to Section 11(e) of the Act."

The plan before us has been submitted to meet the standards of Section 11(b)(2) and the commitment made by Middle South in that proceeding.

After appropriate note,[2] a public hearing was held at which no one appeared in opposition to the plan, and post-hearing procedures were waived. On the basis of the record, we make the following findings.

THE PROPOSED PLAN

The plan provides for the issuance by Middle South of up to 77,004 common shares, par value $5 per share, in exchange for the publicly-held shares of the common stock of Ark-Mo on the basis of 0.7 shares of Middle South for each share of Ark-Mo. The exchange ratio proposed by the plan is the same as that

[1] *Middle South Utilities, Inc.*, 44 S.E.C. 546 (1971).

[2] *Middle South Utilities, Inc.*, Holding Company Act Release No. 17341 (November 2, 1971).

previously proposed by Middle South pursuant to the tender offer, which we found reasonable and fair.

The plan will become effective on the earliest practicable date ("consummation date") after the entry of an order by a District Court of the United States approving and enforcing the plan. On that date, the public holders of shares of Ark-Mo common stock will cease to have any rights as shareholders of Ark-Mo and, upon the surrender of their stock certificates, will be entitled to receive only the common shares of Middle South, any dividend payments thereon (less taxes imposed or paid in respect thereof) and any cash from the sale of fractional interests in shares of Middle South.[3] Upon the fifth anniversary of the consummation date, Middle South and Ark-Mo may, following our approval, apply to the court in which enforcement proceedings under Section 11(e) of the Act were initiated by the Commission for an order or decree finding that all reasonable efforts to locate all holders of unexchanged certificates have been taken and ordering that neither Middle South nor Ark-Mo shall have any further obligations to solicit the surrender of any unsurrendered certificates. At that time (the "expiration date"), upon demonstration by Middle South that all reasonable efforts have been made to locate said shareholders, Middle South may instruct the Exchange Agent to turn over to it any shares of common stock of Middle South and any cash or other property then held by the Exchange Agent and not claimed by stockholders entitled thereto, free from any claim of the persons for whose account such shares were held.[4]

The carrying out of the plan is subject to our approval under the Act, and to approval and enforcement of the plan by an appropriate District Court of the United States as fair and

[3] No certificates for fractional common shares of Middle South will be issued. Any holder of shares of Ark-Mo who would otherwise be entitled to a fractional Middle South share may sell such fractional share interest through an exchange agent designated by Middle South, or he may purchase through the exchange agent additional fractional interest to make up the next higher number of full shares without the payment of any commission or tax. Fractional shares will be so purchased and sold on the basis of the closing price on the New York Stock Exchange for Middle South common shares on the business day next preceding the purchase or sale.

[4] However, any holder of a certificate for common stock of Ark-Mo not surrendered prior to the expiration date, upon the surrender of such certificate to Middle South at any time within ten years following the expiration date, will be entitled to receive from Middle South a cash payment in an amount equal to the sum of (1) the fair market value of the Middle South shares on the expiration date (including any issued by way of stock splits or stock dividends) and any other securities or property (other than cash) to which such holder would have been entitled if he had surrended his certificate for Ark-Mo shares on the expiration date and (2) any cash dividends or other cash to which such holder would have been entitled if he had surrendered his certificate for Ark-Mo shares on the expiration date. No interest will accrue or be paid to any such holder on any amount payable to him.

equitable and appropriate to effectuate the provisions of Section 11 of the Act.

THE COMPANIES INVOLVED

Middle South is solely a holding company, and as of November 30, 1971, it had outstanding 38,512,149 common shares, par value $5 per share, all of which are held by the public. The common shares have sole voting rights.

The principal operating subsidiary companies of Middle South, in addition to Ark-Mo, are Arkansas Power & Light Company ("AP&L"), Louisiana Power & Light Company, Mississippi Power & Light Company, New Orleans Public Service, Inc. ("New Orleans"), and Crossett Electric Company, and are public utilities principally engaged in the production, purchase, transmission, distribution, and sale of electricity to residential, commercial, industrial, and municipal customers in eastern Arkansas, Louisiana, and Mississippi. New Orleans also distributes natural gas and operates a passenger transit system in that city. Middle South also has a wholly-owned subsidiary service company, Middle South Services, Inc.

Ark-Mo distributes electricity and natural gas at retail in northeast Arkansas and an adjoining area of southeastern Missouri. Ark-Mo's wholly-owned subsidiary company, Associated National Gas Company, is engaged in the distribution of natural gas at retail in northeast and southwest Missouri.[5] The electric service areas of the Middle South subsidiary companies and Ark-Mo are geographically contiguous and are physically interconnected through AP&L.

COMPLIANCE WITH STATUTORY STANDARDS

Before we may approve a plan filed pursuant to Section 11(e) of the Act, we must find that such plan is necessary to effectuate the provisions of Section 11(b) of the Act, and fair and equitable to the persons affected thereby. We must also find that the proposed transactions satisfy the other applicable provisions of the Act.

NECESSITY

As noted, the plan is designed to eliminate the publicly-held minority common stock interest in Ark-Mo. We have consistently held that the existence of such an interest is contrary to the standards of Section 11(b)(2) and we make the same find-

[5] As a condition to the acquisition, Middle South has agreed to dispose of all of these retail gas utility properties. *Middle South Utilities, Inc.*, 44 S.E.C. 546, 549–50 (1971).

ings here.[6] We also find that the plan for eliminating the minority stock interest in Ark-Mo is necessary to effectuate the provisions of Section 11(b) of the Act.

Fairness

The "fair and equitable" standard of Section 11(e) requires that each security-holder affected by a plan thereunder receive "the equitable equivalent of the rights surrendered."[7] A determination as to fairness requires a comparison of the various financial characteristics of the securities surrendered and received under the plan. In making such comparison, primary emphasis is given to currently effective rights to earnings and dividends rather than inchoate rights, such as rights in liquidation.[8]

Appendices A and B, attached hereto, present as of November 30, 1971, the comparative consolidated balance sheets and income statements, respectively, of Ark-Mo and its subsidiary company and of Middle South and its subsidiary companies, on a pro-forma basis, to give effect to the proposed acquisition by Middle South of the minority interest in Ark-Mo.

Table I below presents a statement of the capitalization and surplus of the companies on the same basis as indicated above:

TABLE I

(000's Omitted)

	Ark-Mo Consolidated		Middle South Consolidated Pro Forma	
	Amount	Percent	Amount	Percent
Long-term Debt	$27,367	59.0	$ 983,505	58.2
Preferred Stock and Premium	3,950	8.5	160,431	9.5
Common Equity:				
Common Stock	5,730	12.4	201,397	11.9
Capital Surplus (Paid-in)	3,533	7.6	98,330	5.8
Retained Earnings	5,807	12.5	245,309	14.6
Total	15,070	32.5	545,036	32.3
Total	$46,387	100.0	$1,688,972	100.0

We have previously found, in the light of comparative earnings, dividends and book values and various other considera-

[6] See *Eastern Utilities Associates*, 43 S.E.C. 243, 246 (1967) and cases therein cited.

[7] *Otis & Co. v. S.E.C.*, 323 U.S. 624, 639–640 (1945).

[8] *S.E.C. v. Central Illinois Securities Corp.*, 338 U.S. 96, 130 (1949).

tions, that the terms of the initial exchange offer were within the limits of fairness.[9] The more recent data do not indicate any significant alteration in these respects. Accordingly, we find the plan to be fair to the minority stockholders of Ark-Mo. The acquisition by Middle South of the remaining small minority interest will have virtually no effect upon its present shareholders, and accordingly, the plan is also fair and equitable as to them.

OTHER APPLICABLE STATUTORY PROVISIONS

The issuance by Middle South of its common shares is subject to the provisions of Section 7 of the Act. We find that the Middle South common shares satisfy the requirements of Clause (A) of Section 7(c)(1), and we do not observe any basis for adverse findings under the standards of Section 7(d) of the Act. As the issuance and sale by Middle South of its common shares will be made pursuant to a plan which we have found to be fair and equitable, competitive bidding is not necessary in the public interest or in the interest of investors or consumers, and an exception from the competitive bidding requirements of Paragraph (b) of Rule 50 will be granted.

The acquisition by Middle South of the publicly-held shares of common stock of Ark-Mo is subject to the provisions of Sections 9(a) and 10 of the Act. We made no adverse findings under Sections 10(b) or 10(c)(1) of the Act, and we find that the tendency required by Section 10(c)(2) is satisfied.

OTHER MATTERS

ACCOUNTING TREATMENT

The proposed transaction will be recorded on the books of Middle South in the same manner as described in our opinion approving the tender offer, which we found appropriate.

COURT ENFORCEMENT

As a condition precedent to its consummation, the plan provides that it be approved and ordered enforced by an appropriate District Court of the United States. As requested by Middle South, we shall apply to an appropriate court for approval and enforcement of the plan, and our order will provide that it is not to operate as authorizing or directing the consummation of the plan until such court order has been entered.

[9] Middle South Utilities, Inc., 44 S.E.C. 546, 551-53 (1971).

FEES AND EXPENSES

The plan provides that Middle South will pay the fees and expenses relating to the plan. Since the record is incomplete in respect of this matter, we shall reserve jurisdiction with respect thereto.

TAX RECITALS

Middle South and Ark-Mo have requested that any order approving the plan include appropriate tax recitals to meet the requirements of Section 1081(f) of the Internal Revenue Code of 1954. Our order of approval will contain such recitals.

CONCLUSION

Based upon the foregoing, we shall enter an order (1) directing that Middle South and Ark-Mo, pursuant to Section 11(b)(2) of the Act, take appropriate action to effectuate the elimination of the publicly-held interests in the common stock of Ark-Mo, (2) approving the plan filed pursuant to Section 11(e) of the Act, and (3) excepting the issuance and sale by Middle South of its common shares from the competitive bidding requirements of Rule 50 under the Act. We shall reserve jurisdiction with respect to the fees and expenses incurred and to be incurred in connection with the plan, and our order will provide that none of the transactions involved in the plan may be carried out until an appropriate court has entered an order approving and enforcing the plan.

By the Commission (Chairman CASEY, Commissioners OWENS, NEEDHAM, HERLONG and LOOMIS).

APPENDIX A

ARKANSAS-MISSOURI POWER COMPANY AND SUBSIDIARY (CONSOLIDATED)
MIDDLE SOUTH UTILITIES, INC. AND SUBSIDIARIES (CONSOLIDATED)

Pro forma condensed balance sheets
November 30, 1971

(000 Omitted)

	Ark-Mo Consolidated	Middle South Consolidated Pro Forma
ASSETS AND OTHER DEBTS		
Utility Plant		
At original cost:		
Electric	$50,562	$1,965,963
Natural Gas	22,792	72,415
Transit	—	22,561
Construction in Progress	3,588	300,423
Total	$76,942	$2,361,362
Less Accumulated Depreciation	22,325	499,639
Net Utility Plant	$54,617	$1,861,723
Other property and investments, at cost or less	$ 244	$ 6,304
Cost of investment in subsidiary in excess of underlying book value	$ 291	$ 291
Current assets	$ 5,944	$ 110,044
Deferred debits	$ 258	$ 1,777
Total Assets and Other Debits	$61,354	$1,980,139
LIABILITIES AND OTHER CREDITS		
Capitalization		
Common stock	$ 5,730	$ 201,397
Capital Surplus	3,533	98,330
Retained Earnings	5,807	245,309
Total Common Equity	$15,070	$ 545,036
Preferred Stock	$ 3,950	$ 160,431
Long-term Debt	$27,367	$ 983,505
Total Capitalization	$46,387	$1,688,972
Current liabilities	$13,651	$ 121,998
Deferred credits and reserves	$ 1,241	$ 156,024
Contributions in aid of construction	$ 75	$ 13,145
Total Liabilities and Equity	$61,354	$1,980,139

APPENDIX B

ARKANSAS-MISSOURI POWER COMPANY AND SUBSIDIARY (CONSOLIDATED)
MIDDLE SOUTH UTILITIES, INC. AND SUBSIDIARIES (CONSOLIDATED)

Pro Forma statement of consolidated income
Twelve months ended November 30, 1971

(000 omitted)	Ark-Mo Consolidated	Middle South Consolidated Pro Forma
Operating revenues		
Electric	$26,975	$475,380
Natural Gas	11,518	29,177
Transit	—	11,674
Total Operating Revenues	$38,493	$516,231
Operating expenses		
Operations	29,176	215,530
Maintenance	1,077	32,088
Depreciation	1,949	58,590
Income Taxes:		
Federal	830	38,200
State	81	4,308
Deferred	—	9,424
Investment Tax Credit Adjustments—Net	37	2,818
Other Taxes	1,585	42,667
Total Operating Expenses	$34,735	$403,625
Operating income	3,758	112,606
Other income and deductions (Net)	43	14,902
Total income	3,801	127,508
Interest and other charges	2,059	52,555
Net income	$ 1,742	$ 74,953
Preferred stock dividends	186	8,768
Net income for common shares	$ 1,556	$ 66,185

IN THE MATTER OF

R. DANAIS INVESTMENT CO., INC.

and

ROMEO DANAIS

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

File No. 3-2645. Promulgated February 3, 1972

Securities Exchange Act of 1934—Sections 15A(g) and 15A(h)

REGISTERED SECURITIES ASSOCIATION—REVIEW OF DISCIPLINARY PROCEEDINGS

Improper Use of Examination Questions in Preparing Applicants for Qualification Examination

In proceedings for review of disciplinary action taken by registered securities association, expulsion of member and revocation of registration of registered principal who improperly obtained copies of association's qualification examination questions for registered representatives and incorporated questions into practice quiz used in preparing member's trainees for taking examination, *sustained* as not excessive or oppressive, and review proceedings *dismissed.*

APPEARANCES:

Romeo Danais, for R. Danais Investment Co., Inc. and *pro se.*

Lloyd J. Derrickson, *Frank J. Wilson*, and *John F. Mylod, Jr.*, for the National Association of Securities Dealers, Inc.

FINDINGS, OPINIONS AND ORDER

This is an application pursuant to Section 15A(g) of the Securities Exchange Act of 1934 by R. Danais Investment Co., Inc. and Romeo Danais, its president and sole stockholder, for review of disciplinary action taken against them by the National Association of Securities Dealers, Inc. ("NASD"). The NASD found that applicants violated Article III, Section 1 of the NASD's Rules of Fair Practice[1] in that Danais improperly obtained and used examination questions from the association's qualification examination for registered representatives in preparing persons to take the examination. The NASD expelled the firm from membership in the NASD, revoked the registration of Danais as a registered representative and imposed costs of $309.28 against applicants.

Applicants have submitted a statement in support of their application for review and the NASD has submitted a brief in opposition.

The basic facts are not in dispute. Danais has been in the insurance business for about 25 years. About 1965 he decided to also engage in the business of selling shares of investment companies as a sole proprietor and subsequently formed the present corporation of which he is the sole stockholder. Around 1968 he was persuaded by another person to sponsor a training course for prospective part-time registered representatives each of whom would pay that person a fee of $500 out of commissions earned while working for applicant after they became registered.

In June 1968 Danais accompanied a group of approximately 30 trainees to the NASD's regional examination center for the purpose of having them take the Association's qualification examination, and assisted the proctor in the distribution of copies of the examination questions. While he was unobserved by the proctor, Danais took a copy of each of the two series of the examination questions which were being used. At the conclusion of the examination session, the proctor noted that the two copies were missing. He contacted Danais, who had left during the session, suggesting that one or two of the candidates may not have turned in their copies. Later that day Danais told the proctor that he had the copies and he returned them to him the next day without further explanation or discussion.

Although Danais testified that he took the examination questions in "a moment of weakness" about which he felt guilty at the time, he made copies for himself, and in September 1968, he incorporated verbatim the questions from the examinations into practice quizzes which were used in the training seminars sponsored by him. The questions taken from the examinations appeared as even-numbered questions on the

[1] Article III, Section 1 requires that a member, in the conduct of his business, shall observe "high standards of commercial honor and just and equitable principles of trade."

practice quizzes, and prior to an NASD examination session, the trainees would be given a final trial examination in which they were told to answer only those questions. Danais stopped using the quizzes in August 1969 after he was interviewed by an association investigator.

We find, as did the NASD, that applicants committed acts violative of Article III, Section 1 of the Rules of Fair Practice and that such acts were inconsistent with just and equitable principles of trade. Danais is not aided by his testimony that it has been his experience in the insurance business that "there is always somebody that gets hold of a set of examinations somewhere," that he himself had refused a set of examination questions and answers offered to him before he took his own NASD qualifying examination, that he did not tell his trainees that the practice quiz incorporated actual examination questions, and that such quiz was only a part of a thorough training program. These assertions cannot serve to mitigate the seriousness of the violation.

In their statement in support of their application, applicants, apparently acquiescing in the penalty of revocation imposed against Danais, contend that expulsion of the firm will cause severe financial loss. They state that Danais borrowed money to meet the expenses of the 1968 expansion program for the training of registered representatives, that sales by such representatives have not yet produced enough income to repay such loan, and that if the firm is permitted to operate, its assets would be sold to Danais' son and the proceeds used to repay the loan involved, and applicant Danais would sever all relations with the member. In addition, Danais asserted before the NASD that expulsion would result in severe injury to his companion insurance business.

We have previously held that:

> In view of the vital importance of examinations in the program of upgrading the level of competence in the securities business, we regard a deception in connection with the taking of those examinations . . . to be so grave that we would not find the extreme sanction of revocation or expulsion to be excessive or oppressive unless the most extraordinary mitigative facts were shown.[2]

We have carefully considered the facts alleged by Danais to be in mitigation of the violation and have considered the hardship which he claims will result from the expulsion of the member. We are unable to find that extraordinary mitigative

[2] *Hugh M Casper*, 42 S.E.C. 471 (1964).

facts have been shown, and cannot hold, having due regard to the public interest, that the sanction of revocation and expulsion is excessive or oppressive.

Accordingly, IT IS ORDERED that the proceedings for review of the disciplinary action taken by the National Association of Securities Dealers, Inc. against R. Danais Investment Co., Inc. and Romeo Danais be, and they hereby are, dismissed.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM, HERLONG and LOOMIS).

IN THE MATTER OF

TRANSMITTAL SECURITIES CORPORATION

LEO L. CONSTON

ALFRED BENEDICT

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

File No. 3–2430. Promulgated February 3, 1972

Securities Exchange Act of 1934—Sections 15A(g) and 15A(h)

REGISTERED SECURITIES ASSOCIATION—REVIEW OF DISCIPLINARY PROCEEDINGS

Violations of Rules of Fair Practice

Where member of registered securities association obtained secret profits in transactions for customers, and failed to keep certain required records or establish written supervisory procedures, in violation of association's rules of fair practice, association's censure and suspension of member and registered principal and assessment of fine *sustained.*

Where evidence as to capacity in which member of registered securities association acted in handling customers' purchases of mutual fund shares consisted of testimony that selling group agreements with distributors of shares assertedly required confirmation to customers as principal and that member considered it acted as agent, *held,* association's finding that member and its registered principal violated association's rules of fair practice by confirming as agent *set aside.*

APPEARANCES:

Alvin C. Martin and *Mark Alan Siegel,* of Zissu, Halper & Martin, for applicants.

Lloyd J. Derrickson, Frank J. Wilson, and *John F. Mylod,* for the National Association of Securities Dealers, Inc.

FINDINGS, OPINION AND ORDER

This is an application pursuant to Section 15A(g) of the Securities Exchange Act of 1934 by Transmittal Securities Corporation, a member of the National Association of Securities Dealers, Inc. ("NASD"), and Alfred Benedict, vice-president and a registered principal of the member, for review of disciplinary action taken against them by the NASD.[1]

The NASD found that at various times between November 1964 and December 1965 the member and Benedict ("applicants") violated (a) Sections 1, 12 and 18 of Article III of the NASD's Rules of Fair Practice in that secret profits of ⅛ or ¼ of a point and totaling $1,877 were taken in 91 purchases and sales of securities for customers; (b) Sections 1 and 12 of Article III in that eight sales of mutual fund shares were confirmed to customers as agent when in fact the member acted as principal; (c) Sections 1 and 21(a) and (b) of Article III in that, in contravention of record-keeping requirements, the member's order tickets failed to record the time of entry of brokerage orders, memoranda pertaining to cancelled orders were not maintained, a personnel record was not kept for its cashier, and required information was not included in the member's customer account records; and (d) Sections 1 and 27(a) of Article III in that written supervisory procedures were not established or maintained.[2] The NASD suspended the firm's membership and Benedict's registration for 30 days, censured them, and jointly and severally fined them $10,000 and assessed costs of $543. Briefs were filed with us by applicants and the NASD, and we heard oral argument. Our findings are based upon a review of the record made before the NASD.

Applicants do not dispute the NASD's findings of violations. Our examination of the record, however, discloses insufficient support for its finding of violations with respect to the confirmations of the transactions in mutual fund shares. This determination was based on testimony that the terms of the selling agreements between the member and the fund underwriters assertedly required confirmation to the customers as principal. However, as we have held,[3] such agreements govern the legal relationship between the broker-dealer and the underwriter but not between the broker-dealer and the customer. The only

[1] Because of the death of Leo L. Conston, a co-applicant in these review proceedings, who was president of the member, the NASD indicated that it was abandoning the complaint against him. Accordingly, the disciplinary action taken with respect to him will be set aside.

[2] Section 1 of Article III requires the observance of high standards of commercial honor and just and equitable principles of trade. Section 12 requires that the customer be notified in writing of the capacity in which the member is acting in each transaction, and, if acting as a broker, of the source and amount of any commission or other remuneration received in connection with the transaction. Section 18 prohibits the use of fraudulent devices in effecting transactions. Sections 21(a) and (b) require that books and records be maintained in compliance with applicable regulations and that certain information be shown on customer accounts. Section 27(a) requires that written supervisory procedures be maintained.

[3] *First Multifund of America, Inc.*, 44 S.E.C. 678 (1971).

other evidence presented respecting the capacity in which the member acted was the testimony of the firm's cashier that it was thought that the firm was acting as an agent for customers with respect to the above-mentioned sales. On the record before us we are unable to find that those confirmations were improper, and we accordingly set aside the NASD's finding of violations in this respect. As to the other violations, we conclude as did the NASD that applicants violated Sections 1, 12, 21(a) and (b) and 27(a) of Article III, and that their conduct was inconsistent with just and equitable principles of trade.

Applicants contend that the sanctions imposed by the NASD are excessive and should be reduced. With respect to the secret profits taken, which were the principal basis for those sanctions, applicants assert that such profits resulted from a misunderstanding of proper procedures, and not from an intent to defraud customers, because Benedict, as well as the firm's president, was an immigrant and had difficulties with the English language. They stress that their practice was to confirm purchases and sales for customers at the transaction price specified by the customers regardless of the actual price at which the transaction was effected and whether it entailed a profit or a loss to the member. They state that the undisclosed profits of $1,877 were realized in 91 out of about 1,200 transactions checked by the NASD, and that the total of such profits and the commissions charged in those transactions exceeded the minimum commission rates which would have been applicable to comparable transactions effected on the New York Stock Exchange by $1,452, and by a net amount of only $490 if losses sustained in 26 other transactions were deducted.[4]

We note that at the start of the period during which the violations occurred, Benedict had been a registered principal for over 4 years, and the member's president had been so registered for over 10. Benedict and the member must be charged with knowledge of applicable requirements. Moreover, notwithstanding any language difficulty, Benedict should have been aware of the obligation to give the customer the benefit of the best price.[5] It is clear that this obligation was breached in the 91 transactions in question and that the gravity of the offense of taking secret profits is not materially affected by the

[4] It appears that those transactions which involved listed securities were effected in the third market.

[5] *Cf. Thomas Brown III*, 43 S.E.C. 285, 287 (1967).

member's willingness, for whatever motive, to reduce its remuneration in 26 other transactions or by relating the overall remuneration to exchange commission rates.

In further mitigation, applicants note that the NASD accepted their claim that they did not deliberately defraud their customers, and at oral argument before us counsel for applicants expressed a willingness on the part of his clients to make restitution. They also assert that the improper procedures have been corrected and are not likely to recur, and that the $10,000 fine would have the effect of expulsion, which they argue is only proper where violations can be expected to recur. In the latter connection they state that the record before the District Committee showed that the fine would place the member in a negative net capital position as of the time of those hearings in 1969. However, while the lack of an intent to defraud could be considered a favorable factor in mitigation of the secret profits violations, we attach little if any weight to the belated expression of willingness to make restitution to the defrauded customers. Our setting aside of the violations with respect to the confirmations in the eight mutual fund share transactions, although entitled to some weight in mitigation, is more than offset by the previous violations of applicants found by the NASD and this Commission.[6] Those violations, together with the ones found herein by the NASD, reflect an inability to discharge their applicants' responsibilities if not an indifference to such responsibilities for compliance with applicable requirements. In November 1963, the member and its president were censured and fined $1,000 jointly and severally by the NASD for violations by the member of, among other things, credit and net capital requirements.[7] In 1969, pursuant to an offer of settlement, we found that in 1968 the member, aided and abetted by Benedict, willfully violated the recordkeeping, financial reporting, hypothecation, and credit requirements and failed to exercise reasonable supervision. The member was suspended from operations for 30 business days, and Benedict was suspended from association with a broker-dealer for 15 business days.[8] We also note that the member had not prepared written supervisory procedures 17 months after the filing of the NASD's complaint which specifically charged that the failure to do so was a violation of the Rules of Fair

[6] Prior disciplinary action against a respondent may be considered in imposing sanctions in the public interest. *R. H. Johnson & Company* v. *S.E.C.*, 198 F.2d 690 (C.A. 2, 1952), *aff'd* 33 S.E.C. 180 (1952), *cert. denied* 344 U.S. 855.

[7] Complaint NY-805, District Business Conduct Committee for District No. 12 (November 8, 1963).

[8] Securities Exchange Act Release No. 8534 (February 25, 1969).

Practice. And even assuming that the member's net capital position in 1969 is relevant in determining whether the fine is excessive, no basis appears for the assertion that payment of the fine, which is imposed on Benedict as well as the member, would put the member out of business.[9]

Applicants also argue that in other cases involving fraud violations, we reduced the sanctions imposed by the NASD. We have repeatedly held and the courts have confirmed that the remedial action which is appropriate depends upon the facts and circumstances of each particular case and cannot be precisely determined by comparison with action taken in other cases.[10] Moreover, we note that the reductions in the sanction in the cases cited to us by applicants were predicated in part on our setting aside of significant violations found by the NASD, or on the limited extent of the violations, or on mitigative facts not present here.

Under all the circumstances and with due regard to the public interest, we conclude that the sanctions imposed upon applicants by the NASD should be sustained.

Accordingly, IT IS ORDERED that the proceedings for review be, and they hereby are, dismissed as to Transmittal Securities Corporation and Alfred Benedict, and that the sanctions and costs imposed upon Leo L. Conston be, and they hereby are, set aside.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM, HERLONG, and LOOMIS).

[9] Section 1 of Article V of the NASD Rules of Fair Practice provides that a fine of up to $5,000 may be imposed for each violation found.

[10] See, *e.g.*, *Haight & Co., Inc.*, 44 S.E.C. 479, 510–11 (1971), *aff'd* without opinion, C.A.D.C., Nos. 23,244, 23,246 and 71-1136 (June 30, 1971), *cert denied* 404 U.S. 1058 (1972); *Hiller* v. *S.E.C.*, 429 F.2d 856 (C.A. 2, 1970); *Dlugash* v. *S.E.C.*, 373 F.2d 107, 110 (C.A. 2, 1967).

IN THE MATTER OF

WINFIELD & CO., INC. ET AL.*

File No. 3-2249. Promulgated February 9, 1972

Securities Exchange Act of 1934—Sections 15(b),15A and 19(a)(3)

Investment Advisers Act of 1940—Section 203

BROKER-DEALER AND INVESTMENT ADVISER PROCEEDINGS

Grounds for Remedial Action

Receipt of Benefits by Affiliates in Connection with Investment Company Portfolio Transactions

Improper Valuation of and Inadequate Investigation Respecting Restricted Securities

Deviation from Fundamental Investment Policy

Service as Investment Adviser Pursuant to Contract Not Describing All Compensation

* Winfield Distributors, Inc.; David H. Meid; Robert R. Hagopian; Henry L. Jamieson; Meyerson & Co., Inc.; Winfield Underwriters, Inc.; Harry Meyerson; Dean Russell Burwell.

Inaccurate Records and Financial Report

Where investment company's investment adviser and adviser's controlling persons who were also directors and/or officers of investment company entered into arrangement with broker-dealer under which brokerage commissions on company's portfolio transactions were directed to broker-dealer in return for direct and indirect benefits provided to adviser and its principals, and caused company to purchase restricted securities without making reasonable investigation and to value such securities improperly, and to purchase, without shareholder authorization, larger percentage of one issuer's securities than permitted by its fundamental policies; adviser served as investment adviser pursuant to contract which did not describe all compensation to be paid thereunder; and investment company's and broker-dealer's records and latter's report of financial condition were inaccurate, *held*, willful violations of antifraud and other provisions of securities acts, including Sections 2(a)(39), 13(a), 15(a), 17(e)(1), 22(d) and 22(e) of Investment Company Act, and, under all the circumstances, appropriate in the public interest to accept offers of settlement providing for imposition of remedial sanctions.

APPEARANCES:

Theodore Altman, for the Division of Corporate Regulation of the Commission.

Fred C. Aldridge, Jr. and *Philip J. Fina*, of Stradley, Ronon, Stevens & Young, for Winfield & Co., Inc., Winfield Distributors, Inc., and Henry L. Jamieson.

Eugene P. Souther, of Seward & Kissel, for David H. Meid.

Fred W. Drogula, of Ginsburg, Feldman and Bress, for Robert R. Hagopian.

George A. Blackstone and *Weyman I. Lundguist*, of Heller, Ehrman, White & McAuliffe, for Meyerson & Co., Inc., Harry Meyerson, Dean Russell Burwell and Winfield Underwriters, Inc.

FINDINGS AND OPINION OF THE COMMISSION

In these proceedings pursuant to Sections 15(b), 15A and 19(a)(3) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203 of the Investment Advisers Act of 1940 ("Advisers Act"), we heretofore accepted offers of settlement submitted by the above-captioned respondents. Pursuant to such offers, in which the respondents, without admitting the allegations in the order for proceedings, consented to certain findings and sanctions, orders were issued finding violations and failure of supervision as alleged and imposing the specified sanctions. One order dealt with Meyerson & Co., Inc., a registered broker-dealer and former member of the New York Stock Exchange and other national securities exchanges; Winfield Underwriters, Inc. ("Underwriters"), a registered broker-dealer which is a whollyowned subsidiary of Meyerson & Co., and Harry Meyerson and Dean Russell Burwell, who at relevant times were officers, directors and principal stockholders of Meyerson & Co. and directors (and Burwell president) of Underwriters.[1] A second order dealt with Winfield & Co., Inc. ("Adviser"), a registered investment adviser which acts as investment adviser to Winfield Growth Fund, Inc. ("Fund"), a registered open-end investment company; Winfield Distributors, Inc. ("Distributors"), a registered broker-dealer and wholly-owned subsidiary of Adviser; and David H. Meid, Robert R. Hagopian and Henry L. Jamieson, who at relevant times were officers, directors and principal stockholders of Adviser and officers or directors of the Fund and Distributors.[2] The

[1] Securities Exchange Act Release No. 8945 (July 28, 1970).

[2] Securities Exchange Act Release No. 8980 (September 16, 1970).

sanctions imposed included suspensions, ranging variously from 30 days to 9 months, of Adviser's registration as an investment adviser and Distributors' registration as a broker-dealer, and of Hagopian, Meid, Jamieson, Burwell and Meyerson from association with any broker, dealer, registered investment company or registered investment adviser, and a bar of Meyerson from supervisory activities.

We now issue our detailed findings and opinion with respect to the issues presented in these proceedings, which essentially relate to or arise out of transactions in portfolio securities of the Fund during the period beginning in October 1966.[3]

Arrangements for Return of Portfolio Brokerage Commissions to Adviser and its Principals

In September 1966, Meid, Hagopian and Jamieson together acquired a controlling interest in Adviser. At that time, Distributors, the sponsor-distributor of Winfield Investment Programs, a unit investment trust investing solely in shares of the Fund, was also the Fund's principal underwriter. Adviser and its principals ("the Adviser respondents"), pursuant to an agreement with Burwell, immediately began allocating commissions on Fund portfolio transactions ("brokerage commissions") to Meyerson & Co., both by designating that firm as executing broker for such transactions and by directing "give-ups" to it on transactions executed by others, and to arrange for the sale to that firm of the Fund's underwriter, to be represented by a new corporate vehicle. In February 1967, they organized Underwriters for this purpose, and in June 1967 Adviser sold Underwriters to Meyerson & Co. for $25,000. In fact, however, the Adviser respondents retained control of Underwriters, and the transaction was part of a scheme to divert large amounts of Fund brokerage commissions for their own benefit.[4]

[3] Respondents consented that we could base findings on material contained in our public files and obtained by our staff in the investigation of the matters involved herein.

[4] This was not the first instance of such use of Fund brokerage commissions. In early 1966, when Meid was an employee of Adviser and was acquiring increasing influence over the direction of the Fund's portfolio transactions, he and Hagopian had decided to purchase control of Adviser with the assistance of Jamieson, who is Hagopian's father-in-law. Hagopian had then obtained employment with a broker-dealer after arranging with Meid that the latter would channel Fund portfolio transactions to that broker-dealer. During the approximately eight months that Hagopian was employed by the broker-dealer, Meid directed a total of $129,000 in brokerage commissions, representing more than half of such commissions generated by the Fund, to that firm. Out of this amount, Hagopian received approximately $40,000 after expenses. Hagopian's activities during this period were devoted to the promotion and sale of Fund shares. He played no role in the execution of portfolio transactions, and the Fund was essentially his only customer. Shortly after Hagopian left the broker-dealer to join Adviser, the allocation of Fund brokerage transactions and commissions to the broker-dealer ceased.

In 1967 and 1968, Adviser directed almost $2,250,00 of Fund brokerage commissions, representing about 33 percent of the total commissions generated by the Fund, to Meyerson & Co.[5] Whenever possible, Meid, who placed the Fund's portfolio transactions, placed orders directly with Meyerson & Co. In addition, he directed other New York Stock Exchange members who executed Fund portfolio transactions to give up part of their commissions to Meyerson & Co. Adviser respondents also directed commissions derived from transactions of other clients to Meyerson & Co. Thus, the Meyerson firm was designated as broker for a significant number of Adviser's privately-advised accounts, and give-ups were directed to it through a broker who executed transactions for an off-shore fund account of Adviser.

As noted above, a large amount of Fund brokerage commissions found its way back from Meyerson & Co. to the Adviser respondents, largely through the vehicle of Underwriters. Notwithstanding the sale of that company to Meyerson & Co., Hagopian, who had established the underwriting organization, continued to exercise full direction over its activities, including all advertising and other promotional activities. Underwriters had no full-time employees. Its offices were contiguous to those of Adviser and were occupied by personnel of Adviser who performed substantailly all underwriting-related administative and managerial tasks. In 1967 and 1968, Meyerson & Co. paid some $2 million to or for the benefit of the Adviser respondents, including direct payments to Adviser for a portion of its rent and salary expenses, and amounts totalling about $1.8 million paid on behalf of Underwriters for various expenses incurred by or in accordance with the directions of Hagopian or other Adviser personnel.[6] When allocations of brokerage commissions to Meyerson & Co. decreased following the ban on customer-directed give-ups in December 1968, the payments by that firm to or for the benefit of the Adviser respondents also decreased. For example, at the end of 1968 it ceased paying the portion of Adviser's salary and rent expense which it had been paying.

[5] This income accounted for about 30 percent of Meyerson & Co.'s gross revenues during those two years.

[6] The amounts thus paid by Meyerson & Co. far exceeded commissions retained by Underwriters on the sale of Fund shares. Simultaneously with the transfer of Underwriters to Meyerson & Co., the dealer allowance had been raised from 7 percent to 8¼ percent, out of the maximum sales load of 8½ percent. The remaining ¼ of 1 percent produced commissions for Underwriters of only about $545,000 during the two-year period ended June 30, 1969.

The Adviser respondents deried additional compensation from Fund brokerage commissions through other arrangements and transactions with Meyerson & Co. Thus, from November 1966 on, after alocations of brokerage commissions to Meyerson & Co. had reached a level exceeding $5,000 per month, it made monthly payments to Adviser for research services, amounting at first to $5,000 and later to $6,000 and totalling $142,000 through 1968. The services were furnished at weekly meetings of approximately one hour's duration and consisted largely of oral presentations by Meid or another officer of Adviser. We note that an individual not associated with Adviser or Meyerson & Co. paid Adviser only $100 a month for the privilege of attending these meetings. In April 1968 Meyerson & Co. purchased from Jamieson and others a school teaching "cram courses" for qualifying examinations given by the National Association of Securities Dealers, Inc. Although the school had virtually no book value and no history of earnings, Meyerson & Co. paid $23,463. In addition, it agreed to pay Jamieson $85,000 out of the net profits of the school. However, even though Meyerson & Co. did not maintain separate records for the school and was therefore unable to determine whether the school was operating at a profit, it commenced payments to Jamieson on the basis of a percentage of each student's tuition.

Meid, Hagopian, and Jamieson, as officers of the Fund and as persons responsible for directing the execution of its portfolio transactions, and Adviser, by virtue of its position as investment adviser, were fiduciaries of the Fund. As such, they were under a duty to act solely in the best interests of the Fund and its shareholders.[7] However, in violation of that duty, they entered into arrangements designed to further their own interests and to obtain benefits for themselves in the form of rebates of a portion of the commissions generated by the execution of Fund portfolio transactions. Moreover, they committed themselves and the Fund, for their personal benefit, to a relationship with Meyerson & Co. which did not permit them to retain the freedom of judgment and action in selecting broker-dealers to execute Fund portfolio transactions that as managers they owned to the Fund.[8]

Meyerson & Co. and its principals and Underwriters ("the Meyerson respondents") knowingly participated in and were

[7] See *Provident Management Corporation*, 44 S.E.C. 440, 445 (1970), and cases cited there.

[8] See *Provident Management Corporation*, *supra*, at p. 446.

an integral element of the unlawful rebate arrangements which, as found above, violated the Adviser respondents' fiduciary obligation to the Fund and its shareholders.

Accordingly, we conclude that the Adviser respondents and Distributors engaged in a scheme to defraud and in a practice which operated as a fraud upon the Fund and its shareholders, and that thereby they willfully violated, or willfully aided and abetted violations, of the antifraud provisions of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Exchange Act and Rule 10b–5 thereunder, and Sections 206(1) and 206(2) of the Advisers Act. We further conclude that the Meyerson respondents willfully violated or willfully aided and abetted violations of those provisions.

we further find that by engaging in the conduct described above, the Adviser respondents willfully violated Section 17(e)(1) of the Investment Company Act of 1940, and the Meyerson respondents willfully aided and abetted such violations.[9] As pertinent, here, that section makes it unlawful for any affiliated person of a registered investment company "acting as agent, to accept from *any source* any compensation . . . for the purchase or sale of any property to or for such registered investment company . . . except in the course of such person's business as an underwriter or broker." [Emphasis added]. The Adviser respondents, who were affiliated persons of the Fund, were acting as its agents in placing orders for the purchase and sale of its portfolio securities and the exceptions provided in the section were not applicable. They were not engaged in the brokerage business and did not in fact perform any brokerage services in connection with the execution of the Fund's portfolio transactions.[10] Although many of the activities of these respondnets, especially Hagopian, were related to the promotion and underwriting of Fund shares, the benefits received by them were not received in the course of an underwriting business but were in the nature of compensation for the allocation of brokerage commissions to Meyerson & Co. In light of the objective of Section 17(e) "to prevent affiliated persons from having their judgment and fidelity impaired by conflicts of interest,"[11] it is evident that

[9] See *Provident Management Corporation*, *supra*, at p. 447.

[10] See *Provident Management Corp.*, *supra* at p. 447. Our recent decision in *First Multifund of America, Inc.*, 44 S.E.C. 678 (1971) is not to the contrary. In that case we found that the adviser of an open-end investment company which invested solely in the shares of other open-end companies acted as broker in effecting portfolio purchases and was entitled to receive concessions of up to 1 percent from the principal underwriters of such shares under the provisions of Section 17(e) (2) of the Act.

[11] *U.S.* v. *Deutsch*, 451 F.2d 98 (C.A. 2, 1971), *cert. denied* 404 U.S. 1019 (1972).

the acceptance of compensation pursuant to an arrangement which, as indicated, carried with it an inherent conflict of interest between the Adviser respondents and the Fund, fell within its prohibition.

PURCHASE AND VALUATION OF RESTRICTED SECURITIES

Additional violations by Adviser, Meid and Jamieson occurred in connection with the Fund's purchases, during the period beginning July 1, 1967, of "restricted" securities, i.e., securities that canot be offered for public sale without first being registered under the Securities Act.

From July 1, 1967 to December 31, 1968, the Fund purchased restricted securities of 12 different issuers at a total cost of $21,497,960. The record shows that proper valuation procedures were not followed with respect to such securities. Section 2(a)(39)) (now 2(a)(41)) of the Investment Company Act and Rule 2a-4 thereunder require that in determining net asset value, "securities for which market quotations are readily available" must be valued at current market value while other securities and assets must be valued at "fair value as determined in good faith by the board of directors." For valuation purposes, restricted securities constitute securities for which market quotations are not readily available and their value must therefore be determined by the directors.

Notwithstanding that requirement, the Fund's board of directors never considered the matter of valuing restricted securities prior to September 1968. Up to that point, Meid alone determined such valuation. At first he generally valued them at the market price of unrestricted securities of the same class, if any, and later he applied a uniform 10 percent discount to such price. In Septemer 1968, when restricted securities represented about 10 percent of the Fund's total net asset value of $180 million, the board ratified the valuation of securities in the portfolio at June 30, 1968 as "representing fair market value as determined in good faith." With respect to future valuations, the board considered the possibility of giving separate consideration to each restricted security but rejected it after Meid represented that such procedure would create a time-consuming administrative burden. Instead, the board concluded that in view of current market conditions a 12 percent discount should be applied in valuing restricted securities, unless an "unusual security" was involved. However, there was no discussion at subsequent board meetings as to whether any securities fell into this category. Indeed, the record indicates that further acquisitions of restricted securities were not thereafter brought to the board's attention.

It is evident that proper valuation of portfolio securities by an investment company is of critical importance. Such valuation largely determines the price at which shares of the company are sold and redeemed and the compensation of the investment adviser where, as here, such compensation is based on net assets. Moreover, investors may be misled by the reported performance of an investment company where portfolio securities are not properly valued.

Adviser and Meid caused the Fund's board to fail to comply with its obligation to determine the fair value of each issue of restricted securities. The valuations that were made by Meid, and subsequently by the board, were clearly improper.[12] Moreover, because the restricted securities were purchased at substantial discounts from the market prices for unrestricted securities, the inflated valuations created an appearance of "instant performance," particularly in those instances where such market price increased between the date on which the Fund made its commitment to purchase and the date on which the securities were first included in the Fund's portfolio for pricing purposes.[13]

Moreover, in causing the Fund to purchase restricted securities, Adviser and Meid failed to make reasonable investigations to obtain pertient information concerning such securities. The record shows that in many cases Meid relied on unsubstantiated representations of other persons, described by him as "research sources," and that such persons frequently had a substantial economic interest in the offering or the issuer of such securities. Adviser and Meid had an obligation to make a reasonable investigation before causing the Fund to purchase any securities.[14] With reference to restricted securities, that obligation would necessarily encompass a thorough inquiry into factors which are of special relevance to such securities, including factors pertinent to the legal restrictions concerning a subsequent resale of the securities. Here Adviser

[12] See Investment Company Act Release No. 5847 (October 21, 1969); *Mates Financial Services*, 44 S.E.C. 245 1970).

[13] For example, while the restricted securities purchased between July 1, 1967 and December 31, 1968 had an aggregate cost of $21,497,960, they were assigned a value of $28,223,375 as of the days on which each was first included in the portfolio.

[14] *Cf.* Securities Act Release No. 4445 (February 2, 1962) and cases cited there, with respect to the duty of a broker-dealer to make reasonable investigation before recommending a security. The obligation of a broker-dealer in this area arises under the antifraud provisions of the federal securities laws. Those provisions are, of course, applicable as well to an Investment Company Act. *Cf. Brown* v. *Bullock*, 294 F.2d 415 (C.A. 2, 1961).

and Meid failed to make the necessary inquiries. For example, in one instance they failed to discover that there was a restrictive covenant prohibiting transfer of the securities which the Fund had agreed to purchase. As a result, the Fund did not actually acquire those securities until some months after they had been included in its portfolio for pricing purposes and then only after protracted negotiations and a settlement.

We conclude that by engaging in the conduct described above, Adviser, Meid and Jamieson, who as president and a director of the Fund and board chairman of Adviser had a duty to assure that proper practices were followed in the acquisition and valuation of restricted securities, willfully violated or willfully aided and abetted violations of the antifraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b–5 thereunder and Sections 206(1) and 206(2) of the Investment Advisers Act, and of Sections 2(a)(39), 22(d) and 22(e) of the Investment Company Act and Rule 2a–4 thereunder.[15]

OTHER VIOLATIONS

1. Although it was a stated "fundational policy" of the Fund to limit acquisitions of any class of securities of any one issuer to 10 percent in January 1968 Meid caused the Fund to purchase restricted securities of one issuer amounting to about 12 percent of that company's common stock. By thus causing the Fund to deviate from its policy without the shareholder authorization required for such action under Section 13(a) of the Investment Company Act, Adviser, Meid and Jamieson willfully aided and abetted a violation of that Section.

2. During the period after October 1, 1966, Adviser, willfully aided and abetted by Meid, Hagopian and Jamieson, willfully violated Section 15(a) of the Investment Company Act in that Adviser served as investment adviser of the Fund pursuant to a written contract which failed to describe precisely all compensation to be paid thereunder. The contracts which were in effect during the period under consideration failed to describe the return of brokerage commissions to those respondents

[15] Sections 22(d) and 22(e) of the Investment Company Act, which deal respectively with sales and redemptions of their shares by investment companies, are both predicated on net asset value properly determined.

under the arrangements with Meyerson & Co. or the extent to which the advisory fees, which under the contracts were based on net asset value of the Fund, had been inflated as a result of the improper valuation of restricted securities.

3. The books and records concerning allocation of orders for portfolio transactions maintained for the Fund by the Adviser respondents were inaccurate and inadequate. Among other things, the Fund's records falsely showed "research" as the reason for allocating orders to Meyerson & Co. The records either gave no reason or contained the designation "special" as the reason for allocating orders to a number of other brokers who provided services to the Adviser respondents or the Fund, or paid give-ups to Meyerson & Co. No one connected with the Fund was able to explain the exact meaning of "special." Thus, the Adviser respondents willfully aided and abetted violations of Section 31(a) of the Investment Company Act and Rule 31a-1(b)(9) thereunder in that they caused the Fund to make and maintain records which did not reflect the actual basis for allocating orders for the purchase and sale of portfolio securities.

4. The Meyerson respondents willfully violated or willfully aided and abetted violations of Section 17(a) of the Exchange Act and Rules 17a-3 and 17a-5 thereunder. Books and records maintained by Meyerson & Co. and Underwriters did not accurately reflect accounts payable and accrued expenses, and a report of financial condition as of August 31, 1968 filed by Meyerson & Co. understated those items.

In determining to accept the offers of settlement submitted by the respondents, we took into account, among other things, the fact that Adviser agreed to pay to the Fund $270,000 in mitigation of any damages which the Fund may have suffered as a result of the matters alleged in the order for proceedings, in addition to benefits in the amount of $350,000 which it was providing to the Fund pursuant to a court order approving the settlement of private litigation. We also considered its undertaking to formulate and adopt written standards with respect to information to be obtained and considered by its portfolio managers in connection with decisions to acquire restricted securities. With respect to the Meyerson respondents, we gave consideration to the fact that Meyerson & Co. and Underwriters were being liquidated,[16] and that in civil proceedings

[16] In April 1970 Distributors again became principal underwriter for the Fund.

instituted by us Meyerson & Co. agreed to consent to a permanent injunction against certain violations of antifraud provisions.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM, HERLONG, and LOOMIS).

In the Matter of

FOUR SEASONS NURSING CENTERS OF AMERICA, INC.
FOUR SEASONS OVERSEAS, N.V.
EMBASSY CONSTRUCTION COMPANY, INC.
NATIONAL MEDICAL SUPPLY, INC.
FOUR SEASONS FRANCHISE CENTERS, INC.
FOUR SEASONS EQUITY CORPORATION
FSN CORPORATION

Debtors

Promulgated March 16, 1972

ADVISORY REPORT ON PROPOSED PLANS OF REORGANIZATION

This advisory report is submitted pursuant to Section 173 of Chapter X (11 U.S.C. 573) with respect to the second amended plan of reorganization involving seven debtor corporations. The two primary debtors are Four Seasons Nursing Centers of America, Inc. ("America") and Four Seasons Equity Corporation ("Equity").

The outstanding common stocks of America and of Equity are publicly held. Three of the other debtors are subsidiaries of America, which owns all of their common stocks.[1] America owns 80 percent of the common stock of Four Seasons Franchise Centers, Inc. ("Franchise"), a debtor herein; Equity owns the remaining 20 percent. Equity owns 70 percent of the common stock of FSN Corporation ("FSN"), also a debtor herein; America owns the remaining 30 percent. The reorganization proceedings encompass also many partnerships in which America and Equity are presently the sole partners.

The voluntary Chapter X petition of America was filed on June 26, 1970, that of Equity was filed on July 22, 1970. The petitions of the subsidiaries followed those of the parent com-

[1] These companies are: Four Seasons Overseas, N.V. ("Overseas"); National Medical Supply, Inc. ("Medical"); Embassy Construction Company, Inc. ("Embassy").

panies.[2] After the resignation of the original trustee, James R. Tolbert, III was appointed successor trustee on February 9, 1971, and has been serving in that capacity for all debtors.

The initial plan was filed by the trustee on September 28, 1971, and was subsequently amended. Hearings were held on November 1 through 4, 1971, and the second amended plan was filed on November 15, 1971. On the latter date the Court referred this plan to the Commission for examination and report pursuant to Section 172 of Chapter X (11 U.S.C. 572).

In the opinion of the Commission the plan, including settlements therein incorporated, would be fair and equitable and satisfy other requirements of Chapter X if amended in certain respects. The plan is feasible.

I. THE DEBTORS AND AFFILIATED ENTITIES

AMERICA

America, a Delaware corporation, was organized on September 11, 1967, to engage in the development, construction and management of nursing centers throughout the United States. Upon organization, it acquired the interests in 12 of such enterprises owned by Jack L. Clark, Amos D. Bouse and Tom J. Gray, who, since 1963, had been associated in the construction and operation of nursing centers. At the time of this acquisition, 5 nursing homes were in operation and 2 under construction.

In exchange for their interests, having an original cost of $53,522, these individuals received 864,000 shares of America common stock,[3] with an underlying book value of about $500,000. Walston & Co., Inc. ("Walston") purchased 36,000 common shares for $45,000, and, pursuant to agreement, privately sold for $1 million 100,000 shares of 6 percent convertible preferred stock, half of which was taken by Montgomery & Company, a partnership consisting of certain officers and stockholders of Walston. The preferred stock was converted into 300,000 shares of common prior to the second public offering of America common stock. The original stockholders thus owned a total of 1,200,000 shares of America common stock.

A Vice-President of Walston, together with Clark, Gray, Bouse and America's general counsel, became the initial directors of America. These persons remained the directors of

[2] The petitions of the subsidiaries were filed as follows: Overseas, July 7, 1970; Medical and Embassy, July 29, 1970; Franchise, August 12, 1970; FSN, October 30, 1970.

[3] All shares of America, noted herein, have been adjusted for a 3 for 1 split prior to the first public offering on May 9, 1968.

America until shortly before the Chapter X proceeding. Walston acted as underwriter for America and Equity. It was also a co-underwriter for Overseas.

On May 9, 1968 America made its first public offering of 300,000 shares of common stock at $11 a share. About six months later, on November 26, 1968, it sold an additional 100,000 common shares at $58.50 per share.[4] Net proceeds from these offerings, after commissions, totaled $8,536,000. Included in the sales to the public were secondary offerings of 557–800 shares by the original stockholders. Net proceeds to them, after commissions, totaled $27,986,200.

The public financing enabled America to initiate an extensive program for the construction of nursing centers, each of which generally was separately incorporated. The design for these centers was developed and standardized by America. The first design was for a one-story structure (about 100-bed capacity) but the later centers were predominantly 2-story buildings (about 200-bed capacity). In most cases the nursing centers, when completed, were under America's management pursuant to long-term contracts. A few early contracts provided for a fixed monthly fee but later contracts provided for a fee based on a percentage of revenues.

As indicated in the prospectus of November 26, 1968, America was then managing 14 completed centers. It had nine under construction and had contracted for seven more. It had also taken preliminary steps to develop an additional 20.

Prior to the organization of Equity in November 1968, America had hoped and tried to sell to local investors, usually physicians, the stock equity in the centers it or its predecessors had built. Such stock equity normally represented about 10 percent to 15 percent of the total price, and in some instances less. But its sale efforts were only partially successful. America retained 100 percent of the equity in one of the 14 centers under its management, 50 percent in three, and 30 percent in two.

America was expected to carry the costs through construction and to find permanent mortgage and equipment financing. In addition, since a nursing center was not expected to be profitable for some time after its opening, America was obliged

[4] As a result of a 2 for 1 split in March 1969, the 1.6 million shares were converted into 3.2 million shares. Other non-public transactions increased the outstanding shares to 3,445,651 at the time of the Chapter X proceedings.

Trading in America' stock on the American Stock Exchange commenced on November 12, 1968; it was suspended on April 30, 1970.

to advance substantial sums to cover the cash deficits of these centers. Much of these advances ultimately proved uncollectible.

America's other corporate activities included its supply division, which performed centralized purchasing and warehousing services for the managed centers, and the management division. Shortly before the Chapter X proceedings, America organized Medical, one of the debtors herein. This company, a wholly-owned subsidiary of America, was to engage in the medical supply business and was to serve the centers under America's management and any other customers. The Chapter X proceedings brought this venture to an abrupt end.

Embassy, another subsidiary debtor, was organized in 1968 to engage as contractor on behalf of America in those states in which America did not wish to undertake construction directly. Embassy served as nominal contractor for America in several states. It had virtually no capital of its own, and in its operations it incurred substantial construction liabilities for which it was to be reimbursed by America. The Court has heretofore determined that America was obligated for these liabilities.[5]

America's ambitious program and its operating and other needs required substantial cash outlays, and to meet these requirements it was necessary for America to increase its volume of sales and profits.[6] From the very beginning profits on construction, anticipated at 50 percent of actual costs, or better, were almost the sole source of America's earnings.[7] But without bona fide sales, America was not in a position under established accounting principles to record these construction profits as income. The price for a nursing center, including equipment, was substantial, ranging from about $500,000 for a 100-bed center in the Southwest to about $1.5 million for a 200-bed center in a high cost area. At the same time the search for purchasers for each individual center was time consuming and the results were mixed or uncertain. The creation of Equity and FSN and the permanent arrangements between them and

[5] Financial data with respect to Embassy and Medical have been treated by the trustees' auditors as part of America's corporate accounts.

[6] America's reported revenues increased from $2.2. million in the year ended June 30, 1967 to $19.3 million in the year ended June 30, 1969. Reported net income increased from $300,000 to $2.7 million for the same periods, with a corresponding spectacular increase in per share earnings.

[7] Construction revenues for the year ended June 30, 1968 were $5.25 million, as against costs of $3.25 million, or a gross profit, before overhead, of 60 percent of cost. The other divisions made only negligible contribution to earnings. Construction profits continued to be the primary source of earnings until the Chapter X petition was filed in June 1970.

America were management's answers to these and other perplexing problems.

EQUITY AND FSN

These debtors, both Delaware corporations with sole offices in Oklahoma City, were incorporated on November 6, 1968. They were organized pursuant to an agreement, dated November 4, 1968, entered into by America and Messrs. Clark, Bouse and Gray, with four individuals who became the sole directors of Equity.

Equity issued initially 120,000 shares of common stock at $11 per share. One-third of these shares, or 40,000, was issued to Equity's four directors, and the remaining two-thirds to America and Messrs. Clark, Bouse and Gray.[8] It was agreed that the latter shares were to be non-voting so long as held by them.

On February 27, 1969, Equity sold publicly, through Walston, 545,000 shares of its common at $11. At the same time it also sold to 14 institutional investors 135,000 shares and $714,000 principal amount of 6$^1/_2$ percent junior subordinated convertible debentures. Net proceeds to Equity from these offerings were, after underwriters' commissions of $281,690, $7.9 million. This amount plus the $1,485,000 received for the initial 120,000 shares raised total net proceeds to $9.4 million.

FSN was to serve as a joint subsidiary of Equity and America, Equity taking 70 percent and America 30 percent of its $1,000 capital stock. Title to completed nursing centers was to be transferred to FSN by America and Equity, from time to time, as security for 7$^1/_2$ per cent first mortgage notes, maturing July 1, 1987, to be issued by FSN as part of the permanent financing of these nursing centers. These notes would be issued under an open-end indenture, all notes being secured by a blanket mortgage. The notes would be fully guaranteed by Equity, America's guarantee to be limited to 30 percent.

The preorganization agreement of November 4, 1969 was linked to mortgage commitments from the same 14 institutional investors who, as noted, purchased the debentures and part of the stock of Equity. The commitments, terminating June 30, 1971, were for the purchase of not more than $19.5 million of mortgage notes. The investors agreed to buy FSN 7$^1/_2$ percent mortgage notes for 62 percent of the lesser of the amount determined, *inter alia*, by the actual cash expenditures

[8] Of these 80,000 shares, America purchased 50,000 and Messrs. Clark, Bouse and Gray purchased 13,500, 10,500 and 6,000, respectively.

for the completed nursing centers conveyed to FSN or the appraised value thereof. Messrs. Clark, Bouse and Gray agreed to buy FSN 7½ percent subordinated notes for 13 percent of such amount. America and Equity agreed to provide the remaining 25 percent by the purchase of additional stock, 70 percent thereof by Equity and 30 percent by America.

In approximately a year and half of their joint corporate affairs, about a hundred projects were initiated by America and Equity. By June 26, 1970, the date of the Chapter X proceeding for America, 25 joint nursing centers were completed and in operation and at least as many under construction. In addition, 31 sites were acquired and others were under contract with escrow deposits. These properties represented an investment of about $43 million in land, buildings and equipment.

Aside from their role in supplying some of the financing, Equity and FSN contributed little to this massive venture. The directors of Equity and FSN acknowledged that they had no previous experience in this business, and neither company attempted to develop its own staff or organization. Equity dealt only with America, and typically each project was organized as a general partnership between them.

Under the standard partnership agreements, America was employed as general contractor to construct the facility and to supply the equipment, both at a profit, and to use its best efforts to secure the necessary financing commitments. It was appointed "Governing Body" with exclusive authority over all aspects of center management and operation at a specified fee, and the partnership itself, meaning Equity, was expressly excluded from participating in any phase thereof. It was also designated to prepare and keep custody of all partnership records, books and operational data. The only matter expressly left to mutual agreement was the selection of the site, but America was designated to make the market survey to determine the feasibility of the project.

Under the partnership agreements for each facility, Equity and America were to share in the profits and losses of the partnership, 70 percent for Equity and 30 percent for America. This is the same ratio in which the contribution to capital was fixed for the two partners.[9]

[9] In three instances in which outside investors were brought in, Equity's ownership was reduced accordingly. The project was either incorporated or continued as a partnership with the outside investor participating as a limited partner.

America, in its various capacities, dealt directly with creditors and suppliers in almost all phases of the operations and was initially responsible for payment of most of the costs, some land purchases being the principal exception. By far the largest expenditures were for construction, and under the construction contract with each partnership America was to receive progress payments on the contract price in five equal installments, based on specified stages of completion. Its initial practice was to bill Equity for 70 percent of each earned construction installment, which was usually remitted by Equity until it substantially exhausted its cash resources in November 1969. Thereafter, America billed 100 percent of its construction charges to the partnership center.

The billing procedure soon broke down, due partly at least to malfunction of America's accounting system, and in preparing financial statements for the six months ended December 31, 1969, both companies found it necessary to adjust their book accounts by more than $10 million for unbilled construction. At about this point in time, Equity ceased to record deficiencies in its partnership contributions, and almost six months of intercompany liabilities were simply omitted from its books at the time the Chapter X proceeding began.

The accounts were further complicated by an inadequate system of handling interim and permanent mortgage financing, by massive commingling of funds from the individual centers into a "joint bank account" under America's control, by large cost overruns which America was experiencing and which it regarded as proper additions to the contract price, and by a high degree of informality in handling intercompany transactions. We will return to these subjects in our discussion of the status of Equity and the treatment of its securityholders under the plan of reorganization.

When 11 Texas nursing centers owned by the partnerships were completed, title to these centers was conveyed to FSN, and permanent financing was effected on April 23, 1970, pursuant to the prior commitments. The 14 institutional investors purchased $4,579,000 principal amount of 7½ percent first mortgage notes (due 1987), and $960,000 of 7½ percent subordinated notes (due 1987) were purchased by the other lenders. The proceeds from the loans, totaling $5,539,000, represented 75 percent of the aggregate value for these 11 centers as fixed by the indenture. Most of the proceeds were used to pay off interim construction loans of $4,143,500, and the balance was placed in the joint account. The actual cash expenditures for these 11 centers as computed at the time of closing under the commitment terms were $7,746,130.[10] There were no further permanent financings through FSN since the investors terminated their commitments.

Under the commitment terms, America and Equity were required to increase the equity capital of FSN by a minimum of $1,846,000, 70 percent to be contributed by Equity and 30 percent by America. Although their joint investment in the 11 partnership centers was substantially more than this minimum, America had invested considerably more than its proportionate share and Equity correspondingly less. Equity had no funds to reimburse America, and no settlement or adjustment between the partners was made. The 11 centers continued to be operated separately as though they were still partnerships between America and Equity. For all practical purposes, FSN was left a dormant corporation, with outstanding capital stock of $1,000

FRANCHISE

This, a Delaware corporation, organized on April 3, 1969, was another joint venture between America and Equity. America subscribed for $12 million and Equity for $3 million of Franchise's capital stock. Funds for this investment were obtained by a private sale of newly issued America and Equity stock to fourteen investors. One subscriber for $1 million of America and Equity stock withdrew, so America wound up supplying $800,000 and Equity $200,000 from their own funds to complete Franchise's $15 million capitalization.

Franchise was organized to grant franchises to construct "Four Seasons" facilities in certain states which the debtors had not yet penetrated. For an advanced fee and 4 percent of gross operating revenues Franchise agreed to provide plans, mortgage financing and other services to the franchisee. In less than a year it reported sale of franchises aggregating $4.5 million in advance fees and receipt of $2.5 million thereof.

On May 5, 1970 the Board of Directors authorized the termination of almost all of the franchise agreements. Franchise refunded the fees it had collected. The franchisees were reimbursed for costs and expenses and transferred to Franchise real estate sites they had acquired. The principal exception was the West Virginia franchise, pursuant to which the franchisee had partially completed three facilities, with $763,-

[10] An additional $1.4 million of equipment for these 11 centers was separately financed by $1.2 million of bank debt (generally in lease form) which the mortage commitment authorized.

000 advanced by Franchise. The status of this loan is presently in litigation with the franchisee. Other aspects of Franchise's operations are under investigation by the trustee.

OVERSEAS AND OTHER BORROWINGS

In the year preceding the Chapter X petition, when debtors' expenditures exceeded $1 million a week while actual operating revenues were negligible,[11] the debtors were kept afloat by massive borrowings. At the time of the Chapter X proceeding, there were outstanding $5.5 million of FSN long-term debt and $10 million of short-term construction mortgage loans, both incurred during the year. Trade and miscellaneous unpaid liabilities were approximately $11 million, of which about a third was secured by mechanics' liens, and $4 million, borrowed without security from the State of Ohio in March 1970, was spent in the same month.

The largest single source of funds was tapped by creating Overseas, organized under the laws of The Netherlands Antilles. America provided Overseas $3 million in equity capital, and Overseas sold $15 million of debentures in the Eurodollar market in October 1969, and the full $15 million was lent to America, without security. The underwriting expenses of the sale were paid from Overseas' capital, and the balance of $3 million capital was kept intact in bank deposits in Overseas' name pursuant to commitments required for this financing. The Court has authorized a 15 percent distribution—$2,250,000—from the Overseas' estate to the Overseas debentureholders as its sole creditors. The debentureholders remain creditors of America by virtue of the Overseas loan to America and of America's unconditional guarantee of the debentures.

The total major net indebtedness incurred in debtor's final year was thus about $42.5 million, and the equitable provision for these liabilities is the fundamental problem to which the Chapter X proceedings and the plan are directed.

II. THE REORGANIZATION PROCEEDINGS

Upon his appointment, the trustee directed his attention to the host of operating and management problems which led to these proceedings. Their resolution was essential to lay the foundation for the plan of reorganization.

As described above, America was primarily engaged in the

[11] Combined patient revenue for the year ended June 26, 1970 was about $5 million, but direct patient care expenses, before overhead and debt service, was about $6 million.

construction of almost one hundred projects scattered all over the United States. Its Construction Division, which dominated the debtors' organization, had been virtually brought to a halt by exhaustion of credit. It was immediately apparent to the trustee that resumption of these activities would be unfeasible and improvident.

His decision required a speedy dismantling of the Construction Division, with a corresponding drastic reduction in overhead, which included a move to much more modest central offices. Work in progress, though, was not abandoned. Two child care centers, one in Colorado and the other in Georgia, have been completed and opened, primarily as a test of their economic feasibility; and three large nursing centers in northern Illinois have been virtually completed. The trustee considers other sites desirable for development, but believes this should be deferred until the reorganization is concluded. In his judgment such major investment programs should be left to the decision of an independent reorganized company under the control of its directors and stockholders.

Upon his appointment the trustee became responsible for the operation of 45 nursing centers for ill and aged human beings. His immediate need was to insure uninterrupted care of these patients. Only slightly less urgent was the fact that all but two of these centers had suffered substantial operating losses in the year prior to the reorganization proceedings.

The trustee also found that the system for the management and control of center operations was wholly inadequate, and that even the flow of accounting and statistical data from the individual centers was slow and unreliable. America had planned an elaborate centralized computer system, but the unit terminals proved unworkable, the central computer inadequate, and the local managers inadequately trained. More than six months were required to install adequate systems of management, budgeting, internal control and accounting to bring field operations to workable levels. Further economies were achieved by dispositions of undesirable and least promising of the debtors' properties, the reduction of related interest charges and the elimination of unaffiliated minority interests.

Table I summarizes the major changes in ownership of debtors' physical properties during the proceedings up to the hearing in November 1971 (including transactions then pending and subsequently closed):

TABLE I

FOUR SEASONS PROPERTIES JULY 31, 1971

	Held At 6-26-70	Disposed of by Trustee	Reclassified**		Held Pro Forma	Book Value	Reserve for Depreciation
Operating nursing homes:							
Majority-owned*	31	(6)	1	(2)	24	$23,257,840	$1,790,470
Leased	2	(1)	—	—	1	35,947	—
50% or less owned	9	(8)	(1)	—	—	—	—
Operated under contract*	3	(2)	—	—	1	—	—
Operating child care center	—	—	—	1	1	227,725	3,994
Total operated	45	(17)	—	(1)	27	$23,521,512	$1,794,464
Homes under construction	24	(8)	—	2	18	10,225,378	48,117
Child care under construction	7	(1)	—	(1)	5	716,497	—
Land:							
Nursing home sites	13	(1)	(3)	—	9	966,995	—
Child care sites	13	—	(1)	—	12	763,554	—
Other	11	(1)	—	—	10	3,329,963	—
Equipment inventory	—	—	—	—	—	509,547	28,522
	113	(28)	(4)	0	81	$40,033,446	$1,871,103

*Now wholly-owned.

**Two operating centers (one demolished by a hurricane) have been closed and the 50 percent interest in one was purchased. Three incomplete centers, still carried as under construction, are now being completed for operations, and one child care center had been completed and was being operated at the time of the hearing. A second child center has since been opened. The trustee has since received authority to purchase the outside owned center carried above as operated under contract. Four parcels of land turned out to be incomplete purchases, so were reclassified as escrow deposits.

The trustee was quite selective in disposing of properties. Sales were not made on a fire-sale basis. They were made when an acceptable offer was obtained, and were approved by the Court after proper notice and public invitation of bids. Most of the proceeds of sale were applied to the discharge of mortgages and other liens amounting to about $12.7 million. Net sales proceeds of jointly-owned properties have been segregated and are held for the joint account of America and Equity.

The trustee's efforts produced considerable improvements in operations. His monthly report for November 1970 shows total revenues of about $1.7 million and operating losses, after depreciation, interest and overhead, of about $319,000. For the month of November 1971, revenues were about $1.6 million but operating losses were about $47,000.

As authorized by the Court, the trustee employed Arthur Young & Company to examine the records of the debtors, their subsidiaries and partnerships. In the last six months of 1970, the auditors spent 13,653 hours examining these records for the year ended June 26, 1970. Among other things, they found that 75 bank accounts had not been reconciled for periods of three to twelve months; that the computer facilities could not produce detailed schedules of accounts to agree with total balances; and that no reconciliations had been made among the numerous intercompany accounts, which had been handled in a wholly inconsistent manner.

Finding the intercompany accounts irreconcilable, the auditors eliminated these accounts completely, and determined as accurately as possible the actual net investments of America and Equity in each of their joint ventures. They computed America's investment in these ventures at $16,833,723 and Equity's at $8,894,986. This is in the ratio of 35 percent and 65 percent, respectively, rather than the 70 percent and 30 percent to which they committed themselves under their agreements.

The trustee's auditors did reduce the chaos they found to order, but only within the limits of their engagement. The results of their audit are proper for the balance sheet presentation of the Four Seasons complex as a whole. The intercompany transactions and their legal consequences remain matters in controversy, which must be reckoned with in considering the treatment of the debtors' securityholders.

III. ASSETS AND LIABILITIES

The following discussion covers all properties of Four Seasons complex, without distinction as to corporate and partnership ownerships. It is based on year-end figures of the trustee's auditors, as of June 30, 1971, adjusted for all transactions in July and all subsequent significant sales and settlements to the date of the November hearings on the plan, and for the effect of consummating the plan, to yield a combined pro forma balance sheet as of July 31, 1971. We have somewhat simplified the auditors' presentation to accent more clearly the effect of certain adjustments proposed by the trustee and the changes made by the plan.

TABLE II

Four Seasons Companies
Combined Pro Forma Balance Sheet as of July 31, 1971
(Reflecting Significant Adjustments Made or Agreed to Prior to November 1, 1971)

(000s omitted)

	Pro Forma Book Balance	Trustee's Adjustment	Plan Consummation Adjustment		Reorganized Company
			Cash	Stock	
Cash and bank deposits [1]	$18,369	$	$(5,459)		$12,910
Receivable for patient care	3,197				3,197
Due from others	3,184				3,184
Allowance for doubtful accounts	(3,217)				(3,217)
Prepaid expenses	283				283
Other investments	1,138	(1,100)			38
Property and equipment, less $1,871,103 depreciation	38,105	(5,000)			33,105
Mortgage and land deposits	100	(100)			—
Deferred financing costs and interest	3,141	(3,141)			—
Good will and deferred opening costs	1,260	(1,260)			—
Other deferred charges	249	(249)			—
Assets	$65,809	$(10,850)	$(5,459)		$49,500
Accounts payable and accrued liabilities after June 26, 1970	$ 2,867	$	$	$	$ 2,867
Estimated costs of reorganization		1,000	(1,000)		—
Secured debt, including $1,894,494 due within one year [2]	13,518		(715)		12,803
Accounts secured by lien	3,550		(3,550)		
Unsecured claims:					
7¼% debentures (Overseas) [3]	13,945			(13,945)	
7½% subordinated notes (FSN) [3]	998			(998)	
9½% notes payable (Ohio) [3]	4,111			(4,111)	
6½% junior subordinated convertible debentures (Equity) [3]	782			(782)	
Other accounts prior to 6/26/70	5,324	2,300	[4] (194)	(7,430)	
Total liabilities	$45,095	3,300	(5,459)	$(27,266)	$15,670
Book equity	20,714	(14,150)		27,266	33,830
	$65,809	$(10,850)	(5,459)	—	$49,500

[1] Includes a $50,000 savings account pledged under a mortgage.

[2] Includes $664,985 of accrued interest, to be paid in cash.

[3] Includes accrued interest to June 26, 1970.

[4] Cash payment of claims of less than $200.

The property account in the pro forma balance sheet, as more fully set forth in Table I, includes operating properties in six states; 13 in Texas, 5 in Oklahoma, 4 in Illinois, 2 in New Mexico, 2 in Colorado and 1 in Kansas. It also includes partially constructed centers and sites acquired during the great expansion in about 20 states. The trustee's reduction by $5 million in this account reflects an adjustment to reduce the book value to his enterprise valuation of the reorganized company. We will later on discuss this adjustment.

The other adjustments are not related to his enterprise valuation. The write-down of "other investments" ($1.1 million) and escrow deposits ($100,000) reflect losses anticipated in pending settlements, and had been substantially realized by the time of the hearing. The write-off of $4.6 million of deferred charges simply eliminates intangibles having no material realizable value. The allowance of $2.3 million for unrecorded liabilities reflected errors and omissions discovered in processing some 6,000 claims.

The trustee has restored all outstanding mortgages to current status, with waiver of defaults. There are outstanding $5,101,519 of nine short-term construction loans (including $765,000 presently being advanced to complete the three Illinois centers). The lenders have agreed to waive penalty interest and to extend the loans until six months following consummation of a plan of reorganization at 8½ percent. They have further granted the reorganized company the option to defer payment of these loans for an additional 5 years at 10 percent interest. Neither the 10 percent interest rate nor the five-year term is satisfactory. The trustee believes that confirmation of the plan will make conventional mortgage financing available on these properties. The option is a standby device to protect against the possibility that the plan might be confirmed at a time mortgage money may not be available.

The balance sheet includes $1,116,000 in construction loans on two centers which are considered undesirable and the lenders are unwilling to grant any extension beyond consummation. The sale of these two centers for $1,375,000 was confirmed on February 22, 1972, and payment of these loans will be made upon closing. The book loss on these sales amounted to about $150,000.

The balance sheet shows a $3.2 million reserve for doubtful accounts. About one-half of the accounts "due from others" consist of large and essentially unsecured loans which appear to be uncollectible. The rest is primarily the accumulation of charges to third-party owned centers which were operated unprofitably by America. Some collections are anticipated from those accounts, but there are sufficient problems with patient billings to make the aggregate reserve for all doubtful accounts seem reasonable.

After the suspension of trading in America's stock and prior to commencement of the Chapter X proceedings, 9 actions were brought in Federal courts in 4 states, 6 in New York and 1 each in Ohio, Illinois and Texas, all against debtors and other defendants. America is a defendant in 8 of such actions, Equity in 2 and Franchise in 1.[12] All but 1 of the 9 were filed as class suits on behalf of plaintiffs and all others similarly situated.

On July 23, 1970 a tenth class action was filed in the Federal Court in Oklahoma City against the officers and directors of America, the underwriter, debtors' former accountants and other affiliates. The debtors were not named as defendants in this action because of the Chapter X injunction restraining any suits against them, but class claims for $100 million were filed in the reorganization proceedings by the same plaintiffs, alleging substantially the same causes of action against the debtors. Additional claims were filed in the reorganization proceedings by at least 7 individual purchasers of debtors' stock aggregating $1.1 million against Equity and $1.8 million against America.[13]

All of the class suits and claims allege violation by debtors and the other defendants of the antifraud and other provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. For present purposes it is not necessary to set forth in any detail these and other charges alleged in the complaints. Insofar as the debtors are concerned, the basic charges are:

1. Filing false, misleading and deceptive registration statements, prospectuses and financial reports;
2. Publishing, disseminating and distributing false statements of material facts, and omitting to disclose material facts with respect to the debtors' finances, earnings and activities;
3. Conspiring with other defendants to manipulate the market price for debtors' shares.

It is alleged that the purchasers of debtors' shares relied upon the false information so disseminated and that they suffered great losses as a result. The defendants, other than the debtors, are charged with knowingly participating in such unlawful activities, and with other violations of the rights of the debtors and of the plaintiffs, individually or as members of the class.

On May 26, 1971 the Judicial Panel on Multidistrict Litigation transferred all of the above civil actions (with certain reservations as to the status of the four individual actions

[12] Four additional actions in Illinois, New York and California were brought by individuals against the broker who had sold them America stock but these actions did not seek relief against the debtors.

[13] The $103 million in claims referred to in the text are limited to claims on stock purchases only. In the record the total of claims is indicated as amounting to $105 million, but this latter amount includes also claims on FSN mortage notes and Equity debentures held by some of the same claimants.

against individual broker) to the Federal Court in Oklahoma City for consolidation for discovery purposes, designating Judge Roszel C. Thomsen of the Federal District Court in Maryland to hear the actions.[14] Two pretrial hearings have been held in this consolidated litigation, in which limited discovery has been granted.

Many of the actions transferred had intermingled class causes of action with derivative claims for the benefit of the debtors. It was recognized, however, that the Chapter X court had stayed further prosecution of causes of action against the debtors, including those filed prior to the Chapter X proceedings; that it had jurisdiction to pass upon all claims insofar as they affected the debtor estates in reorganization; and that its trustee had primary jurisdiction to enforce any causes of action on behalf of the debtors.[15]

The consolidated class suits, the claims filed in the reorganization proceeding, and the matters within the primary jurisdiction of the Chapter X court are quite complex. The plan proposes to cut these Gordian knots by offering to compromise the debtors' potential liabilities involved both in the pending litigation to which they are defendants and from the related individual and class claims filed against the debtors in the Chapter X proceeding.

IV. SUMMARY OF PLAN

The plan provides for the transfer of all the assets of all seven debtors and of all partnerships and corporations in which they are the sole partners or shareholders, to a reorganized company.[16] The reorganized company will assume all the remaining mortgages, and certain lease obligations, upon terms already agreed upon with this group of creditors. It will also assume, and pay in the ordinary course of business, operating liabilities incurred during the proceedings. Those obligations are being paid regularly by the trustee and the assumption refers only to those current accounts payable which will be outstanding at the time the plan is consummated. Costs of administration, including fees and pre-Chapter X claims for wages and taxes, will be paid in cash and in full.

Under the plan mechanics' liens and similar secured obligations are also entitled to cash payment in full. The plan

[14] *In re Four Seasons Securities Laws Litigation*, MDL Docket No. 55.

[15] *Cf. Meyer* v. *Fleming*, 327 U.S. 161, 167–168 (1946).

[16] The plan speaks throughout of a single reorganized company, but authorizes the retention or creation of wholly owned subsidiaries to the extent that technical or administrative convenience may make this the more expedient course.

authorizes the reorganized company to defer, subject to prepayment, payment thereof for two years or until the property subject to existing liens is sold, whichever first occurs, at 6 percent interest on these obligations until paid.[17]

Unsecured creditors of all the debtors are to receive one share of new common stock of the reorganized company for each $7 principal amount of allowed claims, except that claimants holding unsecured claims aggregating $200 or less will be paid such amount in cash. No fractional shares will be issued, but will be paid in cash at the rate of 80 percent of the fractional interest in one share.

Holders of presently outstanding shares of America or Equity, and holders of warrants to buy shares of America, Equity or Franchise will not participate as stockholders. The plan is based upon the conclusion that America and Equity are insolvent, and that the warrants of Franchise are without value.

The plan provides for an offer of settlement to persons who purchased stock or other securities of debtors, either directly from debtors or in the securities markets, on or before July 22, 1970 (the date of the filing of the Chapter X petition by Equity), and who file claims, in a manner and within the time to be fixed by the court in the order approving this plan, for the amount of the loss suffered by them, the loss being defined as the excess of amounts paid by them for all such purchases, over the amounts realized by them from all sales of such securities. The plan proposes to set aside a number of shares of new stock of the reorganized company, equal to one half of the number of shares issued to unsecured creditors, and to distribute such shares among this class of claimants in proportion to the amount of losses claimed and allowed. The number of new shares to be distributed for each dollar of loss will thus depend on the total amount of claims for losses filed and allowed, but the amount of shares to be distributed to any claimant may not exceed one share for each $7 of loss, the amount to be received by unsecured creditors generally.

The compromise applies only to the debtors' potential liabilities of the kind asserted in the class suits or in the proofs of claim filed in the proceedings. It does not affect the class claims asserted on behalf of securityholders in their own right against others. The trustee is to retain for prosecution all causes of action belonging to the debtors.

[17] The trustee has indicated that it is his present intention to pay such lien claims without delay when the plan becomes effective.

V. VALUATION

Chapter X requires that, to be approved and confirmed by the Court, the plan of reorganization must be "fair and equitable" (Sections 174 and 221(2)). A finding of fairness requires first a determination of the value of the debtor's assets. In reorganization reasonably foreseeable earnings are capitalized at an appropriate rate which reflects the business risk of the enterprise.

Since a valuation based upon future earnings, as the Supreme Court states, requires "a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made. But that estimate must be based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth, including, of course, the nature and condition of the properties, the past earnings record, and all circumstances which indicate whether or not that record is a reliable criterion of future performance." [18]

In the Four Seasons complex only 24 operating centers were included by the trustee in his forecast,[19] because its substantial other properties are non-operating and were valued as such by the trustee. Cash funds, to the extent that they exceed working capital requirements of the operating business, should be valued separately. The potential benefits of the tax loss carryforward are only partly available, limited by the forecast of earnings from operations.

TRUSTEE'S EARNINGS VALUATION

As noted previously, virtually all of past reported earnings arose from the construction activities which have been discontinued, and the trustee has disposed of properties he considered unpromising. Hence, in this instance, the past is not prologue, and the value of the retained operating properties turns primarily on future earnings prospects, taking into account the internal economics and efficiencies that have been achieved during the Chapter X administration. *Protective Committee, etc.* v. *Anderson*, 390 U.S. 414, 452 (1968).

[18] *Consolidated Rock Products Co.* v. *DuBois*, 312 U.S. 510, 526 (1941).

[19] The Texas City center was excluded because it was marked for sale and has since been sold.

The following table shows the trustee's projections of revenues and income:

TABLE III

Revenues		$15,768,000
Expenses:		
Direct patient care	$5,767,000	
Dietary	2,175,000	
Laundry and linen	361,000	
Housekeeping	657,000	
Plant operations and maintenance	1,011,000	
General and administrative	1,645,000	11,616,000
Operating profit		4,152,000
Less: Depreciation		920,000
Operating division overhead		800,000
Non-operating division overhead		294,000
Net profit before projected interest and taxes		2,138,000
Interest		866,000
Net profit before taxes		1,272,000
Taxes (48 percent)[20]		610,560
Net profit after taxes		$ 661,440

The trustee based his earnings forecast for the reorganized company upon operating results for the three months of April, May and June 1971, which he projected for a full year's operations. The trustee adjusted the base period upward to allow for anticipated occupancy increases, and related additional costs, in seven centers whose occupancy rate was well below standard, making these adjustments on the basis of established trends. He assumed an average of 90 percent occupancy for the operating division.

The trustee selected this relatively short base period, partly because it was the first quarter in which the systems of management, accounting, budgetary and internal control developed during this proceeding had become sufficiently established and tested to yield reliable income data. He was also satisfied that the months selected were adequate to reflect on the average seasonal cost variations in the regionally diverse centers.

In view of the lack of useful past experience for the Four Seasons centers, we compare the key factors of size, operating and debt-equity ratios projected by the trustee for the operat-

[20] The deduction for taxes is primarily for valuation purposes. The debtors have a tax loss carryforward through 1976, which is valued separately.

ing division of the reorganized company, with others engaged in the health care field:

TABLE IV

Name	No. of Centers	Total Expenses, Excluding Interest, as percent of Revenues	Percent of Long-term Debt to Assets
Unicare Health Services	62	87.1	47
Beverly Enterprises	54	95.5	42
Extendicare	48	85.6	59
Medicenters of America	39	94.6	58
Monterey Life Systems	36	91.4	45
National Health Enterprises	34	82.1	48
Hillhaven, Inc.	34	90.4	14
Continental Care Centers	26	86.6	60
Community Health Facilities	22	86.1	36
Aid, Inc.	21	87.5	47
Care Corporation	17	87.7	62
Four Seasons	24	86.4	53

Source: Annual reports for individual corporations for fiscal years ending during 1970.

Most of these other health care chains have added hospitals to their nursing home operations, and have other special features, so they are not wholly comparable with the proposed reorganized company. Nevertheless, it is apparent that the trustee's judgment with respect to the factors noted is generally consistent with those in the industry.

The trustee's earnings forecast was developed for the first year of operation of the reorganized company, estimated to commence in the middle of 1972. Although he was unwilling explicitly to extend the forecast into future years, his testimony indicated that he had no reason to expect a significant change in his annual forecast of earnings in the future for the 24 centers. Needless to say, such a projection is not intended to predict the actual income of a reorganized company for any particular year. Its business, like any other, will be subject to variations. Projections represent normal and average levels around which operating results may be expected to fluctuate.

To arrive at the value for the operating division, he applied a multiplier of 6 to his projected pre-tax income of $1,272,000 (after interest), as shown in Table III, to which he added $8,564,000 of pro forma secured debt. He thus obtained a value of $16,196,000 for the enterprise value of the division.

For reorganization purposes, we have found it much more appropriate to determine the overall value of the enterprise by applying a proper single multiplier to earnings after taxes and before interest.[21] Table III shows that such earnings estimate amounts to $1,527,000. A multiplier of 10.6 would yield $16,186,000, approximately the trustee's value.

Deducting the pro forma debt from the trustee's valuation, we obtain a value of $7,632,000 for the equity of the operating division. Table III shows projected net income of $661,440 after taxes and interest. The equity of $7,632,000 is thus 11.5 times these projected earnings.

We refer again to published information for the 11 companies we have noted in Table IV. The table below shows price-earnings ratios for the common stocks of these companies early in 1969 and in October 1971.

TABLE V

Name	Price-Earnings Ratios	
	*	**
Unicare Health Services	700	NA
Beverly Enterprises	120	21
Extendicare	212	26
Medicenters of America	208	57
Monterey Life Systems (formerly Monterey Nursing Inns)	73	93
National Health Enterprises	84	30
Hillhaven, Inc.	57	13
Continental Care Centers	NA	NA
Community Health Facilities	NA	19
Aid, Inc. (formerly American Institutional Developers)	82	30
Care Corporation	73	18
Four Seasons	184	—

Source:
*Barron's "Unhealthy Growth," February 10, 1969.
**Standard & Poor's Stock Guide, November 1971.
("NA" signifies not available).

The 1969 prices certainly did not reflect genuine investment values; they are symptoms of a dazzling euphoria that had gripped the market.[22] The 1971 prices, as noted in the table, are evidence of a return to some realism, although a skeptic may still discern some elements of a lingering afterglow. In any event, the 1971 price-earnings ratios for the 11 companies are higher than what the trustee would accept for Four Seasons.

[21] *Yale Express System, Inc.*, 44 S.E.C. 770 (1972).

[22] The high of the America common, on February 11, 1969, was 125. After the two for one stock split in March 1969, the high, on October 31, 1969, was 90¾. Thus the peak market value of the 3,353,115 shares then outstanding was $304,295,186.

The multiple applied by the trustee to projected earnings of the 24 operating centers was based on an extensive survey of industry statistics and financial information, and an intimate knowledge of the nursing centers he was dealing with. He took into account the relatively large size of the Four Seasons centers, their operating economies and the convenient locations of the 24 centers which he retained. It was his judgment that this group of operating centers would have a competitive advantage as substandard homes were eliminated from the industry. On the other hand, he could hardly overlook that a major part of revenues are derived from welfare patients supported by Medicaid programs.[23] The extent of this government support varies from state to state. The trustee felt that this industry is developing into a quasi-public utility at least insofar as profit margins and service standards are concerned.

In the face of such considerations, it certainly cannot be said that the current market assessment of earnings of other health care chains is the last word. The trustee testified that many of the companies in the industry have multiple operations and that he was unable to find fully comparable data for his own valuations. We think that, in light of his own experience with the Four Seasons operations, his less sanguine judgment is acceptable.

An additional source of value related to projected earning arises from the tax loss carryover. According to the auditors' report the debtors had a combined tax loss carryover of about $23 million at June 30, 1971, which can be used only to the extent of available taxable income. The trustee's projected income would be subject to $610,560 of annual Federal income taxes, and the tax benefits will expire on June 30, 1976.[24] Since his projected income is not expected to commence until about July 1, 1972, there are only four years available for these tax benefits. Discounting estimated yearly tax savings over four years at 10 percent, we obtain a present value of $1.9 million for the tax savings applicable to the operating division.[25]

[23] *Nursing Home Fact Book*, 1970-71, published by American Nursing Home Association, p. 11.

For the month of October 1971 about 72 percent of the average daily occupancy in the 24 operating centers consisted of welfare patients.

[24] Current reports indicate that no tax loss should be realized in the present fiscal year.

[25] These benefits would exhaust about $5.1 million of the $23 million tax loss carryover.

TRUSTEE'S VALUATION OF NON-OPERATING PHYSICAL PROPERTIES

The following shows the trustee's valuation of these properties:

TABLE VI

(000 omitted)

	Book Value Less Depreciation	
3 Nursing homes being completed	$3,513	
Mortgaged Texas City and Ledbetter centers, (later sold)	1,513	
11 Nursing homes in various stages of construction	5,688	
6 Child care centers in various stages of construction	717	
31 Parcels of land, with little or no development	5,061	
Equipment inventory	480	
Total property		$16,972
Construction mortgages:		
3 nursing homes being completed	2,345	
2 nursing homes later sold	1,116	
Applicable funded debt		(3,461)
Net book equity		$13,511
Trustee's valuation adjustment		(2,400)
Trustee's net property valuation		$11,111

It must be emphasized that the distinction between operating and non-operating properties is transitory. Thus the three nursing homes being completed will be added to the operating division in the near future, together with an estimated $500,000 in cash for equipment and working capital. Two of the child care centers have already been placed in operation, although operating experience was insufficient for inclusion in the earnings forecast.

All of the non-operating properties were acquired for use in Four Seasons' business. In the trustee's judgment approximately $4 million would be required to complete all the properties of the non-operating division now above foundation level.[26] He said that he was not recommending completion of all these centers, but expected the reorganized company to find some of them desirable.

The trustee further pointed out the opportunity, already practiced by the more successful chains in the industry, of converting some nursing homes into various types of special-

[26] This presumably refers to the 11 nursing centers and 6 child care centers with a book value of $6.4 million shown in Table VI.

ized hospitals which might produce a better return. These and other possibilities of profitable development of the debtors' assets, including the substantial land holdings, he felt were matters that should be decided by the reorganized company in normal business fashion by its directors and shareholders. He emphasized the urgency of prompt action to develop income in time to utilize the balance of the tax loss carryover.

In view of the foregoing uncertainties, the properties were not valued by the trustee on a basis of earnings projections. He valued these non-operating properties item by item, primarily on the basis of experience developed in the sale of 28 properties and negotiations on others. In a few cases appraisals were obtained. If neither was available, the cost basis was used, if it appeared reasonable. After adding up these valuation results, the trustee found it convenient to retain net book values as a base subject to a reduction by $2.4 million to reach an aggregate of $11.1 million for the market value of the non-operating properties.

Cash and Working Capital

The trustee included $11,308,000 of cash among his non-operating assets. In our judgment two adjustments, listed below, are necessary.

The following table shows pro forma gross working capital and the amount thereof which the trustee treated as non-operating assets and hence as additions to value:

TABLE VII

(000 omitted)

	Pro Forma	Transferred to Non-operating Assets	Retained for Working Capital
Cash	$12,859	($11,308)	$1,551
Receivables, net	3,164	(1,500)	1,664
Prepayments	283	—	283
Current Assets	$16,306	($12,808)	$3,498
Accounts and accruals	$ 2,866		$2,866
Current maturities of long-term debt	778*		778
Current Liabilities	$ 3,644*		$3,644

*Excluding $1,116,000 construction loans currently paid.

The trustee recognized that there would be some additional working capital requirements which he could not project. Since the operating division forecast estimates cash expenses at more than $1.1 million a month, and since revenues come largely from welfare funds, payment of which is subject to unpredictable delays, it is clear that the trustee's doubts about the adequacy of his working capital provision were well founded. We are satisfied that a working capital ratio of 1 1/4 to 1 is the minimum for orderly operation of the 24 center operating division, and this requires an allocation of an additional $1 million in cash to working capital.

The trustee has budgeted $700,000 to correct certain structural and design deficiencies discoverd in the operating centers, for which he did not provide in his computations. Hence non-operating cash must further be reduced by this amount.

The increase in cash for working capital by $1 million would increase current assets to about $4.5 million against current liabilities of about $3.6 million. The adjustment for this amount and for the expenditure of $700,000 to correct structural deficiencies will reduce non-operating cash to $9.6 million pro forma.

SUMMARY OF VALUATION

The following table shows total valuation of the reorganized company as developed in the preceding discussion:

TABLE VIII

(In Millions)

	Trustee	Commission
Capitalized value of operating division	$16.2	$16.2
Present value of tax saving	3.2	1.9
Market value of non-operating physical properties	14.6	14.6
Term notes receivable	1.5	1.5
Cash (non-operating)	11.3	9.6
	$46.8	$43.8
Long-term debt of reorganized company	(12.1)	(12.1)
Value of stock equity of reorganized company	$34.7	$31.7

The total of $34.7 million is shown in the trustee's valuation exhibit. But he concluded that $33.8 million equity, as shown in the pro forma balance sheet (*Table II*, *supra*), was preferable.

The difference in the value of the tax savings is essentially a matter of arithmetic. We, like the trustee, computed these savings on the same annual taxable income of $1,272,000, but the trustee assumed a five-year period of tax loss carryover rather than the 4 years we believe to be available. In addition, he failed to discount his computation to present value. His reduction of the stock equity to $33.8 million may well have reflected a recognition that the computation on his exhibit was somehow excessive. We have already discussed our differences regarding non-operating cash, which account for the significant variation in our respective total valuations.

VI. FAIRNESS, FEASIBILITY AND OTHER MATTERS

Chapter X requires that, before the judge may approve a plan, he must find it to be "fair and equitable" (Sections 174 and 221(2)). This standard incorporates the doctrine of absolute priorities, pursuant to which shareholders may participate only if there is an equity remaining after satisfaction of all creditors' claims,[27] but this does not require that creditors be paid in cash.[28] Nor do these standards preclude compromises which are "a normal part of the process of reorganization." [29] Compromises, like other aspects of a plan, must satisfy the standard of fairness, and hence an independent determination by the court is required that such compromises are fair to all parties affected.[30]

Before approving or confirming a plan under Chapter X, the court also must find that the plan is "feasible" (Sections 174 and 221(2)). Feasibility requires, among other things, sufficient cash to meet payments under the plan; adequate working capital; a sound capital structure; and prospective earnings sufficient to service the financial obligations of the reorganized company.

FAIRNESS

The plan provides for all secured and priority debts, either by payment in cash or by assumption of these liabilities by the reorganized company. No one disputes that the plan is fair to them, so our discussion will focus on the rights of unsecured creditors and shareholders. The plan assumes that the debtors are insolvent and that, therefore, shareholders, as such, are not entitled to any participation in the reorganized company.

As shown in Table VIII, the values available, after deducting secured obligations, are $31.7 million. Table II details approximately $27.3 million of unsecured debt not entitled to security or priority. This sum does not include interest for the two

[27] *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106, 119-121 (1939).

[28] *Consolidated Rock Products Co.* v. *DuBois*, 312 U.S. 510, 530 (1941).

[29] *Case* v. *Los Angeles Lumber Products Co., supra* p. 130.

[30] *Protective Committee, etc.* v. *Anderson*, 390 U.S. 414, 424 (1968).

years between June 26, 1970 and an assumed consummation date of June 30, 1972. Including such post-bankruptcy interest of about $3.2 million,[31] the priority of these claims over shareholders is about $30.5 million.

Under the plan, these creditors receive two-thirds of the stock of the reorganized company, which is equivalent to about $21.2 million of the equity of the reorganized company, or about 80 percent of their claims (exclusive of post-bankruptcy interest). The remaining one-third of the stock, equivalent to $10.5 million, is to be distributed to claimants, including stockholders, who are asserting creditor claims against debtors for alleged violations of the Federal securities laws and other alleged frauds. The plan proposal in this respect is a $10.5 million settlement of claims against the debtors exceeding $100 million.

Any substantial recognition of these claims would clearly render Four Seasons system as a whole insolvent. Recognizing the $10.5 million settlement as a fair measure of their rights, the claims of creditors exceed the value of the debtor estates by at least $9.3 million.[32]

A two-day hearing was held before the court on the issue of the fairness of the settlement. The principal evidence was presented by counsel who had filed the $100 million class claim on behalf of shareholders in the Chapter X proceeding and who had negotiated the settlement with the trustee. The evidence consisted essentially of an offer of proof of approximately 60 documents from the files of debtors and the alleged co-conspirators, supplemented by testimony of counsel. Those who opposed any recognition of the claims primarily confined themselves to objections to the evidence proffered as not being sufficiently authenticated to be admissible at a formal trial on the merits, and to cross-examination of counsel.

The trustee had been advised by his counsel that the outcome of the litigation would be in doubt and that there were substantial questions of fact to be resolved. He was also greatly concerned about the time and expense involved in a trial of such complexity and the serious impact any substantial delay of the proceedings would have on operating and financial

[31] Post-bankruptcy interest on unsecured claims is not considered in computing distributions if a debtor is insolvent, but claims for post-bankruptcy interest must be considered in determining participation by shareholders. See *Consolidated Rock Products Co.* v. *DuBois*, 312 U.S. 510, 527–528 (1941); *Ruskin* v. *Griffiths*, 269 F.2d 827, 830–832 (C.A. 2, 1959), *cert. den.*, 361 U.S. 947 (1960); *Vanston Bondholders Protective Committee* v. *Green*, 329 U.S. 156, 163–165 (1946).

[32] Since the fraud claims are on parity with unsecured claims generally, an equity distribution of $10.5 million is equivalent to 80 percent of allowed claims of about $13 million.

arrangements and benefits that depend upon an early reorganization. The settlement terms embodied in the plan were reached in extensive arm's-length negotiations with counsel for the class claimant in the Chapter X proceedings.

The plan provides for filing, within a short bar-date to be fixed by the court, of proofs of claim for the net losses suffered by securityholders who purchased debtors' securities prior to July 22, 1970. The compromise thus is not one that they must accept. It is an offer of settlement, which under the provisions of Chapter X, requires the affirmative vote of at least two-thirds in amount of the claims of securityholders who file such claims. The required vote is that of the individual claimant. Chapter X does not permit an unsolicited omnibus vote on behalf of the class.

As noted, compromises are an integral part of the reorganization process, and in the pending proceedings a settlement is not only appropriate but also vital to the reorganization. A judgment on the merits against the debtors, even if, for example, it should amount to $100 million, would not bring them satisfaction for anything near that amount. The debtors' equity for unsecured creditors, if it should still remain unimpaired by the litigation, amounts to $31.7 million, which they would share ratably with the general unsecured creditors whose claims amount to about $27 million. To be sure, a $100 million recovery would give them about four-fifths of this equity rather than the one-third that the plan provides for them. But litigation has its hazards, and so there is the ever-present possibility that in pursuing too much they may realize far less or even nothing. Nor is there any good reason for assuming that a settlement exacted later in the course of litigation, as not infrequently occurs in cases of this nature,[33] will be better than what the plan offers to them now. All facts considered, we think that the trustee's offer of settlement is a practical proposal that under Chapter X standards the court may approve in the interest of a prompt reorganization and as fair to all persons affected by this settlement.

It should be noted also that the settlement does not call for any release of the defendants other than the debtors. Claimants will remain as free as heretofore to pursue the class suits against such other defendants, but with one-third of the reorganized enterprise securely tucked away in their pockets.

[33] See *Stella* v. *Kaiser*, 218 F.2d 64 (C.A. 2, 1954); *Allegheny Corp.* v. *Kirby*, 333 F.2d 327, 333 (C.A. 2, 1964); *Cherner* v. *Transition Electronic Corp.*, 221 F. Supp. 48, 52 (D. Mass., 1963); *Fox* v. *Glickman Corp.*, 253 F. Supp. 1005, 1013 (S.D. N.Y., 1966).

In concluding this phase of our discussion, we suggest clarification of the proposed settlement insofar as it extends to *any* security of the debtors purchased prior to July 22, 1970. This feature of the offer, as such, presents no problems to us. We are apprehensive, however, that it may be interpreted as allowing a creditor to receive a distribution for 80 percent of his claim and assert a claim for the balance against the one-third equity reserved for settlement of the fraud claims. We think that this would give such creditor a preferential distribution over all other creditors and would be unfair to them. The plan itself has built-in provisions which are intended to limit the distribution to any creditor to not more than one share for each $7 in claims. Nonetheless, we suggest that the settlement should be clarified so that the creditors who vote on the plan would be under no misapprehension regarding this matter.

We agree with the trustee's conclusion, as embodied in the plan, that the debtor companies should be considered collectively as a single enterprise for purposes of valuation and distribution.[34] We do so in this instance, fully recognizing the firm principle announced in *Consolidated Rock Products Co.* v. *DuBois*, 312 U.S. at 519–524, that mere joint operation of related companies is not sufficient to justify the failure to determine the separate rights of creditors for each corporate debtor. The Supreme Court in that case set aside the plan of reorganization because the court below had not adequately explored the possibility that among several groups of creditors one group might be entitled to a larger proportion of the combined estate because of their specific rights in one of such estates.

We accept the trustee's views because to treat these debtors as though they were distinct enterprises would not merely be difficult but, more important, would be highly arbitrary and call for recognition of distinctions that agreements, partnerships, guarantees and joint accounts have submerged. Indeed, the question in these proceedings is not whether the fusion of interests upon which the plan is predicated is appropriate. The real issue is whether as a consequence of the tangled intercompany relationships, through which the corporate debtors have been so inexorably linked, a meaningful separation could make sense and yield results that would be more reliable. This issue, as thus stated, turns principally on the intercompany relation-

[34] An exception is Overseas, whose cash assets were kept in separate bank depositis in Overseas' name in accordance with regulations governing foreign borrowings.

ships between America and Equity, to which we must now turn our attention.

The following table shows corporate balance sheets of Equity at June 26, 1970 and at June 30, 1971, condensed from the statements of the trustee's auditors. Equity's 20 percent ownership of Franchise, a large inactive company, appears on these corporate statements as an investment, but for present purposes the third column shows Equity's position at June 30, 1971,[35] as if it owned directly its 20 percent of the Franchise assets:

TABLE IX

Condensed Balance Sheet of Equity

(000 omitted)

	June 26, 1970	June 30, 1971	Including 20 percent of Franchise June 30, 1971
Cash and bank deposits	$ 2,530 [1]	$ 116	$ 2,336 [3]
Receivables—net	54	21	21
Investment in jointly owned property	8,895	8,622	8,622
Furniture—net	44	20	20
Escrow deposits	2	—	—
Deferred charges	152	152	152
Investment in Franchise	2,964	2,964	—
Misc. assets of Franchise (net)	—	—	263
Total Assets	$14,641 [2]	$11,895	$11,414
Accounts payable—trustee	—	$ 21	$ 21
Notes payable—banks	3,200 [1]	848	848 [4]
Accounts payable & accrual, pre-bankruptcy	182	194	194
Due Franchise	249	249	[3]
6½ percent convertible debentures	714	760	760
Total Liabilities	$ 4,345	$ 2,072	$ 1,823
Stock & paid-in surplus	11,146	11,146	11,146
Deficit	(850)	(1,323)	(1,555)
	$14,641 [2]	$11,895	$11,414

[1] The amount of $2,450,000 of bank deposits were pledged to secure bank loans and was applied to their payment.

[2] Adjusted to restore to the appropriate accounts $2,776,072 of valuation adjustments made in 6-26-70 audit but subsequently reversed.

[3] In computing these items, Franchise funds previously diverted to America and Equity are treated as advance distribution to them.

[4] Subsequently, by order of the court, the secured bank loans were settled by payment of $519,000 in cash, and the balance was allowed as an unsecured claim.

[35] It is actually based on the July 31, 1971 Franchise balance sheet in the record, but that company had no material change from June 30, 1971.

All that these balance sheets show is Equity's corporate financial history. As described in the introduction, Equity obtained, after commissions and selling expenses, a net of $11,114,000 from sale of its stock and $714,000 from the subordinated debentures. Equity also borrowed a net of $1 million from banks.[36] About $3 million of this amount was invested in 20 percent of Franchise and $8.7 million in the other joint ventures with America. Equity's deficit of $1.3 million arose primarily from general and administrative expenses of about $700,000 in the 20-month period prior to the Chapter X proceedings and $270,000 during the following year, the balance representing net interest costs and minor miscellaneous items.

Equity's substantial assets, aside from its liquidating right to cash from Franchise, consists of its investment in properties jointly owned with America. These include operating and partly completed centers or real estate sites purchased for construction. As we have noted, each of such properties was acquired by or for the partnership between America and Equity created for that specific purpose. At June 26, 1970, 81 of these partnerships remained,[37] and mortgage and construction loans and other lien obligations were incurred by or on behalf of these partnerships. As we have indicated previously, title to 11 centers in Texas were transferred to FSN for purposes of permanent refinancing, of which six were subsequently sold, but these centers continued to be operated as partnerships, as shown by their books of account.

The combined Four Seasons enterprise, considered collectively, as set forth in the pro forma balance sheet (Table II), is predominantly jointly-owned. America alone owns nine 100-bed operating centers, with property and equipment (after depreciation) of $3,966,680, one of which was completed but later closed and is classified as non-operating. These pre-date the organization of Equity. America is also the sole owner of certain other real estate, carried at $2,689,786.[38] Properties not jointly-owned thus total about $6.7 million.

Jointly-owned properties include the remaining 16 operating centers, of which 12 are 200-bed units, with property and

[36] It was the practice to invest proceeds of securities sales in certificates of deposits and to use these certificates as collateral for borrowings as funds were needed. Equity actually reported substantial cash balances up to June 26, 1970, but had fully hypothecated these balances by November 1969.

[37] There is testimony that actual partnership agreements were not found in the files for 22 of these ventures, but separate partnership books of account had been set up for each, and they were treated in the same mannner as the other partnerships by America and Equity.

[38] The principal item is a $2.2. million tract of land in Oklahoma City purchased for a hospital site before the Chapter X proceedings by a private exchange for America stock.

equipment (after depreciation) of $17,674,401. The child care centers and the non-operating properties (after depreciation), including undeveloped sites, all jointly-owned, are carried at $12,720,271. The total of these is about $30.4 million.

The pro forma mortgage debt, assumed by the reorganized company, is about $12.9 million, all amply secured. Of this total amount, $2.4 million represents permanent mortgage financing on the centers owned solely by America. The balance of $10.5 million relate to jointly-owned centers. These centers are security, property by property, for about $9.5 million of obligations of partnerships, each obligation guaranteed by America and Equity. The remaining $1 million is the balance of FSN's mortgage debt, guaranteed 100 percent by Equity and 30 percent by America. Hence, neither America nor Equity, nor their respective investors, are affected by the assumption of these mortgage debts by the reorganized company.

Deducting these assumed mortgages, we restate from Table II the remaining aggregate debts, including pre-bankruptcy interest, dealt with by the plan (exclusive of the fraud claims):

TABLE X

(000s omitted)

7¼ percent debentures (Overseas)	$13,945
7½ percent subordinated notes (FSN)	998
9½ percent notes payable (Ohio)	4,111
6½ percent junior subordinated convertible debentures (Equity)	782
Pre-bankruptcy trade & misc. debts including those secured by mechanics liens	11,174
Total	$31,010*
Less: cash estimated for lien claimants (about $3.5 million) and claims under $200	(3,744)
Balance of unsecured claims (to receive new stock)	$27,266

*These figures include some small errors in computation of pre-bankruptcy interest, insufficiently significant to require correction here.

We cannot regard all these liabilities as corporate obligations alone, and no more. To do so is to indulge in fictions. At the least, Equity and America are dual personalities. Both are corporations, and their balance sheets are summations of their respective corporate accounts. But Equity and America are also general partners in the many partnerships they had organized for their joint ventures, and the interests and obligations which arise from these pervasive and dominant relationships are not limited or insulated by the surface appearance of their corporate personalities.

In corporate terms, the $4 million liability to the State of Ohio and the $13.94 million debt to Overseas are contractual obligations of America as debtor and also, in case of Overseas, as guarantor. But this is by no means the end of the inquiry regarding the actual status of these substantial debts. The standard partnership agreements required America to use its best efforts to procure financing for the partnership undertakings, and bound the partners—America and Equity—to guarantee such obligations. Although the procedures under the partnership agreements in this and other respects were often not complied with, America did procure the Ohio and Overseas loans and spent the bulk of the net proceeds on the partnership ventures. It should also be noted that, its funds exhausted, Equity ceased in November 1969 to meet its partnership obligations for construction and operating losses. The funds from Overseas were raised in October 1969 and spent in the next four months. The Ohio funds were obtained and spent in March 1970. Hence, creditors may well insist that as to their rights these loans be equitably treated also as partnership obligations, for which America and Equity are liable jointly and severally as general partners.

The route to partnership responsibility is more direct with respect to the mercantile debts of about $11.1 million (Table X). These debts, comprising some 6,000 individual claims, were predominantly incurred in the construction and operation of the jointly-owned properties. Most of these claims appear on the books as claims against America, and this is quite natural since the claimants dealt only with America as contractor and manager of these properties. But, insofar as they represent expenditures on partnership ventures, they are actually partnership liabilities.

When the nature of these liabilities, including the Ohio and Overseas claims, is thus understood, it is clear that a separate valuation of the two debtor estates, if it were possible, would serve no useful purpose. America and Equity as partners are jointly and severely liable for the bulk of these liabilities, and any deficiency in one estate would simply transfer the unsatisfied creditors' claims to the other. Since the value of the combined estates (less the assumed mortgage debts) is not sufficient to satisfy the remaining claims plus the settlement of the fraud claims, nothing would be achieved by a separate valuation. Even if America were charged for the full settlement of the fraud claims,[39] that would only reduce the participation of the other creditors in its estate and correspondingly magnify deficiency claims of such creditors against Equity as joint and several obligor.

Further, a separate valuation of America and Equity would require a definitive determination of their interests in the partnership ventures and the respective liabilities emanating from these ventures. The auditors spent much effort on this subject but with limited success. The Supreme Court's decision in *Consolidated Rock* did not contemplate that having failed so far, we should prolong the effort in the hope that something better may turn up.

Our description of America's business during its association with Equity foreshadowed the key role the intercompany bookkeeping played in its affairs, and particularly in the financial statements upon which its financing and credit were based. America's charges for the construction of jointly-owned centers created accounts receivable to swell America's assets and sales to swell its profits. Theoretically its partner, Equity, was to pay 70 percent of these amounts, which it ceased to do in November 1969. It was sales to Equity which kept America's reported income and assets at a level sufficient to present itself as a strong and prosperous company and enable it to incur $31 million of non-mortgage debt for which the plan must provide. Equity was a full participant in this program from the moment of its organization until the bubble burst.

Much of the confusion about the state of accounts between America and Equity arises from the fact that the two companies had kept their books in an inconsistent manner and, as the Trustee's auditors found, the accounts were unreconcilable. America's books showed at June 26, 1970, approximately $18.3 million in receivables from the nursing centers, while the books of Equity did not include corresponding items as liabilities.

The auditors contented themselves with determining, as accurately as possible, the actual investment of Equity in the 81 partnerships. They eliminated from America's accounts all of the accounts receivable, whether for construction or operating losses of the centers.[40] To determine America's investment,

[39] Actually, $1.1 million of claims by individual shareholders of Equity for violation of the Federal securities laws have been filed in the Chapter X proceedings, and class actions are pending on behalf of Equity shareholders. The settlement proposed in the plan settles all liabilities of this nature against Equity as well.

[40] The accumulated operating deficit of the jointly-owned centers at June 30, 1971, totaled about $4.4 million.

the auditors analyzed the accounts of the individual centers and credited America with its construction and operating advances, but limited the amount of construction allowed America for each incomplete center to the portion of the original price for the fully completed stages of the five-stage billing procedure specified in the construction agreements.

It is scarcely necessary to say that this procedure was justified by sound accounting principles, and established reasonable book values for the properties. As a result, however, America's audited income statement for the year ended June 26, 1970, showed only $23.9 million of construction revenues against $28.6 million of direct construction costs, a loss of $4.3 million on direct costs alone, although the contracts and estimates had been negotiated to allow a large profit to America. America's loss for that year also included $6.9 million of general and administrative expenses and $1.7 million of interest expense, the larger part of which was incurred in construction activities. The auditors' accounting procedures were not intended to release Equity from liabilities for its failure to meet the balance of its partnership obligations as contribution to capital and for its share of operating losses. Nor did the result of the audit constitute a determination of the amounts to which America may be entitled for its construction of the centers.

It is indisputable that Equity fell far short of paying its 70 percent partnership share of the costs and operating losses of the joint ventures,[41] and a determination of America's proper charges against Equity and the partnerships would require an item by item re-examination of the data underlying those charges. In view of the state of the records, this is a task of extraordinary complexity, as the auditors discovered. One of the major sources of difficulty is the "joint bank account" through which about $18 million in money flowed, mostly in the last seven months. This account was never under proper accounting control, never fully reconciled, and the mass of bills paid were inadequately identified as to specific purpose.

We agree with the trustee's conclusion that further efforts to refine the value of America's and Equity's interests in the partnerships and to measure precisely the rights of their creditors would be unproductive. This is eminently a case for practical adjustment. The creditor claims against Equity as

[41] The June 30, 1971 audit figures, which, as shown, do not account for America's enormous losses on this construction, indicate an investment ratio of $8.6 million for Equity against $17.2 million for America or 35-65.

shown on Equity's balance sheet (Table IX) amount to about $1.8 million, of which $520,000 has since been paid as a secured claim, leaving a balance of about $1.3 million. The plan allows for these claims about 80 percent in equivalent value on the same basis as the claims allowed against America. In the face of the substantial and unresolved issues, and since, as we have previously explained, the attempt to reconcile the intercorporate and partnership accounts may well be an academic exercise, we regard such equal treatment as a fair solution for all creditors.

The only other corporate entity with unsecured debt affected by the plan is FSN. Its pro forma balance sheet at June 30, 1971, shows:

TABLE XI

(000s Omitted)

Assets		*Liabilities*	
Cash and bank deposits	$ 442	Accounts payable and accruals	$ 572
Patient receivable, less reserve of $273,093	649	Mortgage and equipment	1,250
Prepayments	32	Old accounts payable	679
Plant, less reserve of $359,936	5,521	7½% notes	960
		Parent companies*	3,892
		Liabilities	7,353
		Stock and paid-in surplus*	1,827
		Defict	(2,536)
Total Assets	$6,644		$ 6,644

*The additional stock required under the terms of the mortgage commitment was never issued or reflected on FSN's books of account, but has been allowed for by transfer of $1,826,485 to paid-in surplus from accounts payable to America and Equity.

This statement gives effect to the sale of five of the eleven centers originally transferred to FSN and the application of the sale proceeds to reduce senior mortgage debt. The $5.7 million invested in FSN, as stock or advances by America and Equity, is included in the auditor's investment totals for America and Equity in jointly-owned centers.

The trustee has projected earnings for the six centers now owned by FSN as part of his overall earnings projections for the twenty-four centers, as follows:

TABLE XII

(000 Omitted)

	FSN 6 Centers	Four Seasons as a Whole—24 Centers	FSN as % of Total
Revenues	$3,634	$15,768	23.0
Operating expenses	2,747	11,616	23.6
Depreciation	225	920	24.5
Interest	75	866	8.7
Net income before overhead	$ 587	$ 2,366	24.8

It appears that the projected earnings of the FSN properties is similar to that of the twenty-four center operating division. The assets contributed by FSN to the proposed reorganized company bear approximately the same relationship to its corporate liabilities as do the aggregate assets and liabilities of the whole system. Hence, the treatment of FSN liabilities on a parity with all other liabilities of the same character is justified.

FEASIBILITY

It is unnecessary to elaborate on the debtors' financial ability to carry out the plan. A glance at Table II demonstrates the adequacy of the resources to meet the required payments under the plan. The ability of the reorganized company to service the long-term debt assumed is equally clear from our valuation analysis. The trustee's forecast of annual earnings of the operating division before interest and taxes (Table III), is $2.1 million, which covers interest requirements 2.4 times.

Total debt service, including amortization of principal, is affected by the large proportion of construction loans on which only a five-year standby extension has been obtained. On this basis, debt service requirements would be inordinately low in the first five years with a $5 million bàlloon payment at the end of the fifth year. The trustee expects these loans to be refunded. If we assume 25-year mortgage debts in place of these loans, principal and interest requirements would be about $1.5 million for the first three years and $1.2 million thereafter, the difference reflecting final payment of some equipment debt.

The cash flow for the operating division is estimated at $3.1 million, before allowance for the four new centers now being added. Hence, the ability of the proposed reorganized company to meet its obligations and provide a surplus, either on a cash flow or income basis, is sufficiently provided by the operating assets alone.

OTHER MATTERS

The plan provides that the common stock of the reorganized company will have full voting rights. We recommend that the plan be amended to provide for cumulative voting. This is the intent of Section 216(11) which requires that the plan include equitable provisions for the election of directors, and of Section 216(12) which specifies that the charter of the reorganized company must provide "for the fair and equitable distribution" of voting power among the securityholders. The plan should be further amended to provide for pre-emptive rights to stockholders.[42]

The plan provides for a board of nine directors, the initial directors to be designated by the court. The first annual meeting of stockholders is to be held the first Monday in May 1973, but the first election of new directors is postponed until the second annual shareholders' meeting. Only three directors are to be elected at that meeting and three at each subsequent meeting.

The practice of providing the initial directors of the reorganized company for a year is not unusual in plans of reorganization, but we believe that in this case a substantial departure is necessary.

In the present case, about half of the assets, including a large cash fund, are non-operating assets. The trustee has deliberately reserved their use to be determined by the reorganized company and has stressed the urgency and importance of prompt decisions regarding these assets. Under the circumstances, we do not believe that exclusion of the shareholders for a year, much less two or three, from a direct voice in selecting their representatives, can be considered consistent with the standards of §216(11) of Chapter X. An election of all directors within 90 days after the effective date of consummation of the plan is essential in the interest of public investors.

Finally, as noted, the value of the reorganized company is significantly less than the original cost of its assets. The trustee has made an adjustment for the difference in the form of a valuation reserve.[43]

[42] As to these requirements, see *Parker Petroleum, Inc.*, 39 S.E.C. 548, 570-571 (1959); *Yale Express System, Inc.*, 44 S.E.C. 770 (1972).

[43] *Cf. Elmer E. Bauer, et al.*, 32 S.E.C. 155, 164-166 (1950).

Since the reorganized company will be subject to the registration and reporting requirements under Section 12(g) of the Securities Exchange Act of 1934, and the technical details will not be finally determined until after the plan is confirmed, it would be premature to suggest the specific method of presentation of this and other items. We recommend that, as soon as practicable after confirmation, appropriate pro forma financial statements of the reorganized company should be submitted to our Division of Corporation Finance for examination and review.

VII. CONCLUSION

The plan is feasible. It should be amended regarding the election of directors, and to provide cumulative voting and preemptive rights for the stock of the reorganized company. It should be clarified with respect to the distribution under the class settlement. As thus amended and clarified, the plan would be fair and equitable and satisfy the other requirements of Chapter X.

By the Commission (Commissioners OWENS, NEEDHAM, HERLONG and LOOMIS), Chairman CASEY absent and not participating.

In the Matter of

FILTROL CORPORATION

File No. 3-3068. Promulgated March 20, 1972

Securities Exchange Act of 1934—Section 15(c)(4)

REPORTING COMPLIANCE PROCEEDINGS

Where annual reports filed under Securities Exchange Act of 1934 included among issuer's assets large amount of municipal bonds, in part under current assets as "shortterm securites (at cost plus accrued interest, which approximates market)" and in part as "other investments (at cost)," but reports failed to disclose, among other things, inability of brokerage firm, whose agreement with issuer to repurchase certain bonds at issuer's cost was principal basis for their inclusion among current assets, to meet repurchase obligations; transaction in which issuer's board chairman caused issuer to purchase from that firm bonds delinquent as to interest payments on same day and at same price at which he had sold them to that firm pursuant to repurchase agreements; and delinquencies and defaults as to certain bonds making them publicly saleable only below cost, *held*, reports were materially misleading, and under circumstances in public interest to accept offer of settlement providing for filing of amended reports and transmission of such reports to stockholders requesting them.

APPEARANCES:

Richard H. Rowe, *Mario V. Mirabelli* and *Carl R. Klein*, for the Division of Corporation Finance of the Commission.

Robert S. Daggett, of Brobeck, Phleger & Harrison, for Filtrol Corporation.

FINDINGS, OPINION AND ORDER

These are proceedings pursuant to Section 15(c)(4) of the Securities Exchange Act of 1934 ("Exchange Act") to determine whether Filtrol Corporation failed to comply with the provisions of Section 13 of the Exchange Act and rules and regulations thereunder by filing annual reports on Form 10-K for its fiscal years ended December 31, 1966 through 1970 which included misleading statements of material facts and omitted information necessary to make the statements therein not misleading.[1] The common stock of Filtrol, a Delaware corporation with principal offices in Los Angeles, California, has been registered on the New York Stock Exchange since 1953.

Filtrol submitted an offer of settlement in which, solely for the purpose of these proceedings and without admitting or denying the allegations in the Statement of Matters filed by our Division of Corporation Finance, it consented to findings based upon such Statement and the offer of settlement that the above-mentioned annual reports failed to comply with the provisions of Section 13 of the Exchange Act and rules and regulations thereunder. In addition, it agreed to amend those reports as specified in the offer of settlement and to notify each stockholder of record that he may obtain copies of the amended reports by returning a postage prepaid request to be enclosed with such notification.

Upon consideration of all the circumstances, including the recommendation of the Division, we determined to accept the offer of settlement, and we accordingly make the following findings:

Each of Filtrol's annual reports on Form 10-K for its fiscal years ended December 31, 1966 through 1970 was materially misleading with respect to the value of certain municipal bonds representing a substantial proportion of the company's assets.

1966 REPORT

Filtrol's balance sheet as of December 31, 1966, contained in its 1966 10-K report, included under the caption "current assets" an item "short term securities (at cost plus accrued interest, which approximates market)," consisting entirely of municiapl bonds and totalling more than $22 million.[2] Of this amount, a total of about $2.7 million[3] represented certain municipal bonds which Filtrol had purchased from the broker-

[1] Section 13 of the Exchange Act, as pertinent here, requires issuers of securities registered pursuant to Section 12 of that Act to file annual reports with us pursuant to rules prescribed by us thereunder. The requirement that reports be filed necessarily embodies the requirement that such reports be true and correct. See, *e.g.*, *Great Sweet Grass Oils Limited*, 37 S.E.C. 686, 684 (1957), *aff'd* 256 F.2d 893 (C.A.D.C., 1958). Moreover, Regulation S-X which states the requirements regarding the form and content of financial statements required to be filed as part of such annual reports, specifies in Rule 3.06 that "The information required with respect to any statement shall be furnished as a minimum requirement to which shall be added such further material information as is necessary to make the required statements, in the light of the circumstances under which they are made, not misleading."

[2] A supporting schedule listed the individual securities, the face amount and a cost figure for each, and an aggregate figure for accrued interest on all the securities.

[3] This figure, and those referred to hereafter, do not include accrued interest except where otherwise indicated.

age firm of Taylor & Company. Another balance sheet item, captioned "other investments (at cost)" and totalling about $2.4 million,[4] consisted principally of municipal bonds purchased from the brokerage firm of J. B. Hanauer & Company at a total cost of about $1.9 million. The bonds purchased from those two firms represented about 15.5 percent of Filtrol's stated total assets. We find that the balance sheet presentation respecting such bonds was materially misleading because of the failure to disclose certain information bearing on their value.

The principal basis on which Filtrol classified municipal bonds as "short-term securities (at cost plus accrued interest, which approximates market)," even though virtually all of them had maturity dates of more than one year after December 31, 1966, was the existence and viability of agreements between it and various brokerage firms, including Taylor, under which those firms were obligated to repurchase the bonds at Filtrol's cost. However, at December 31, 1966, Taylor was not financially capable of fully meeting such obligations.[5] Moreover, absent the possibility of a resale at cost to Taylor, bonds purchased from it on October 10, 1966 at a total cost of more than $1.6 million could not have been publicly resold at a price as high as Filtrol's cost. Most of those bonds were at the time of such purchase already delinquent as to payment of interest, and the remaining ones had suffered a sinking fund deficiency prior to 1965 and the interest due on November 1, 1966 was not paid. Those bonds, or identical ones, had on the same day they were bought by Filtrol been sold to Taylor, pursuant to the latter's repurchase agreement, by Myron A. Bantrell, Filtrol's board chairman who had virtually complete control over Filtrol's investments, for precisely the same amount, which represented Bantrell's original purchase price plus accrued interest, and Taylor actually acted merely as a conduit in the sale to Filtrol without expending any of its own funds. In view of the delinquencies and deficiency and the fact that, as Filtrol knew, Taylor was already on October 10, 1966 unabie to perform fully under the repurchase agreement, it was improper merely to show the bonds purchased on that date at cost figures without appropriate qualifying disclosure.

In addition, some of the bonds purchased from Taylor, for

[4] A supporting schedule showed, as to each issue of bonds, face amount and cost.

[5] Taylor's certified financial statement as of October 31, 1966 showed that its net assets (without taking into account liabilities under repurchase agreements) were substantially less than its liabilities under such agreements.

which Filtrol showed a total cost of more than $1.1 million, were so-called California 1911 Act Assessment bonds, for which there was no established market that could serve as a basis for valuing the bonds.

Filtrol's failure to disclose the above facts regarding the bonds purchased from Taylor rendered its balance sheet presentation with respect to those bonds materially misleading.

With respect to the bonds purchased from Hanauer, they had in 10-K reports prior to 1966 been classified as "short-term" securities and were transferred to the "other investments" category because Hanauer had been adjudicated a bankrupt during 1966 and was financially incapable of performing repurchase obligations. No disclosure was made, however, concerning those facts. Moreover, the report did not disclose that as of December 31, 1966, a substantial proportion of the accrued interest on the Hanauer bonds was delinquent, thus indicating that the value of the bonds had been materially reduced. Of a total of $71,404 in interest accrued as of that date, approximately $30,500 was delinquent as of January 2, 1967.

1967 REPORT

Filtrol's balance sheet as of December 31, 1967, included in the financial statements in its 1967 10-K report, reflected the bonds purchased under repurchase agreements with Taylor and Hanauer in the same manner as in the previous report. In these respects, the report was materially misleading in failing to make appropriate disclosure of material facts relating to the value of those bonds.

At December 31, 1967, the bonds purchased from Taylor were carried at a total cost figure of more than $2.2 million. However, the record indicates that Taylor could not have fully performed under the repurchase agreements as of December 31, 1967, because on Febuary 12, 1968 it filed a petition under Chapter XI of the Bankruptcy Act.[6] In addition, as of December 31, 1967, certain bonds purchased from Taylor at a cost of more than $1.7 million were delinquent as to the payment of interest and certain of these bonds purchased at a cost of $104,000 were also in default as to the payment of principal. The existence of the delinquencies and defaults indicates that the value of these bonds had been materially reduced and that, to the extent there was any market for them, they could only have been sold for a price below their cost. Indeed, in a sworn

[6] This was more than three months before the filing of the 10-K report.

proof of claim filed by Filtrol in June 1968 in the Chapter XI proceedings, it alleged that the actual value of these bonds, as of January 31, 1968, was $405,670, a reduction of more than $1.3 million from the cost figure.[7]

With respect to the bonds purchased from Hanauer, which were reflected at a total cost of about $1.8 million as of December 31, 1967, that firm was still in a bankrupt status on that date and was therefore unable to perform under the repurchase agreements with Filtrol. Moreover, delinquencies existed as to the payment of interest on a substantial amount of those bonds.

REPORTS FOR 1968–1970

Filtrol's balance sheets as of December 31, 1968, 1969 and 1970, which were part of the financial statements in its 10–K reports for the years ended on those dates, reflected the municipal bonds held under repurchase agreements with Taylor and Hanauer as "other investments (at cost)." However, Filtrol failed, in each of these reports, to disclose delinquencies and defaults with respect to a large proportion of those bonds, as a result of which they could only have been sold publicly at a price below Filtrol's cost. The following table reflects, as of the three year-end dates, total stated cost of those bonds, the aggregate cost of those which were delinquent as to the payment of interest (on all of which Filtrol had ceased accuring interest as of February 1968), and the total cost of those delinquent bonds which were also in default as to the payment of principal:

	Total cost	Cost of bonds delinquent as to interest	Cost of bonds in default as to principal
December 31			
1968	$3,851,000	$1,884,000	$147,000
1969	3,730,000	1,879,000	864,000
1970	3,529,000	1,870,000	799,000

CONCLUSION

The Division considers, and we agree, that the amendments proposed to be filed by Filtrol pursuant to its offer of settle-

[7] All but $6 of the value assigned to the bonds in the proof of claim was assigned to one issue, with a nominal value of $1 each being assigned to the remaining 6 issues, all except one of which were California 1911 Act Assessment issues for which, as noted above, no established market existed that could serve as a measure of their value. The bonds as to which there were no delinquencies or defaults were valued more than $111,000 below cost.

ment will provide appropriate disclosure regarding the matters discussed above.

Accordingly, IT IS ORDERED, pursuant to the undertakings in the offer of settlement of Filtrol Corporation, that it file correcting amendments to its Form 10-K reports for the 5 fiscal years ended December 31, 1970, and that it notify each stockholder of record that he may obtain copies of the amended reports, without charge, by returning a postage prepaid request to be provided him with such notification.

By the Commission (Chairman CASEY and Commissioners OWENS, HERLONG, NEEDHAM and LOOMIS).

In the Matter of

YALE EXPRESS SYSTEM, INC.

and subsidiaries

Debtors

Promulgated March 23, 1972

SUPPLEMENTAL REPORT ON PROPOSED PLANS OF REORGANIZATION

This report supplements our original report on the trustee's amended plan of reorganization of Yale Express System, Inc. ("Yale Express") and its subsidiaries.[1] The trustee has amended the plan, which meets only in part some of our recommendations but not others. He has also proposed other amendments to the plan not heretofore considered. The hearing on the plan as thus amended was held on February 18, 1972.

The trustee has amended the plan to provide cumulative voting and pre-emptive rights for the common stock of the reorganized company. The latter feature was qualified in certain respects, as to which we agree only in part.

Under the plan the reorganized company will issue to its creditors 10-year notes and common stock on the basis of one share of common stock for each $5 in claims. The amount of notes to be issued will total about $2.3 million in principal amount. The trustee has amended the plan to provide that these notes may be converted at any time prior to maturity at the rate of one share of stock for $5 principal amount of the note, and he modified the pre-emptive rights to exclude therefrom stock to be issued on conversion of such notes. But the exclusion is also extended to any issue in the future of "other convertible debt securities of Yale Express or otherwise issued in connection with borrowings by Yale Express . . . . "

Although generally we have reservations about the propriety of issuing convertible securities under a plan of reorganization, we do not object to the conversion feature of the notes

[1] *Yale Express System, Inc.*, 44 S.E.C. 770 (1972).

to be issued under the plan, and the related modification of pre-emptive rights. In addition to projected earnings per share, we have also considered that the notes will be subject to sinking funds requirements pursuant to which 70 percent of the issue will be retired prior to maturity, and that the full conversion of the notes, if not previously retired or redeemed, will add about 380,000 shares to the 3.3 million shares to be outstanding at consummation of the plan.[2]

We do not agree that the exception should extend to any convertible security that the reorganized company may issue in the indefinite future. A convertible security can substantially dilute the interest of existing stockholders if, later on, at the time of conversion, the conversion price should be considerably less than the then market price of the stock. Pre-emptive rights would bar this source of potential dilution, since, without the modification proposed by the trustee, the reorganized company would be precluded from issuing convertible securities other than those the plan now specifies.

We are not suggesting that the reorganized company should remain permanently under this bar. If management believes that pre-emptive rights should be modified to permit the issue of convertible securities, it can secure such modification by a vote of stockholders specifically directed to this proposal. We do not consider such modification a proper proposal for inclusion in the plan.[3] Present securityholders voting on the plan do not have the opportunity to address themselves to this specific feature of the plan. Their only alternatives are to vote for or against the plan in its entirety.

The trustee has accepted our valuation of Yale Transport's earnings and there is no dispute regarding the value of Yale Express buildings. He agrees with our computation of the present value of the projected tax savings, but at the reconvened hearing he introduced additional data to show that there are other sources for additional pre-tax income and therefore more tax savings, which discounted to present worth amount to about $562,000. He disagrees with our adjustment of his estimated excess cash at May 31, 1972, the assumed consummation date.

The trustee has estimated excess cash at $1.5 million, which

[2] The plan excludes pre-emptive rights for stock issued pursuant to the employee benefit plans which meet the requirements of the Internal Revenue Code. This provision is also not objectionable.

[3] *Cf.* Section 216(12) (b) (1) of Chapter X which provides that the charter of the reorganized company shall include "provisions which are fair and equitable . . .," including provisions "with respect to the issuance" of securities by the reorganized company.

we reduced to $1.16 million. The reduction was to reflect $340,000 in expenditures for equipment that the trustee had projected. At the reconvened hearing he stated that his estimate of excess cash had allowed for these purchases and that our disagreement was due to a misunderstanding.

His projection of excess cash showed that at February 28, 1972 he would have $2,074,000 cash on hand. But as of that date actual cash, including certificates of deposit, totaled about $1,885,000, or about $200,000 less than projected. Thus, on the trustee's assumption, excess working capital would be about $1.3 million if we accept his estimate and adjust for this $200,000. We need not, however, pursue this matter any further at this time. Starting with $1.3 million as a base, the trustee can ascertain the actual amount by an adjustment, up or down, shortly prior to consummation.[4]

The additional tax savings that the trustee anticipates are based primarily on pre-tax operating profits of Yale Express from rentals of its Manhattan building. Yale Express derives its corporate revenues partly from rental of equipment to its subsidiaries but mostly from rentals to tenants in this building. Originally the trustee did not project any income for Yale Express because revenues have not been sufficient to produce an operating profit. However, he has recently negotiated a lease with the United States Postal Service for additional space that became available. Effective January 1, 1972, the Postal Service occupies about 83 percent of the available space; the remainder is leased to other tenants.

According to the trustee, the new lease, for a term of four years, is more advantageous than the lease with the prior occupant. He estimates additional rental revenues of about $170,000 per year and an annual pre-tax net income for Yale Express of $150,000 for 1972–1976. In view of the tax loss carryover, this income will not be taxable and hence produce additional tax savings.

The trustee's estimate of additional tax savings based on additional rental income is not consistent with available data. For the 11 months ended November 30, 1971, Yale Express had an operating loss of $49,122,[5] or about $54,000 on an annual basis. Thus the annual operating profit over the five years as adjusted for the additional $150,000 may be about $100,000 per

[4] The Court has recently approved a petition to purchase equipment which will require and expenditure of $159,000 out of $340,000 he had contemplated.

[5] The 11-month revenues reflect a non-recurrent amount of $21,668 received from Postal Service for certain construction by Yale Express.

year. Discounted to present worth at 8 percent, the additional tax savings would have a value of $142,000. In any event, whatever the amount, it is sure to be reduced by a rise in expenses due to inflation, which the trustee did not consider. This is a significant consideration when, as here, the major portion of the rental income is fixed by longterm leases, which allow an adjustment in rental payments for a rise only in some of the expenses.[6]

The trustee has also estimated additional tax-free income from investment and reinvestment of excess cash. No such projections were submitted at the time of the first hearing on the plan in September 1971.

The trustee's projection of interest income for 1972–1976 from investments is based on his assumption that initially excess cash for investment will amount to $500,000 as a result of cash payments to creditors under the plan. Thereafter it will continue to accumulate at the constant rate of $500,000 per annum and reach $2.5 million by December 31, 1976. He also assumed an interest yield of 6 percent during the period.

In these cash flow projections the trustee apparently allowed for purchases of equipment during the 5-year period, but he made no allowance for dividend payments. His assumed rate of 6 percent interest yield does not appear realistic. Current rates for certificates of deposit and commercial paper, and the yields that the trustee is receiving on certificates of deposit, are substantially less than 6 percent. We do not know how the trustee may assume a 6 percent yield over the next five years.

It is clear that his projected cash flow requires considerable modification and that his estimated additional tax benefits, reconsidered in light of our discussion, may not add much to the net equity for stockholders.

Total valuation, as indicated in our prior report, included an appraised value of $6,221,500 for the two buildings. The Manhattan building, appraised at $5,876,500, was built on two adjacent lots, and are subject to two separate leases, one expiring in 1974 and the other in 2014.

The appraised value assumed the extension of the 1974 lease to 2014. At the earlier hearing the trustee stated that the consent of the lessors to the extension "will be predicated on the plan of reorganization being accepted by this court." At

[6] The Postal Service under its leases will pay only 20 percent of any increase in real estate taxes on 204,528 sq. ft. and 31.5 percent of the increase for the balance of 139,404 sq. ft.

the reconvened hearing the trustee advised that the status of this lease was unchanged and that a written agreement for its extension has not yet been executed. The motor carrier operations of Yale Express and its subsidiaries will not be affected by the status of this lease, but the stockholders' equity undoubtedly will.

Under the plan originally filed by the trustee, creditors were to receive post-bankruptcy interest on their claims at 4¼ percent per annum when no rate was specified in the instrument giving rise to the obligation. In our report we differed with this approach and, in accordance with precedent, we computed interest on such claims at the applicable legal rate prescribed by New York law.

The trustee, although conceding that the rate of 4¼ percent was inappropriate, does not agree that the legal rate should apply. Instead, he has amended the plan to provide for payment of interest, where there is no contractual rate, at the rate charged from time to time by the Chase Manhattan Bank (N.A.) on short-term loans to prime commercial borrowers. The trustee believes that this rate will provide creditors with "commercially normal compensation" for the loss of use of their money during the reorganization proceeding. He also states that the requirement of paying interest in excess of "commercially normal" rates would penalize a corporation for having sought the protection afforded by Chapter X. According to the trustee, application of the prime rate rather than the legal rate will result in a reduction of liabilities by approximately $242,000.

We find this alternative unacceptable. The prime rate is a rate established by major lending institutions for loans to a limited class of borrowers. For most individuals and commercial enterprises, the prime rate is not a realistic yardstick of income lost as a result of a debtor's inability to satisfy pre-Chapter X claims. No showing has been made by the trustee that Yale creditors are exclusively or even to any significant extent prime borrowers, who could have borrowed at the prime rate during the Chapter X proceeding. When a debtor is confronted with a diversified group of trade and other general creditors, it is reasonable to assume that the interest rates which these creditors would be able to receive from their borrowers or which they would be required to pay to their lenders would vary from creditor to creditor. Unless a detailed inquiry is to be made into the ability of each and every creditor to negotiate interest rates based upon his particular circumstances, we believe the appropriate rate to be that fixed by local law with respect to debts which call for the payment of interest but as to which the rate is not specified in the terms of the instrument.

The approach we suggest in no sense inflicts a penalty on a debtor in Chapter X. Apart from the fact that it is most unlikely that Yale is a prime commercial borrower, the trustee concedes that for a period of 470 days during the reorganization proceedings, the prime rate charged by the Chase Manhattan Bank (N.A.) has been higher than the legal rate established under § 5–501 of the New York General Obligations Law. Nor has the trustee taken into account the general practice of banks to require even prime borrowers to maintain compensating balances. As a result the effective cost of money is actually more than the ostensible prime rate. Thus, the rate proposed by the trustee could increase a debtor's liabilities if it happened to be in reorganization largely during a period when the prime rate, adjusted or not for compensating balances, is higher than the legal rate.

Rather than focus upon the effect of a given interest rate upon the estate, which in any event may vary from case to case, we believe that the plan should incorporate a standard which will provide adequate compensation to creditors for delay. The legal rate serves this purpose.[7]

One merchandise creditor asserts that the plan is unfair to vendors who sold to the debtors on credit.[8] This contention is bottomed entirely on the so-called "six-months rule" according a priority to those who supplied goods and services essential to the operation of the enterprise within a reasonably short period prior to the initiation of the insolvency proceedings.[9] That rule "had its origin in railroad receivership cases." [10]

[7] *Cf.* Section 3–118(d) of the Uniform Commercial Code which provides that "[u]nless otherwise specified a provision for interest means interest at the judgment rate at the place of payment . . . " This is the same as the legal rate. See § 5004 of the New York Civil Practice Law and Rules and *Rachlin and Co.* v. *Tra-Mar, Inc.*, 33 App. Div. 2d 370, 308 N.Y.S. 2d 153, 157–159 (1st Dept. 1970).

[8] That creditor, Altul Fuel Company, supplied the debtors with oil and gaoline. The principal amount of Altul's claim is approximately $74,000. Even when 42 percent is added to that sum as it must be in view of the debtors' solvency, Altul's claim scarcely bulks large here. But claims of the class for which Altul has appointed itself spokesman bulk very large indeed. They amount (with interest) to some $3,290,000. A determination that this class is entitled to treatment more favorable than that which the plan accords to it would at the very least require drastic revisions in the plan and might, the trustee suggests, render unfeasible any attempt to reorganize within the calculable future.

[9] "Six months is the limit", *Dudley* v. *Mealey*, 147 F.2d 268, 271 (C.A. 2, 1945), *cert. den.* 325 U.S. 873.

[10] 6A *Collier on Bankruptcy*, page 249.

Like the trustee, we think it inapplicable here.[11] Hence we agree with him that the plan is fair to trade creditors.

To begin with, there is some question as to whether the rule applies at all to debtors other than railroads.[12] We recognize that the doctrine has been extended in this and in other circuits to a narrow class of non-rail cases. It is significant that while Congress codified the six-months rule in Section 77 of the Bankruptcy Act (11 U.S.C. 205) for railroad reorganization, it refrained from doing so when later it wrote Chapter X in 1938. That was no oversight; it was a deliberate policy decision.[13]

Even if the six-months rule carries over to some extent from Section 77 to Chapter X,[14] it is clear that it does not carry over to the ordinary, private corporation.[15] It is limited to cases in which "there is a public interest in maintaining uninterrupted the business of a corporation which is public or semi-public in character,"[16] and when there is a "compelling necessity for the continued operation of this . . . business in terms of public

[11] We are not unmindful of the footnote dictum in a 1966 Court of Appeals opinion written in these proceeding suggesting that the appellant then before it "might argue that it is entitled to preferred treatment in a plan . . . at least where the claims accrued within six months of the filing of the petition." *In re Yale Express System, Inc.*, 362 F.2d 111, 117, n. 5. But we think that the court was there engaged in a more tentative exploration of argumentative possibilities. It certainly was not laying down the law of the case.

[12] The Supreme Court has never applied the rule to a debtor that was not a railroad and has said that the rule ". . . lays great emphasis on the consideration that a railroad is a peculiar property . . . discharging a great public work." *Wood V. Guarantee Trust & Safe Deposit Co.*, 128 U.S. 416, 421 (1888).

[13] Former Section 77B of the Bankruptcy Act (48 Stat. 912, 915), the predecessor to Chapter X enacted in 1934, had made express provision for the six-months rule. It was excluded from Chapter X, although originally it was proposed to include it. See *Analysis of H.R. 12889 Containing Amendments Proposed By the National Bankruptcy Conference Printed For the Use of The Committee On The Judiciary House of Representatives* (74th Cong., 2d Sess. (1936)) at p. 74.

See also Finletter, *The Law of Bankruptcy Reorganization* 384 (1939) where it is stated that the rule ". . . is not based on any general principle of equity applicable to all persons having the same legal claim against the assets of the debtor. To extend it beyond its present limits by judicial decision would be an unsound form of legal development and would be appropriate only if effected by an act of Congress."

[14] If it does, the carryover must be based entirely on the court's general equity jurisdiction. There is no other basis for it. See *In re Yale Express System, Inc.*, 362 F.2d 111, 117, n. 5 (C.A. 2, 1966); *In re North Atlantic & Gulf Steamship Co., Inc.*, 200 F. Supp. 818, 821 (S.D. N.Y., 1962), *affd sub. nom., Schilling* v. *McAllister Bros.*, 310 F.2d 123 (C.A. 2, 1962). See also Gerdes, *Corporate Reorganizations: Changes Effected by Chapter X of the Bankruptcy Act*, 52 Har. L. Rev. 1, 28–29 (1938); 6A Collier at pp. 251–252.

[15] See, *e.g.*, *In re North Atlantic & Gulf Steamship Co., Inc.*, 200 F. Supp. 818, 821 (S.D. N.Y., 1962, *aff'd* without discussion of this point *sub. nom, Schilling* v. *McAllister Bros.*, 310 F.2d 123 (C.A. 2, 1962); "With rare exceptions the rule has been confined to cases involving public or quasi-public corporate debtors where there is a public interest in the continued operation of the business . . . In addition to railroads such enterprises as utility or public transportation systems have been deemed to fall within this category . . .; *In re Pusey & Jones Corp.*, 192 F. Supp. 233, 236 (D. Del., 1961): "Considered reflection leads to the view the exception of the six-months' rule should not be extended to all private corporations. This . . . probably accounts for the fact that no case has been found where the six-months' rule has been squarely applied to a private corporation . . ." and where the Third Circuit in affirming observed that "The question in this case is whether this rule which started as one having to do with a railroad is to be applied to a private business. The district court said no in a thoroughly considered opinion and in spite of references to Remington and Collier, both of which do not limit the rule to public service reorganization cases." *In re Pusey & Jones Corp.*, 295 F.2d 479, 480 (C.A. 3, 1961).

[16] 6A Collier at p. 251.

interest."[17] It has no application to the kind of debtors in this proceeding.

The objecting creditor relies on the fact that the case involves a common motor carrier subject to the jurisdiction of the Interstate Commerce Commission. But the mere fact that an industry is regulated is by no means enough in itself to demonstrate the vital interest in the continued operation of each specific firm within the industry that must be shown before the six-months rule can be invoked. The six-months rule makes sense in insolvency proceedings involving railroads (where the rule originated and to which, we suggest, it may well be limited), electric companies, gas companies, and enterprises such as street railway companies or bus companies which have the exclusive right to carry passengers over specified routes. Such enterprises are natural or quasi-monopolies, legally obligated to render continuous service and to serve all comers. Because of the vital public interest in their uninterrupted operation such enterprises may be publicly owned, but the public interest in their continuance is no less vital when they are privately owned. Hence those who supply them with the goods and services, without which they cannot function, are given a favored position in the event of insolvency.

When an industry, including motor carriers, consists of many competing firms, and the degree of freedom of entry is relatively high, regulation is based on the real or assumed need to control "destructive" competition. There is no basis for the six-months rule for such enterprises.[18] For example, the taxi business in New York City and the securities business are also regulated enterprises. But it does not follow that the public has a vital stake in seeing to it that each and every firm in those industries stays in existence.

There are many firms in the trucking business, and their routes are non-exclusive. Trucks run on public highways built

[17] *In re North Atlantic & Gulf Steamship Co., Inc.*, 200 F. Supp. 818, 822 (S.D. N.Y., 1962), *aff'd* without discussion of this point *sub. nom., Schilling* v. *McAllister Bros.*, 310 F.2d 123 (C.A. 2, 1962).

[18] Motor carrier regulation falls into this latter category. See Note, *National Transporation Policy and the Regulation of Motor Carriers*, 71 Yale L. J. 307 (1961) cited with approval and commented on as follows by Circuit Judge Feinberg while on the bench of this court in *In re Chicago Express, Inc.*, 222 F. Supp. 566, 570 (S.D. N.Y., 1963), *aff'd* without discussion of the point in 332 F.2d 276 (C.A. 2, 1964), *cert. den.* 379 U.S. 879. "A recent survey of motor carrier regulation lends considerable support to the conclusions that the policy reasons responsible for the evolution of the 'six months rule' in railroad receiverships are not as compelling with respect to motor common carriers." The regulatory scheme on the existence of which the objecting merchandise creditor's contentions rest came into being in 1935 as a result of the Morot Carrier Act of that year. Section 202(a) of the statute referred to at page 14 of the trustee's memorandum spoke of the need to avoid "unfair or destructive competitive practices." (49 Stat. 543) That section was repealed when the Motor Carrier Act was consolidated with the other statutes administered by the Interstate Commerce Act of 1940. (54 Stat. 899)

and paid for by the taxpayers. Hence no expensive right of way need be maintained. If one trucker disappears, another is likely to take his place.

The foregoing considerations were recognized in *In re Richards*,[19] where the court held the six-months rule inapplicable to a common carrier by motor vehicle because:

> "One of the chief differences between the operation of this debtor and a railroad is that, from a practical standpoint, it is virtually impossible to supply the same services which a railroad gives without using the property of the railroad acquired through eminent domain and improved at great expense. Hence, the public has a great interest in the continued operation of the facilities of the railroad which does not exist in an operation such as this debtor's, which can be duplicated without the acquisition of property by eminent domain and without the investment of large sums of money and which is in fact duplicated by competitors at the present time." (43 F. Supp. at pp. 734–5.)[20]

Further, these debtors are solvent. General, unsecured creditors are receiving full compensation (including post-bankruptcy interest) for their claims, and a residual equity for stockholders remains. In such circumstances there is no scope at all for the six-months rule—whatever the industry involved. That rule is an equitable device. It was fashioned for the purpose of saving certain trade creditors from the total or nearly total loss that they would otherwise suffer when secured claims threaten to consume the entire estate. Hence, in those circumstances there is need for "some protection to supply creditors."[21] There is no need for such protection when, as here, the liens are few and amply secured and the debtor solvent. To grant it in such a case is to single out one group of general, unsecured creditors for especially favored treatment at the expense of others in the same class (such as the public debentureholders here) and of stockholders as well.[22] Neither precedent nor policy warrants so inequitable a result.

[19] 43 F. Supp. 733 (M.D. Pa., 1942).

[20] *Richards*, a Chapter XI case, was cited approvingly in a later Chapter XI case in this court. *In re Chicago Express, Incorporated*, 222 F. Supp. 566, 570 (S.D. N.Y., (1963)), *affirmed without discussion of the point* in 332 F.2d 276, *certiorari denied* 379 U.S. 879. As *Chicago Express* points out, the six-months rule seems inapplicable in any Chapter XI case since "chapter XI itself appears to preclude application of a priority rule developed in federal equity receivership cases. . . . Priorities in Chapter XI . . . are specifically enumerated in Section 64 of the Act." But there are no Chapter X cases dealing with the applicability of the six-months rule to truckers. And we consider the reasoning of *Richards* and *Chicago Express* persuasive here. The only case in which the six-months rule was applied to a trucker, *In re Missouri Motor Distrib. Corp.*, 21 F. Supp. 13 (W.D. Mo., 1937) was decided under former Section 77B where the rule appeared in the test of the statute as it does not in Chapter X.

[21] *Dudley* v. *Mealey*, 147 F.2d at 271.

[22] *Cf. Young* v. *Higbee*, 324 U.S. 204, 210 (1945): ". . . [H]istorically one of the prime purposes of the bankruptcy law has been to bring about a ratable distribution among creditors of a bankrupt's assets; to protect the creditors from one another. And the corporate reorganization statutes look at a ratable distribution of assets among classes of stockholders as well as creditors."

There is, finally, the provision proposing to discharge the indenture trustee for debentureholders of Yale Express. Its inclusion in the plan meant that the order confirming the plan would grant the discharge. We stated in our report that such a provision was not appropriate as part of the plan of reorganization.

At the reconvened hearing the Court suggested that the plan only recite the proposed discharge and thereby give notice to debentureholders, but that the actual discharge will be deferred until the hearing on applications for allowances, unless there is any objection thereto at or prior to this hearing. This is an appropriate modification, which obviates the objections noted in our report.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM, HERLONG and LOOMIS).

IN THE MATTER OF

ABACUS FUND, INC.

File No. 3-3603. Promulgated March 28, 1972

Investment Company Act of 1940—Section 17(d)

MEMORANDUM OPINION AND ORDER

Abacus Fund, Inc. ("Abacus"), a Delaware corporation, registered as a closed-end, non-diversified, management investment company, has filed an application pursuant to Section 17(d) of the Investment Company Act of 1940 ("Act") and Rule 17d-1 thereunder for an order permitting the participation of Abacus with Frank A. Weil ("Weil") and Peter J. Sharp ("Sharp") and persons controlled by them in the proposed merger of Abacus into Paine, Webber, Jackson & Curtis, Inc. ("PWJC"), and certain related transactions.

On March 9, 1972, the Commission issued a notice of filing of such application (Investment Company Act Release No. 7053), describing the participation of Abacus with Mr. Weil and Mr. Sharp in the proposed merger of Abacus into PWJC and the transactions related to the merger.

The notice gave interested persons an opportunity to request a hearing and stated that an order disposing of the application might be issued on the basis of the information stated in the application. No request for a hearing has been filed and the Commission has not ordered a hearing.

In determining whether the application should be granted, we have considered, among other things, the fairness of the terms of the merger agreement between Abacus and PWJC. In particular, we note that the merger agreement provides that PWJC will issue 1/2 share of its $1.30 Series A Convertible Preferred stock and 1/2 share of its common stock for each share of Abacus common stock, and, in lieu of receiving PWJC common and preferred stock, the agreement provides that each Abacus stockholder will have an option to receive cash in an amount equal to the net asset value of his shares on the date of the merger. Since the merger agreement affords an

Abacus shareholder with two alternatives; i.e., accepting the PWJC securities package or electing the cash option, we must consider the fairness of each alternative to the Abacus shareholder. Abacus represents that the terms of the merger agreement are the result of arms-length negotiation between it and PWJC; that it has been advised by Kuhn, Loeb & Co. that it is prepared to underwrite, on a firm basis, a public offering of the PWJC securities to be received by the Abacus shareholders at a net price to such shareholders in excess of the net asset value of the Abacus common stock; and that all of the Abacus directors except Mr. Sharp have advised Abacus that they and their associates will exchange their Abacus shares for PWJC securities.

We have weighed the various pertinent factors presented, including the representations of Abacus, an evaluation of the rights attaching to the PWJC convertible preferred and common stock, and the option available to shareholders to receive cash equal to the net asset value of their Abacus shares. On the basis of such consideration we have concluded that the alternative accorded the shareholders of receiving the PWJC shares bears a relationship to the option to receive the cash net asset value which is within a reasonable range of fairness, and that each alternative may be deemed fair to the Abacus shareholder. In thus concluding that the merger agreement offers the Abacus shareholders two fair alternative courses of action, we express no view as to whether any particular shareholder may or may not find it advantageous to elect one or the other of the options given him.

Accordingly, the Commission finds that the participation of Abacus with Mr. Weil and Mr. Sharp and persons controlled by them in the proposed merger of Abacus into PWJC and certain related transactions, on the basis proposed, is not on a basis different from or less advantageous than such other participants and is consistent with the provisions, policies and purposes of the Act.

IT IS ORDERED, pursuant to Section 17(d) of the Act and Rule 17d–1 thereunder, that said application is hereby granted, effective forthwith.

IT IS FURTHER ORDERED, pursuant to Section 38(a) of the Act, that the Commission's prior Order dated November 26, 1969 In the Matter of Star Capital Corporation (Investment Company Act Release No. 5902), is hereby amended to the extent necessary to permit consummation of the proposed merger of Abacus and PWJC, wherein PWJC will succeed to ownership of all the outstanding stock of Star Capital Corporation on the effective date of the merger.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM, HERLONG and LOOMIS).

IN THE MATTER OF

PATHE INDUSTRIES, INC.

File No. 3-2272. Promulgated April 13, 1972

Investment Company Act of 1940—Section 17(b)

TRANSACTIONS BETWEEN AFFILIATED PERSONS

MODIFICATION OF WARRANTS FOR PURCHASE OF STOCK OF AFFILIATE

Where proposed modification of terms of warrants, previously issued by affiliate of registered investment company in partial consideration for purchase of certain assets of investment company, including extension of exercise period so as to preserve value of expiring warrants, accorded with intention of parties at time of purchase, *held*, modification met requirements of Section 17(b) of Investment Company Act of 1940 for exemption from Section 17(a) prohibition of such modification, and application for exemption *granted*.

APPEARANCES:

E. Eugene Mason and *Carol Broderick*, of Mason & Ringe, for Pathe Industries, Inc.

Stephen M. Axinn, *Robinson Markel*, *Robert Hermann*, *Herbert Teitelbaum*, and *Dennis J. Drebsky*, of Skadden, Arps, Slate, Meagher & Flom, for Perfect Film & Chemical Corporation (now Cadence Industries Corporation).

Stanley B. Judd and *Daniel C. Maclean*, for the Division of Corporate Regulation of the Commission.

FINDINGS AND OPINION OF THE COMMISSION

Pathe Industries, Inc. ("Pathe"), which became registered as a closen-end non-diversified management investment company in April 1968, has filed an application pursuant to Section 17(b) of the Investment Company Act of 1940 ("Act") for an exemption from Section 17(a) of the Act with respect to a proposed agreement dated September 15, 1969 between it, Perfect Film & Chemical Corporation ("Perfect") (now Cadence Industries Corporation), an affiliate, and Pathe Laboratories, Inc. ("Laboratories"), a subsidiary of Pathe.[1] That agreement provides for

[1] Laboratories is wholly owned by Theta Enterprises, Inc. ("Theta"), which in turn is wholly owned by Pathe.

modification of the terms of warrants which were issued by Perfect to Laboratories in 1967 in partial consideration for its purchase of Laboratories' assets and which are now held by Pathe.

After appropriate notice, hearings were held at which Perfect participated in opposition to the application. An initial decision by the hearing examiner was waived, and briefs were filed by Pathe and our Division of Corporate Regulation ("Division") in support of the application and by Perfect, and we heard oral argument. Our findings are based upon an independent review of the record.

BACKGROUND

In 1967 Perfect was engaged in the processing and development of photographic products, primarily for the amateur photographer. With a view to expanding its operations in professional photograph processing areas, Perfect obtained control of Pathe in June 1967 by acquiring about 9.5 percent of its common stock and proposed the purchase of the principal assets of Laboratories, which processed motion picture film for commercial users. The consideration was to include $3,025,000 in cash, a certain amount of Perfect's common and convertible preferred stock, and warrants to purchase 209,220 shares of Perfect common stock. It was contemplated that the warrants would be distributed to Pathe's stockholders as a dividend upon their effective registration under the Securities Act of 1933 and be exercisable for a period of 14 months from the date of distribution. Because of Perfect's control of Pathe, Standard Research Consultants, Incorporated (then a subsidiary of Standard & Poor's Corporation), an independent financial expert, was hired under the direction of Martin Ackerman, who was president and board chairman of Perfect and assumed the same positions with Pathe, to value the assets of Laboratories and determine the adequacy of the consideration proposed to be paid by Perfect.

Following Standard's determination that in its opinion the consideration for Laboratories' assets, which it valued at $9,729,000, was adequate, an agreement was entered into between Perfect and Laboratories on October 27, 1967 ("1967 agreement") specifying the proposed consideration and, as supplemented by a warrant agreement, providing for the terms of the warrants to be distributed to Pathe's stockholders. These were to be exercisable within 14 months from the effective date of registration or by December 31, 1969, whichever occurred first, at $48 per share of Perfect stock or, if lower, the average market price of such stock, which is listed on the New York Stock Exchange, on the day preceding the effective date. Perfect undertook to use its best efforts to have the warrants and underlying stock as well as the other securities registered, and Laboratories agreed to take the necessary steps to enable Pathe to distribute the warrants to its stockholders.[2]

Pursuant to the agreement, Perfect acquired Laboratories' assets and paid the cash and issued the securities to it, and in July 1968 it filed a registration statement with respect to the warrants and other securities. Pathe, following its receipt of the warrants, declared them as a dividend around August 1968 for distribution to its stockholders upon effective registration.

Shortly before Perfect filed the registration statement, it acquired subsidiaries of The Curtis Publishing Company; thereafter, because of the length of the period for which the required certified financial statements respecting those subsidiaries had to be obtained for inclusion in the registration statement, it became apparent that the processing of the registration statement would be substantially delayed.

On June 9, 1969, Perfect's Board voted to propose to Pathe the extension of the exercise period of the warrants so that they would expire 14 months after effective registration, provided that Pathe agreed that the exercise price be the lesser of $48 or $7 above the average market price for 30 days prior to the effective date. Pursuant to a suggestion made at that Board meeting, Standard was again retained to make an independent study to determine the fairness as of June 30, 1969, of the proposed modifications of the exercise period and exercise price. The then counsel to Perfect and Pathe, who attended the meeting, testified that it was contemplated by the Board that Standard's opinion with respect to fairness would be final and that no further action would be required by the Board. After review, Standard expressed the opinion that the proposed modifications would be fair to the parties if, in fixing the alternative exercise price that was related to market price, the premium were set at 25 percent above the average market price, rather than at a fixed dollar figure, because of the fluctuations in the market price of Perfect's common

[2] Laboratories agreed to declare a dividend of the Perfect warrants to Theta upon the latter's undertaking to declare a dividend of them to Pathe.

stock.[3] The Perfect Board, at a meeting conducted by Ackerman as chairman on September 15, 1969,[4] directed the company to enter into the proposed agreement with Pathe, which incorporated the modifications of the warrants as proposed by Standard, and further directed Perfect to cooperate with Pathe (which was now a registered investment company) in obtaining the necessary exemption from Section 17(a) of the Act discussed below.[5] That agreement, which is the subject of these proceedings, was entered into the same day by Perfect, Pathe and Laboratories. Later that day, the Board which had directed execution of the modification agreement was replaced by a new group, and in November 1969 Perfect requested withdrawal of its registration statement because it wished to submit certified financial statements for 1969 and make substantial revisions in its registration statement. In March 1970, withdrawal was permitted.

SECTION 17(b) EXEMPTION

Perfect, by virtue of its ownership of more than 5 percent of the voting securities of Pathe, is an affiliated person of Pathe within the meaning of Section 2(a)(3) of the Act. The proposed modification of the warrants issued by Perfect, constituting a sale of such warrants as modified, therefore comes within the prohibition of Section 17(a) of the Act which, in pertinent part, makes it unlawful for an affiliated person of a registered investment company to sell any security to such registered company or to any company controlled by such registered company. Section 17(b) provides for the granting of an exemption from such prohibition if evidence establishes that "the terms of the proposed transaction, including the consideration to be paid or received, are reasonable and fair and do not

[3] Standard valued the warrants as of June 30, 1969, at $3.50 each without any changes, and at $7 with the proposed changes, compared to its 1967 valuation of $11. In reaching the $3.50 valuation, it took into account that as of June 30, 1969 a maximum of only six months remained assuming registration had then become effective, compared to the 14-month exercise period originally intended to be granted to Pathe's stockholders, and that the market price of Perfect's common stock had evidenced a sharp downward trend, closing at 21¾ on June 30, compared to its average price of 48¾ from October 2 to 27, 1967. In a subsequent appraisal as of December 31, 1969, Standard valued the warrants at $4 each on the assumption the modification agreement would be approved by us, and considering the indeterminate nature of the exercise period and price, lack of marketability, the continued downward trend in the market price of the underlying common stock, and the closing market price of 15 on that date.

[4] At the June 9, 1969 meeting, the Board had accepted Ackerman's resignation as president of Perfect.

[5] According to the minutes, Ackerman stated that he and other members of the Board with one exception believed they had already authorized the extension of the exercise period and the increase in the alternative exercise price at the June 9 meeting but felt a responsibility to take "clear and definitive action" with respect to the modifications in line with Standard's opinion in order to assure the value of the consideration given to Laboratories in the 1967 agreement. The then counsel to Pathe and Perfect testified that he recommended the September 15 meeting because he felt that the minutes of the June 9 meeting did not accurately reflect what was approved.

involve overreaching on the part of any person concerned" and that the proposed transaction is consistent with the policy of the registered investment company and with the general purposes of the Act.

Perfect contends that the record does not establish that the proposed modification agreement is reasonable and fair and does not involve overreaching. It asserts that it used its best efforts to secure registration of the warrants, that the warrants expired on December 31, 1969, that it had no obligation to extend them, and that the warrants as modified are in effect new warrants for which no consideration is being received by it. It argues that Laboratories' acceptance in the October 1967 agreement of warrants with alternative expiration dates, one of which (December 31, 1969) was not tied to the effectiveness of a covering registration statement, necessarily contemplated that the warrants might expire before the registration statement became effective and that the agreement could be fully performed irrespective of an effective registration statement. It points out that two forms of warrants were provided for under the October 1967 agreement and asserts that the first or interim one, which was to be exchanged for the second one upon effective registration, was immediately exercisable by Laboratories and that Laboratories could have profitably exercised them at $48 per share until they expired on December 31, 1969, since Perfect's common stock traded as high as 88½ during the exercise period. It argues that the interim warrants were a hedge against the possibility that registration would not be obtained and therefore represented an extremely valuable asset.

On the record before us, we are satisfied that the terms of the modification agreement meet the equity standards of Section 17(b). Concerning the necessity for legal consideration, as urged by Perfect, it appears that under New York law, which as provided in the 1967 agreement governs its construction, no legal consideration is necessary for an agreement to modify the terms of a prior agreement.[6] Moreover, legal consideration is provided by the increase in the alternative exercise price or by Laboratories' or Pathe's forebearance from asserting a claim against Perfect based on its acquisition and retention of the Curtis subsidiaries which prevented performance of its "best efforts" undertaking to register the warrants. Turn-

[6] Section 5-1103 of the New York General Obligations Law provides that an agreement to modify any contract is not invalid because of the absence of consideration if it is in writing and signed by the party against whom it is sought to enforce the modification.

ing to the equitable considerations, the facts show that the parties to the 1967 agreement did not consider the December 31, 1969, expiration date to be of operative importance. They believed and intended that the warrants would be effectively registered in sufficient time to give Pathe's stockholders an exercise period of 14 months, and Standard's 1967 valuation of the warrants was based upon this premise.[7] As previously mentioned, this expectation was not realized as a result of Perfect's own act in acquiring the Curtis subsidiaries and its failure to divest itself of them when it became apparent that their ownership would prevent registration for a considerable period. It is therefore clear that the modification of the warrants cannot be viewed as an isolated transaction, but rather as restoring the parties, in light of the changed circumstances arising from Perfect's own action which stalled the registration process, to a position comparable to that originally intended.

Perfect's assertion that the interim warrants were immediately exercisable by Laboratories is contradicted by the terms of the 1967 agreement. While those warrants appeared to permit Laboratories to exercise them, they were subject to the terms of the agreement under which Laboratories undertook to and did transfer them to Pathe for distribution as a dividend to the latter's stockholders upon effective registration and exchange for the second warrants. Distribution of the warrants to Pathe's stockholders was provided so that the warrants would not, through single ownership, pose a threat to Perfect's management, which owned fewer shares of Perfect stock than the warrants would entitle their owners to purchase.

Perfect further argues that the fact that it, as an affiliated person, opposes the modifications creates a strong presumption of unfairness, and it stresses Ackerman's common control of Perfect and Pathe at the time of the June 1969 authorization of a modification agreement, and the authorization of the final agreement three months later by Perfect's old board, shortly before election of the new board, assertedly to deny the latter an opportunity to consider it.

[7] We note that under the 1967 agreement Perfect undertook to use its best efforts to file the registration statement within 30 days of receipt of the audit for the year ending December 31, 1967, and to cause the registration statement to become effective as soon as practicable thereafter. In a joint press release announcing the 1967 sale, Perfect and Pathe stated: "It is contemplated that the Warrants will be distributed to Pathe's stockholders in the first half of 1968, pursuant to a registration statement of Perfect . . . and . . . shall remain exercisable for 14 months following [the] effective date [of registration]." And a note to Perfect's financial statements for the period ending December 31, 1967, stated with respect to the warrants that it was agreed to distribute them to Pathe's stockholders in 1968.

We do not agree with this argument. The 1967 agreement was executed at a time when Pathe was not a registered investment company subject to our jurisdiction and, as Perfect concedes, is not before us for review. Perfect had then recently acquired control of Pathe with a view to its own economic expansion, and under the agreement Perfect was contractually obligated to issue and use its best efforts to register the warrants in partial consideration for Laboratories' assets which it received. As we have seen, the modification of the terms of the warrants was decided upon three months before the change in Perfect's Board and was an equitable readjustment made necessary by Perfect's inability to secure an effective and timely registration statement because of its Curtis acquisitions. Certainly, the old Board of Perfect was in a better position than the new Board to known what its intentions were when the warrants were originally issued and what was required to implement them. To permit the expiration of the warrants before they could be distributed to Pathe's stockholders would have frustrated the intentions of the parties and caused a substantial loss to those stockholders. As previously mentioned, Standard had been hired because of Perfect's control of Pathe, and, while Ackerman assumed the presidency of Pathe, he never owned any Pathe stock. By following Standard's advice as to what modifications were required to achieve fairness in light of the circumstances then prevailing, the parties did all they reasonably could to fairly readjust their agreement. We find that, notwithstanding the opposition of Perfect's present management. Pathe has satisfied the fairness and absence-of-overreaching tests of Section 17(b).

We note that Perfect has not claimed that the proposed modification agreement is inconsistent with the investment policy of Pathe or with the general purposes of the Act, and on the record before us we make no adverse findings in these respects. We conclude that an exemption from Section 17(a) should be granted with respect to that agreement.

An appropriate order will issue.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM, HERLONG and LOOMIS).

IN THE MATTER OF

BENJAMIN WERNER

doing business as

BENJAMIN WERNER COMPANY

File No. 3-2764. Promulgated April 24, 1972

Securities Exchange Act of 1934—Sections 15(b) and 15A

BROKER-DEALER PROCEEDINGS

Sales of Unregistered Securities

Where broker-dealer sold unregistered stock of issuer on behalf of issuer's controlling person and failed to make appropriate investigation regarding status of seller, *held*, willful violations of registration provisions of Securities Act.

APPEARANCES:

Paul Chernis, *Dennis J. Block* and *David M. Greenberg*, of the New York Regional Office of the Commission, for the Division of Trading and Markets.

Stanley Kligfeld, for respondent.

FINDINGS AND OPINION OF THE COMMISSION

In these proceedings pursuant to Sections 15(b) and 15A of the Securities Exchange Act of 1934 with respect to Benjamin Werner, doing business as Benjamin Werner Co. ("registrant"), who was formerly a registered broker-dealer, the order for proceedings alleged willful violations of the registration provisions of the Securities Act of 1933 in the offer and sale of common stock of Dyna Ray Corporation during the period July 1967–October 1968, and the issuance of a permanent injunction in May 1970 enjoining registrant from violating those provisions in connection with the offer and sale of such securities. Following hearings, registrant and our Division of Trading and Markets waived an initial decision by the hearing examiner, and they filed proposed findings and briefs with us. Thereafter, in another proceeding, we issued an order revoking regis-

44 S.E.C.—34——9579—(To be printed on bottom of first page)

trant's broker-dealer registration and barring him from association with a broker or dealer.[1] While the issue raised as to the remedial action to be taken in these proceedings has thus become moot, we deem it to be appropriate in the public interest to make findings with respect to the remaining issues. Such findings are based upon an independent review of the record.

Between July 1967 and October 1968, when no registration statement under the Securities Act was on file or in effect with respect to Dyna Ray stock, registrant sold a total of 28,300 shares of such stock for the account of one Mac Elrod, who was the controlling shareholder of Dyna Ray and from at least October 1967 was its president. Following an initial sale of 600 shares for Elrod in July 1967, registrant's sales of Dyna Ray stock assumed substantial proportions in 1968. In January, Elrod delivered two blocks totalling 12,000 shares to registrant, which by early April had sold all the shares except for 700 that were apparently returned to Elrod. On July 2, registrant received an additional 16,400 shares from Elrod, which it sold by October 14. According to Werner's testimony, the shares were sold for the most part to dealers whose quotations appeared in the quotation sheets, although some were sold to retail customers in assertedly unsolicited transactions.

Werner testified that during the period in question he did not know Elrod's relationship to Dyna Ray or the number of Dyna Ray shares which were outstanding. That testimony appears inconsistent, however, with his admission that in October 1967 he saw a release issued by us announcing the termination of a trading suspension with respect to Dyna Ray stock,[2] which pointed out, among other things, that according to a company release, Elrod was its president and controlling stockholder.[3] Moreover, in early August 1968, prior to registrant's sales of the last 6,700 shares of Dyna Ray stock, Elrod opened an account with registrant for Dyna Ray, thus indicating at least that he occupied a principal position with the company. Even assuming, however, that registrant was not aware of Elrod's status, the circumstances surrounding Elrod's sell orders, including the sizeable blocks involved in the

[1] Securities Exchange Act Release No. 9422 (December 17, 1971), *app. dismissed* (C.A.D.C., February 9, 1972).

[2] Securities Exchange Act Release No. 8178 (October 12, 1967).

[3] Dyna Ray's release indicated further that it had no product, operating facilities or employees and had only $10,000 in cash, and that its only other assets were interests of questionable, if any, value in two other companies. Our release cautioned broker-dealers to consider the facts set forth in connection with any transactions in Dyna Ray securities.

1968 transactions and the fact that by his own testimony Werner was completely ignorant about the issuer, called for a searching inquiry on his part.[4] Yet registrant contented himself with the most perfunctory inquiries, consisting of a check with the transfer agent regarding the existence of any transfer restrictions, and an inquiry addressed to Elrod, in January 1968, whether the 12,000 shares delivered to registrant in that month were restricted and whether they represented more than 1 percent of Elrod's holdings, to which Elrod replied in the negative.[5] Such reliance on the self-serving statements of Elrod and the representations of the transfer agent respecting transfer restrictions was unwarranted.[6]

Under the circumstances, it is clear and we find that registrant willfully violated and willfully aided and abetted violations of Sections 5(a) and 5(c) of the Securities Act. We further find that on May 22, 1970, registrant, with his consent, was permanently enjoined by the United States District Court for the Southern District of New York from violating those provisions in connection with the offer and sale of Dyna Ray securities.[7]

In the prior proceeding with respect to registrant we found that during the same period as that involved here he participated in a distribution of unregistered stock of another issuer and noted that, in injunctive proceedings pertaining to yet other securities, the court found that registrant had engaged in a serious fraud. While there is no occasion, in view of our prior revocation and bar order, to determine what remedial action would be appropriate on the basis of the record here, it seems clear that the additional findings herein of registrant's disregard of his responsibilities as a broker-dealer would represent a further adverse factor for consideration should he seek to return to the securities business.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM, HERLONG and LOOMIS).

[4] See Securities Act Releases Nos. 4445 (February 2, 1962) and 5168 (July 7, 1971).

[5] Elrod's response as to the small percentage of his stock being then sold thus indicated the magnitude of his total holdings.

[6] See, *e.g.*, *S.E.C.* v. *Culpepper*, 270 F. 2d 241, 251 (C.A. 2, 1959); *Quinn and Company, Inc.*, 44 S.E.C. 459, 467–68 (1971).

[7] *S.E.C.* v. *Dyna Ray Corp.*, 68 Civ. 4622.

IN THE MATTER OF

AMERICAN EUROPEAN SECURITIES COMPANY

File No. 3-3195. Promulgated May 10, 1972

Investment Company Act of 1940—Section 6(c)

MEMORANDUM OPINION AND ORDER

American European Securities Company ("American European"), a corporation organized under the laws of Delaware and a closed-end investment company registered under the Investment Company Act of 1940 (the "Act"), has filed an application pursuant to Section 6(c) of the Act with respect to certain aspects of a Plan of Reorganization ("Plan") which is designed in effect to reconstitute American European as a Panamanian corporation. As more fully described below, the Plan provides for the transfer of substantially all of the assets of American European to a corporation to be organized by it under the laws of the Republic of Panama to operate as a closed-end investment company under the name American European Securities, Inc. ("Panama Company"),[1] and for the exchange of each share of American European stock for one share of Panama Company stock. Any holder of American European stock may, however, elect to receive the net asset value of his holdings in cash. Applicant seeks an order exempting from the provisions of Section 7(d) of the Act the proposed public offering of Panama Company stock.[2]

The Plan was approved by American European's stockholders. Thirty stockholders, who own 8,886 shares and have addresses of record in the United States, voted against the Plan and under its terms became entitled to request cash for their shares.

Under the Plan, all of the assets of American European, except cash needed for payments to objecting stockholders and

[1] The application has also been filed on behalf of Panama Company.

[2] Under Section 7(d), a foreign investment company may not make use of the mails or facilities of interstate commerce in connection with a public offering of its securities unless we permit it to register under the Act and make such offering.

certain other purposes,[3] will be transferred to Panama Company in exchange for shares of stock of that company equal to the number of shares of American European held by its stockholders (other than by objecting stockholders), and Panama Company will assume any liabilities in excess of the amount of cash retained by American European. Promptly after the transfer of American European's assets to Panama Company, the objecting stockholders of American European who have made appropriate demand and have surrendered their shares will be paid the net asset value thereof as of the close of business on the date of the exchange.[4] The other stockholders will have the right to exchange each share of American European stock for one share of Panama Company stock. Following such exchange, American European intends to file an application pursuant to Section 8(f) of the Act for an order declaring that it has ceased to be an investment company and to be dissolved.[5]

Section 6(c) of the Act provides for the exemption of a transaction from any provision of the Act if we find such exemption to be in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act. In support of its application, American European relies principally on the asserted lack of any significant American investor interest in it as well as on certain circumstances leading up to formulation of the Plan.

The record shows that American European was formed in 1925, as the successor to a Swiss company formed in 1910, to serve as a vehicle for investment by Europeans in United States securities. American European has been sponsored since its incorporation by four private banks located in Geneva, Switzerland, each of which since then has been represented by one of its partners or former partners of the board of directors of American European. Partners and retired partners of these banks have for many years constituted a majority of the members of the board. It has outstanding 768,900 shares of common stock, which has been traded on the Geneva Stock Exchange since 1926. The stock is not presently listed or

[3] American European will pay its liabilities and pay non-objecting stockholders a dividend and distribution of capital gains representing investment income and net gains from January 1, 1972 to the date of the exchange.

[4] Net asset value will be determined without deduction of the final income dividend and capital gains distribution to be paid to stockholders who do not receive cash.

[5] The Plan as submitted for stockholder approval included a provision designed to meet the requirement in Section 13(a)(4) of the Act that shareholder authorization be obtained for a change in the nature of a registered investment company's business under which it would cease to be an investment company.

traded on any exchange in the United States.[6] As of January 3, 1972, 734,466 shares (about 95.52 percent) were registered in the name of Pictet & Cie., one of the private banks referred to above;[7] 665 shares in the names of 9 other persons having addresses outside the United States; and the remaining 33,769 shares in the names of 94 persons having addresses in the United States. American European states, however, that as best it can ascertain only about 83 persons who are beneficial owners of its stock are residents or citizens of the United States, and that approximately 97 percent of its stock is owned beneficially by persons who are neither citizens nor residents of the United States.

In support of its contention that the proposed offering by Panama Company is entitled to the exemption requested because of the limited United States investor interest, American European cites *Paribas Corporation*, 40 S.E.C. 487 (1961), where this Commission exempted a domestic investment company from all provisions of the Act because of the insignificant American investor interest. However, unlike the situation presented here, in *Paribas* no shares of that company or of the foreign company which owned 100 percent of the stock of Paribas had ever been publicly offered in the United States, and it was represented that no securities of either company would be so offered. Here, the consummation of the proposed Plan involves a public offering of Panama Company's stock in the United States. The *Paribas* decision in our view does not provide a basis for granting an exemption from Section 7(d) of the Act for any public offering of securities of a foreign investment company through the use of the mails or means or instrumentalities of interstate commerce merely on the ground of the small size of the domestic investor interest. We note in this connection that Section 3(c)(1) which affords an exception from the definition of an investment company when there is limited public interest is not applicable where the company proposes to make a public offering.[8]

[6] American European stock was delisted from the New York Stock Exchange in August 1962.

[7] None of the shares registered in Pictet's name is owned beneficially by it, and it appears that they are so registered in order to facilitate trading on the Geneva Stock Exchange.

[8] Moreover, it is questionable whether the size of investor interest in a foreign investment company using the mails or means or instrumentalities of interstate commerce in connection with a public offering should be judged with sole reference to the size of the American investor interest and without considering the interests of foreign investors. Since *Paribas*, we have expressed the view that in certain situations foreign as well as domestic investors in registered investment companies are entitled to protection under the Act. See *Guidelines Concerning the Applicability of the Federal Securities Laws to the Offer and Sales Outside the United States of Shares of Registered Open-End Investment Companies*, Investment Company Act Release No. 6082 (June 23, 1970).

Nevertheless, in view of the special circumstances leading to the formulation of the Plan and the filing of the application, and in the light of the Plan's provision for payment of net asset value to objecting shareholders, we have concluded that the standards of Section 6(c) are met and it is appropriate to grant the exemption requested here. In the fall of 1967, counsel for American European, at the request of its board of directors, prepared and submitted to the board a draft of a proposal for reorganization of the company into a foreign corporation. The board decided that efforts should be made to determine whether our staff considered the proposal contrary to any provisions of the federal securities laws. To this end counsel submitted the draft proposal to the staff and furnished additional information requested by the staff. In April 1968, after discussions, the staff informed counsel that it would raise no objections provided the Plan were amended, as it has been, so as to offer objecting stockholders at least the net asset value of their shares, and provided that American European had no more than 100 beneficial owners of its stock who were residents or citizens of the United States. In view of the staff's position, American European proceeded to request and obtain favorable rulings from the Internal Revenue Service and a favorable opinion from the Federal Reserve Bank of New York with respect to the instant proposal.

Accordingly, IT IS HEREBY ORDERED, pursuant to the provisions of Section 6(c) of the Act, that the proposed public offering of Panama Company stock is exempted from the provisions of Section 7(d) of the Act.

By the Commission (Commissioners OWENS, NEEDHAM, HERLONG and LOOMIS), Chairman CASEY not participating.

In the Matter of

BASIC SCIENCES INC.

File No. 3–3329. Promulgated May 12, 1972

Securities Act of 1933—Section 8(d)

FINDINGS AND STOP ORDER

These are proceedings under Section 8(d) of the Securities Act of 1933 to determine whether a stop order should issue suspending the effectiveness of a registration statement on Form S–1 filed by Basic Sciences Inc. ("BSI"), a Delaware corporation primarily engaged in testing and marketing a thin-walled mobile incinerator system. The registration statement, which after six amendments was declared effective on April 12, 1971, related to a public offering of 75,000 shares of common stock, par value 1c, at $12.50 per share. The offering was terminated on June 14, 1971, after a total of 30,710 shares had been sold.

BSI submitted an offer of settlement in which, solely for the purpose of these proceedings, it consented to certain findings consistent with the allegations contained in the Statement of Matters filed by the Commission's Division of Corporation Finance ("Division"), and to the issuance of a stop order.

After due consideration of the offer of settlement and upon the recommendation of the Division, we determined to accept such offer. On the basis of the Statement of Matters and offer of settlement, we find that the registration statement as amended was materially misleading. It stated that the common stock of BSI would be publicly offered without an underwriter, that securities dealers who were members of the National Association of Securities Dealers, Inc. ("NASD") would be paid a certain commission on sales of such stock but were under no obligation to sell any, and that officers and directors would assist in the distribution. The registration statement, however, failed to disclose that as of the effective date of the registration statement BSI had an understanding with Victor Securities Corporation ("Victor"), then a registered broker-dealer, that the latter would act as the underwriter of the public offering.

The second through fifth pre-effective amendments to the registration statement had stated that Victor was to act as the underwriter pursuant to an agreement with BSI, and that Victor, which was organized in February 1970, had limited or no experience in underwriting public offerings. Shortly after the fifth amendment was filed, BSI became aware that the Commission's staff had raised questions concerning the conduct of Victor in public offerings of other issuers.[1] As a result, BSI's underwriting agreement with Victor was cancelled, and on April 5, 1971, BSI filed amendment number 6 to its registration statement setting forth the self-underwriting and dealer plan of distribution referred to above, which further provided that unless 30,000 shares were sold within 30 days (by May 12, 1971) all proceeds were to be returned to the subscribers. BSI did, however, seek and obtain Victor's participation in the public offering. During the time it was listed as the contractual underwriter, Victor had assured BSI of its ability, based on indications of interest received by it, to sell more than 30,000 shares, and as of the effective date Victor was the only broker-dealer with whom BSI had an arrangement for the solicitation of sales of the offering. By May 12, 1971, Victor had sold precisely the necessary 30,000 hares that would permit BSI to keep the proceeds, and no other sales were made by that date.[2] Under the circumstances, Victor should have been identified as the underwriter in the registration statement that was declared effective, and its lack of experience and its business history should have been disclosed.[3]

In view of the foregoing, a stop order should issue suspending the effectiveness of the registration statement.

As part of its offer of settlement, BSI undertook to file, within 10 days after the date of the Order herein, a post-effective amendment to correct the deficiency in the registration statement described above. Pursuant to Section 8(d) of the Act, this stop order will cease to be effective when the Commis-

[1] On April 27, 1971, we instituted broker-dealer proceedings to determine if Victor and its president had violated, among other things, antifraud provisions of the securities acts in matters not related to BSI or its public offering. Pursuant to an offer of settlement, in which the alleged violations were not admitted, Victor's broker-dealer registration was revoked. Securities Exchange Act Release No. 9456 (January 18, 1972).

[2] The record establishes that Victor sold 28,000 of the 30,000 shares of BSI common stock after the institution of the broker-dealer proceedings against it.

[3] See *The Richmond Corporation*, 41 S.E.C. 398, 403 (1962); *The Surinam Corporation*, 39 S.E.C. 657, 661 (1960); *Institutional Investor Study Report of the Securities and Exchange Commission*, H. Doc. No. 92–64, Part 5, 92d Cong., 1st Sess., p. 2513 (1971).

sion declares that the deficiency has been corrected. BSI in addition agreed, promptly after such declaration, to furnish a copy of the instant decision to each subscriber to its offering.

Accordingly, IT IS ORDERED that the effectiveness of the registration statement filed by Basic Sciences Inc. be, and it hereby is, suspended.

By the Commission (Commissioners OWENS, NEEDHAM, HERLONG, and LOOMIS; Chairman CASEY not participating).

In the Matter of

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

File No. 3-2428. Promulgated June 7, 1972

Securities Exchange Act of 1934—Section 15A(k)(1)

REGISTERED SECURITIES ASSOCIATION

Abrogation Proceeding

Where registered association's rule of fair practice, adopted pursuant to authority granted under Section 15A(i)(1) of Securities Exchange Act of 1934 to prohibit members from dealing with nonmembers except on same basis accorded by such members to general public, is interpreted and applied by association to bar receipt by members from nonmembers of concessions or other allowances, *held*, association's interpretation of rule improper, and, pursuant to Section 15A(k)(1) of Act, appropriate to abrogate rule to extent it permits or is interpreted to permit such bar.

APPEARANCES:

Martin Moskowtiz and *Richard Gordon*, for the Division of Trading and Markets of the Commission.

Warren G. Elliot, *Stephen B. Middlebrook*, and *George N. Gingold*, for Aetna Life and Casualty Company and Aetna Financial Services, Inc., and, with *Larry D. Gilbertson*, for Aetna Variable Annuity Life Insurance Company.

Lloyd J. Derrickson, *Frank J. Wilson*, and *Dennis C. Hensley*, for the National Association of Securities Dealers, Inc.

FINDINGS AND OPINION OF THE COMMISSION

These are proceedings pursuant to Section 15A(k)(1) of the Securities Exchange Act of 1934 to determine whether the National Association of Securities Dealers, Inc. ("NASD") has improperly construed or applied the authority granted to it, as a registered securities association, under Section 15A(i)(1) of the Act, and Section 25 of Article III of its Rules of Fair Practice ("Rule 25") adopted thereunder, and, if so, what if any remedial action is necessary or appropriate to effectuate the purposes of the Act.[1] Aetna Life and Casualty Company and two broker-dealer subsidiaries, which underwrite mutual fund shares and variable annuities sold by Aetna affiliates, were allowed to intervene as parties.[2] Following hearings, the hearing examiner filed an initial decision in which he concluded, among other things, that Rule 25 should be partially abrogated. Petitions for review filed by the NASD, Aetna and its broker-dealer subsidiaries, and our Division of Trading and Markets were granted, briefs were filed, and we heard oral argument. Our findings are based upon an independent review of the record.

The NASD is the only securities dealer association registered with this Commission pursuant to Section 15A of the Act and has a membership of some 4,500 or over 90 percent of all broker-dealers registered under the Act. Under that Section, the NASD has authority to issue rules, with the approval of its members, subject to various statutory standards and to our right to disapprove such rules and, pursuant to Section 15A(k)(1), to abrogate any rule not previously disapproved.

Aetna and the two subsidiaries, which are not NASD members, had petitioned this Commission to institute abrogation proceedings pursuant to Section 15A(k)(1). Rule 25, as interpreted by the NASD, restricted Aetna's ability to market its mutual fund shares and variable annuities as part of the employee-oriented programs offered to its regular group insurance customers through insurance brokerage firms, which

[1] Section 15A(k) (1) of the Act authorizes us to abrogate any NASD rule if, after appropriate notice and opportunity for hearing, it appears that "such abrogation is necessary to appropriate to . . . efectuate the purposes of [the Act.]" Section 15A(i) (1) provides in pertinent part:

> "The rules of a registered securities association may provide that no member thereof shall deal with any nonmember broker or dealer . . . except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public."

The NASD's Rule 25 provides in pertinent part:

> (a) No member shall deal with any non-member broker or dealer except at the same prices, for the same commissions or fees and on the same terms and conditions as are by such member accorded to the general public.
>
> (b) Without limiting the generality of the foregoing no member shall:
>
> (1) in any transaction with any non-member broker or dealer, allow or grant to such non-member broker or dealer any selling concession, discount or other allowance allowed by such member to a member of a registered securities association and not allowed to a member of the general public;
>
> (2) join with any non-member broker or dealer in any syndicate or group contemplating the distribution to the public of any issue of securities or any part thereof; or
>
> (3) sell any security to or buy any security from any non-member broker or dealer except at the same price at which at the time of such transaction such member would buy or sell such security, as the case may be, from or to a person who is a member of the general public not engaged in the investment banking or securities business.

[2] The two Aetna broker-dealer subsidiaries are Aetna Financial Services, Inc., which underwrites the mutual fund shares of Aetna Fund, Inc., a registered investment company, and Aetna Variable Annuity Life Insurance Company, a registered investment company which principally sells variable annuities.

have been the traditional and assertedly are the only practical means of reaching those customers. The restriction resulted from the fact that, in order to handle the sale of such securities, most of the larger insurance brokers, which are used by major employers for the purchase of group insurance for employees, organized registered broker-dealer subsidiaries which joined the NASD. Under the NASD's interpretation, those broker-dealers could not receive compensation from Aetna's broker-dealer subsidiaries for selling the Aetna securities, particularly because of the prohibition in Rule 25(b)(2) against members joining with nonmember broker-dealers in a securities distribution.

The hearing examiner concluded that Rule 25(b)(2), as applied by the NASD to bar a member's receipt of concessions from nonmembers as well as a member's giving of preferential concessions to nonmembers, is a valid exercise of the NASD's authority under Section 15A(i)(1) of the Act. He further concluded, however, that the Rule should be partially abrogated so as to permit NASD-member affiliates of insurance-brokerage firms to join in distributions involving group sales of mutual fund shares and variable annuities whose principal underwriters, like those of Aetna, are not members of the NASD. He based that conclusion on his finding that the present application of the Rule hindered a free and open market in the employee securities area and impaired investor protection and the public interest, contrary to the specific directives of Section 15A(b)(8) of the Act.[3]

The basic question before us is whether Rule 25, particularly subsection (b)(2), as construed and applied by the NASD, is without the scope of the authority granted by Congress in Section 15A(i)(1) of the Act. The Division, as well as Aetna, takes the position that the NASD has no authority under Section 15A(i)(1) of the Act to restrict its members from receiving concessions in their dealings with nonmember broker-dealers, and can only prohibit members from giving nonmembers concessions not available to the general public. We agree with that position.

Section 15A(i)(1), part of the "Maloney Act" amendment to the Exchange Act in 1938 providing for the voluntary registration of self-regulatory associations of securities dealers under the general oversight of this Commission, was designed to give

[3] Section 15A(b)(8) requires that the rules of an association be designed, among other things, to protect investors and the public interest and "to remove impediments to and perfect the mechanism of a free and open market."

dealers an economic incentive to join such an association, and to make the denial of membership or the suspension or expulsion of members effective sanctions. The legislative history of the amendment shows that Congress, in implementing that objective, intended to give registered securities associations the power to prohibit only the according of preferential concessions by members to nonmember broker-dealers, and did not consider or legislate with respect to the members' receipt of concessions from such nonmembers in underwritings or otherwise.

George C. Mathews, then a member of this Commission, testified before the Senate Committee considering the Maloney bill:

> "[Section 15A(i)] permits registered securities associations to adopt rules requiring each member to deal with non-members on . . . terms no more favorable than the general public *receives* from such member. [That section] will give registered associations an effective sanction in *withholding* dealers' discounts, allowances, and commissions from that portion of the business which has not seen fit to submit itself to registration or which is by reason of past misconduct, not eligible to membership in registered associations.[4] (Emphasis supplied.)

An industry representative who participated in the drafting of the bill testified:

> "As I understand the powers as outlined in the bill, the right is given to members of this association to *give* discounts to other members of the association and to *deny* them to people who are not members of the association . . . If [nonmembers] are barred from obtaining commissions and underwritings and things of that nature, there is pressure on them to join the association."[5] (Emphasis supplied.)

The Senate and House Committee Reports on the Maloney bill state with respect to Section 15A(i)(1):

> "The individual [association] member is left free to determine his own business policy, but insofar as he differentiates in prices, discounts, and other charges or allowances between brokers and dealers and members of the public, the rules of the association may require him to classify 'nonmember brokers or dealers' with members of the public."[6]

The NASD has not cited any contrary legislative history. The testimony it presented of industry representatives, who gave their recollections of what was the "intent" of certain persons who participated in drafting the Maloney Act, is of little or no

[4] Hearings on S. 3255 before the Senate Committe on Banking and Currency, 75th Cong., 3d Sess. p. 24 (1938).

[5] *Id.*, at 53.

[6] S. Rep. No. 1455, 75th Cong., 3d Sess., pp. 8–9 (1938); H.R. Rep. No. 2307, 75th Cong., 3d Sess., p. 9 (1938).

provision in subsection (b)(2) is not, properly interpreted, a flat prohibition against the member joining with a nonmember in a securities distribution, but must be viewed merely as a restriction on the ability of members to give underwriting concessions and discounts to nonmembers not accorded to the public.

The NASD argues that, as the agency charged with responsibility for implementing Section 15A(i)(1), its consistent long-term interpretation of that Section and Rule 25 establishes the validity of its interpretation; that this Commission has "acquiesced" in that interpretation; and that Congress, assertedly with full knowledge of that interpretation, indicated its approval thereof by amending the Exchange Act in 1964 and the Investment Company Act of 1940 in 1970 without modifying the Section.[9]

These contentions are without merit. Whatever value consistent administrative practice may have as an aid to statutory construction in other contexts, it is entitled to little, if any, weight in a proceeding under Section 15A(k)(1). To allow the NASD's interpretation, however longstanding, to determine statutory purpose in such a proceeding would subvert the oversight function conferred on this Commission by Congress. As to the asserted Commission acquiescence in the NASD's interpretation, it does not appear that prior to the events leading to this proceeding this Commission ever specifically focused on the application of Rule 25 at issue here. NASD counsel conceded at the hearings that the Association was unable to show that any member of the Commission had knowledge of the manner in which the NASD was applying its Rule. But even assuming we should have been aware of the NASD's interpretation, we are not estopped from carrying out our statutory functions under Section 15A(k)(1).[10] Finally, it does not appear that Congress either had before it or considered the questioned application of Rule 25 when it amended the Exchange Act and Investment Company Act without amending Section 15A(i)(1). As the Supreme Court has observed, "Where . . . there is no indication that a subsequent Congress has addressed itself to the particular problem, we are unpersuaded that silence is tantamount to acquiescence. . ."[11]

[9] In 1964, the Exchange Act was amended to grant authority to this Commission to regulate nonmember broker-dealers in a manner comparable to an association's regulation of its members. In 1970, the Investment Company Act was amended to grant additional authority to the NASD to regulate mutual fund sales charges.

[10] *Automobile Club of Michigan* v. *Commissioner of Internal Revenue*, 353 U.S. 180, 183 (1957); *Capital Funds, Inc.* v. *S.E.C.*, 348 F.2d 582, 588 (C.A. 8, 1965); *S.E.C.* v. *Culpepper*, 270 F.2d 241, 248 (C.A. 2, 1959).

[11] *Zuber* v. *Allen*, 396 U.S. 168, 186, n. 21 (1969). *Cf. Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955); *Girouard* v. *United States*, 328 U.S. 61, 69 (1946).

value in determining the proper construction of Section 15A(i)(1) since such intent was not reflected in the hearings on the bill or in the committee reports.[7]

It is clear that an association, in promulgating rules pursuant to Section 15A(i)(1), cannot exceed the authority granted in that Section, and such authority being in the nature of an exception to the restrictions in Section 15B(b)(8) upon anticompetitive rules, must be narrowly construed. We note that this Commission, in determining not to disapprove the Rule at the time of its adoption in 1939, viewed it as prohibiting members from *giving* preferences to nonmember brokers and dealers, and did not mention any restriction upon members receiving allowances from nonmembers.[8] Subsection (a) of the Rule follows the language of Section 15A(i)(1). Subsection (b) indicates that its three subsections are merely particular examples of the conduct prohibited by subsection (a) and that they are not meant to exceed the scope of that subsection. Although subsection (b)(2), by prohibiting a member from joining with a nonmember in any syndicate or group in a securities distribution, appears to be broader in scope than subsection (a), it cannot fairly be so interpreted in view of the opening clause of subsection (b). Thus, the language "join with" cannot be more comprehensive than the language "deal with" appearing in subsection (a) as well as in the statute, which is modified by language indicating that such dealing is permissible provided the nonmember receives no preference not "accorded" to the "general public." Indeed, the NASD, as well as the hearing examiner, has equated "joining" with "dealing," and the NASD's own explanation for the absence of any reference to the general public in subsection (b)(2) is that an ordinary investory cannot underwrite or participate in the distribution of an issue of securities on behalf of an issuer or selling stockholder. At the time Rule 25 was adopted the formation of underwriting syndicates was largely under the control of the nation's leading investment bankers, who were expected to form the core of the new self-regulating association that became the NASD. To induce smaller underwriters and dealers to join the NASD, membership was made a prerequisite to participating in underwriting and dealer discounts within the control of the leading firms. Thus, the "joining"

[7] See *Epstein* v. *Resor*, 296 F. Supp. 214, 216 (N.D. Cal. 1969), *aff'd* 421 F.2d 930 (C.A. 9, 1970), *cert. denied* 398 U.S. 965; *National School of Aeronautics, Inc.* v. *U.S.*, 142 F. Supp. 933, 938 (Ct. Cl. 1956); *Day* v. *North American Rayon Corp.*, 140 F. Supp. 490, 493 (E.D. Tenn. 1956).

[8] *National Association of Securities Dealers, Inc.*, 5 S.E.C. 627, 632 (1939). See also *National Association of Securities Dealers, Inc.*, 19 S.E.C. 424, 446, n. 34 (1945).

The NASD further argues that abrogation of Rule 25(b)(2) might cause a loss in membership and revenues. It asserts that if nonmembers are free to give concessions to members, some of the large underwriting firms that are presently members and account for a substantial portion of the NASD's revenues, might withdraw from membership and still be able to distribute their securities through selling groups of NASD members. It concedes, however, that the concept of self-regulation will itself keep most members in the Association, and that NASDAQ, the recently instituted automated over-the-counter quotation system, in which only NASD members may qualify to enter quotations, will undoubtedly encourage continued membership by those members who find it useful.[12] Moreover, NASD membership will still be required for participation in member-sponsored underwritings and the receipt of concessions from members. In any event, Congress clearly considered the authority it granted registered securities associations in Section 15A(i)(1) sufficient to make them viable and effective. Neither we nor the NASD has the power to expand that authority.

We conclude that the NASD has improperly construed and applied Rule 25 and the authority granted to it under Section 15A(i)(1) of the Act in barring the receipt by members of concessions or other allowances from nonmembers.[13] Accordingly, we must determine what remedial action pursuant to Section 15A(k)(1) of the Act is necessary or appropriate to effectuate the purposes of the Act. We cannot agree with the Division's position that the proper remedy is abrogation of subsection (b)(2) of Rule 25 because that subsection has been misapplied and is susceptible to misinterpretation. Those objections could also be asserted with respect to the entire Rule since 25(b) is embraced by 25(a). In view of the fact, however, that 25(a) directly parallels Section 15A(i)(1), it would clearly not be in order to abrogate the whole Rule. The appropriate remedy, in our opinion, is the abrogation of Rule 25 to the extent that it permits or has been construed to permit the NASD to bar receipt by its members of any commission, concession, discount or other allowance from nonmembers. In

[12] The NASD further acknowledges that there may be no withdrawals at all since at the present time there are no significant nonmember channels of distribution.

[13] Our conclusion resolves in the affirmative the questions raised in these proceedings with respect to whether it is permissible for a member to receive any concession from a nonmember arising from so-called parallel underwritings (where an issuer distributes a security through both NASD member and nonmember underwriters) and from the dual registration of representatives (where an associated person of a nonmember is employed by an NASD member to sell a security underwritten by the nonmember).

order to inform members of the proper construction of the Rule on a continuing basis, we shall direct that such construction be incorporated in the Interpretation of the Board of Governors accompanying the Rule, which is published in the NASD Manual.[14]

An appropriate order will issue.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM, HERLONG and LOOMIS).

[14] The NASD may, of course, with to consider whether the Rule itself should be amended to reflect that construction.

IN THE MATTER OF

THE CARTER GROUP, INC.

UTILITIES & INDUSTRIES CORPORATION

File No. 3-3576. Promulgated June 16, 1972

Investment Company Act of 1940—Section 3(b)(2)

MEMORANDUM OPINION AND ORDER

The Carter Group, Inc. ("Carter Group") and Utilities & Industries Corp. ("U&I"), which are not registered as investment companies under the Investment Company Act of 1940, have each filed an application pursuant to Section 3(b)(2) of the Act for an order declaring it to be primarily engaged in businesses other than that of an investment company.

Carter Group, a Delaware corporation, was organized in September 1968 for the purpose of combining investment banking activities with the acquisition and management of operating industrial companies. Its application, which was filed in March 1969, stated that it proposed to acquire about 21 percent of the outstanding common stock of U&I, a New York corporation principally engaged in owning and operating two New York water supply systems and in real estate operations, pursuant to a purchase agreement with Richard L. Rosenthal, the former president of U&I. Carter Group considered that upon such purchase it would obtain control of U&I, and it proposed to acquire an additional 4 percent of U&I stock on the market. The application further stated that upon consummation of the Rosenthal agreement, the 21 percent block of U&I stock will represent about 80 percent of the assets (exclusive of government securities and cash items) of Carter Group and its subsidiaries. The purchase from Rosenthal was effected shortly after the application was filed, and the control of U&I became Carter Group's principal business. The application as thereafter amended asserted that, upon the granting of an order to U&I under Section 3(b)(2), Carter Group would also be entitled to such order by reason of being primarily engaged through a controlled company—U&I—in a business other than that of an investment company.

U&I filed its application in September 1971. The application as amended stated that U&I intended to purchase 61 percent of the outstanding common stock of Colonial Sand & Stone Co., Inc., which is engaged in the concrete and cement business, pursuant to an agreement with the controlling stockholders of Colonial, and to assume control of Colonial's business. The application as further amended stated that, assuming without conceding, that U&I had been an investment company as defined in Section 3(a)(3) of the Act, upon its acquisition of Colonial stock which had been completed it no longer was within such definition but had become primarily engaged in businesses other than that of an investment company within the meaning of Section 3(b)(2) of the Act.[1]

On March 8, 1972, we issued a consolidated notice of the filing of the applications, giving interested persons an opportunity to request a hearing and stating that orders disposing of the applications might be issued upon the basis of the information stated therein unless a hearing should be ordered.[2]

Rosenthal, who represents that he continues to own stock of a subsidiary of U&I which owns U&I stock, requests that the applications be dismissed without a hearing and that applicants be directed to register as investment companies. A hearing is requested by Abraham & Co. and Sheriff Securities Corporation, registered broker-dealers and shareholders of U&I.[3] Rosenthal, Abraham and Sheriff do not dispute that applicants at the present time are primarily engaged in businesses other than the investment company business.

Rosenthal urges that the applications be dismissed because applicants did not register as investment companies as they had advised their shareholders they would in proxy state-

[1] Insofar as relevant here, Section 3(a) (3) of the Act defines an investment company as including any issuer which is "engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis." For purposes of this section, investment secutities are defined not to include, among other things, "securities issued by majority-owned subsidiaries of the owner which are not investment companies." Section 3(b) (2) provides that, notwithstanding Section 3(a) (3), any issuer which we find and declare to be primarily engaged either directly or through majority-owned subsidiaries, or through controlled companies conducting similar types of businesses, in a business or businesses other than that of an investment company, is not an investment company.

[2] Investment Company Act Release No. 7041.

[3] We also received a request for a hearing from Nathan B. Kogan and his wife, Marjorie D. Kogan, stockholders of U&I, after the expiration of several extended periods of time to request a hearing, and it does not appear that copies of their request were served upon applicants as required. The grounds for a hearing alleged by them are similar to those urged in the other requests for a hearing, and we do not deem it necessary specifically to consider their request.

ments in July 1971 when they sought the approval of their respective shareholders to resolutions authorizing both companies to conduct their businesses so as not to be investment companies. However, applicants' proxy statements further advised their shareholders that, if so authorized, they would seek to engage in transactions of a non-investment company character so that applicants might be deregistered under the Act. Shareholders were also advised of the differences between the protections afforded shareholders of investment companies and the protections afforded shareholders of other companies. Nevertheless, the resolutions were approved by applicants' shareholders. No sufficient reason has been presented for questioning the statements of intention at the time they were communicated to the shareholders, and applicants' objective of not engaging in the investment company business must have been clear to the shareholders. Moreover, the intended process of registration and deregistration to accomplish that objective became clearly unnecessary when, after the U&I proxy statement was mailed, U&I arranged for and concluded the purchase of the majority interest in the operating business of Colonial, thus removing any question as to U&I's, and thus Carter Group's, status as a non-investment company.[4]

The grounds urged by Abraham and Sheriff in requesting a hearing are based in large part upon a provision in the Rosenthal agreement and the impact of Section 17 of the Act.[5] That agreement, which was dated March 12, 1969, provided:

> "Within twelve months from the date hereof, Carter [Group] will propose a merger, consolidation, sale of assets or exchange of securities intended to provide all other shareholders of U&I Corp. with securities of the merged or surviving company or Carter [Group], as the case may be, if possible in the form of a tax free exchange, based on the valuational principles recognized in the purchase of the shares of U&I Corp. pursuant hereto."

After Carter Group's purchase of the U&I shares from Rosenthal and in purported compliance with the quoted provision, Carter Group caused the formation of Utilities & Industries Corporation (Delaware) ("U&I Del."). That company filed

[4] Rosenthal's further request for oral argument is denied.

[5] In November 1969, we issued an order pursuant to Section 6(c) of the Act retroactively exempting Carter Group from Section 7 of the Act (which prohibits certain transactions by unregistered investment companies) from May 15, 1969, when the automatic 60-day exemption from the Act upon the filing of its Section 3(b) (2) application expired, until we had acted upon its application for a Section 3(b) (2) order. Our order provided, however, that during the temporary exemption period Carter Group, and other persons in their relations and transactions with the Carter Group, would be subject to certain provisions of the Act and the rules and regulations thereunder, including Sections 17(a), (b) and (d) of the Act, as though Carter Group were a registered investment company. Investment Company Act Release No. 5780 (November 7, 1969).

a registration statement under the Securities Act of 1933 covering a proposed offer of its shares to stockholders of U&I and Carter Group in exchange for Carter Group and U&I shares. Shareholders of U&I then brought suits against Carter Group ("*Boorstin* action") alleging that the offer, as described in the registration statement, was not based on the assertedly more favorable valuational principles recognized in Carter Group's purchase of U&I shares from Rosenthal, and thus did not fulfill Carter Group's obligations under the Rosenthal agreement.[6] The parties to the *Boorstin* action, other than Rosenthal, entered into a stipulation of settlement which revised the terms of U&I Del.'s offer. Pursuant to such revised offer, Carter Group intended to exchange its shares of U&I for shares of U&I Del., and affiliated persons of Carter Group intended to exchange their shares of Carter Group for shares of U&I Del. It was therefore necessary, because of our order, previously noted, which subjected Carter Group and other persons in their relations and transactions with it to Section 17 of the Act, that an application be filed pursuant to Sections 17(b) and (d) of the Act and Rule 17d-1 thereunder, and applicants' proxy statements stated such application would be filed in connection with the offer.[7] Such an application was filed but was withdrawn when the settlement agreement expired under its terms and the settling shareholders declined to extend it.[8]

Abraham contends that shareholders of U&I could have reasonably inferred from statements made by applicants that the Section 17 application would be determined by us, and asserts that Carter Group seeks to avoid such a determination by obtaining a Section 3(b)(2) order. Abraham and Sheriff also urge that any order granted pursuant to Section 3(b)(2) should

[6] Suits were also brought against Rosenthal by U&I shareholders on the ground that he had sold a corporate office. The suits were consolidated in *Boorstin* v. *Utilities and Industries Corporation (Delaware)*, which is pending in the Supreme Court of the State of New York.

[7] Section 17(a) of the Act prohibits an affiliated person of the registered investment company from selling any security to such investment company or buying any security from such investment company. Section 17(b) of the Act provides that we shall, upon application, exempt a proposed transaction from the provisions of Section 17(a) upon showing that the terms of the proposed transaction, including the consideration to be paid or received, are reasonable and fair and do not involve overreaching on the part of any person concerned, and that the proposed transaction is consistent with the policy of the registered investment company and with the general purposes of the Act.

Section 17(d) and Rule 17d-1 prohibit an affiliated person of a registered investment company from participating in or effecting any transaction in which such registered company or a company controlled by it is a joint or joint and several participant unless an application regarding such arrangement has been granted by us. In passing upon such application we are required to consider whether the participation of the registered investment company or its controlled company is consistent with the provisions, policies and purposes of the Act and the extent to which such participaion is on a basis different from or less advantageous than that of other participants.

[8] See investment company act release No. 6952.

retain jurisdiction to apply Section 17 to any future offer which may be made to the shareholders of U&I pursuant to the Rosenthal agreement or in settlement of any suit concerning that agreement. Abraham further asserts that, prior to the Colonial acquisition, U&I operated as an unregistered investment company, and Carter Group would also have done so if not for the retroactive exemption we granted. Abraham asks that we require applicants to register as investment companies so that their release from our jurisdiction could only be considered pursuant to an application to deregister under Section 8(f) of the Act in connection with which it is undisputed we could impose appropriate conditions. Sheriff also urges that applicants should be directed to register but that if we determine that a Section 3(b)(2) order should be issued, we should provide that it not take effect until Carter Group has proposed an exchange offer approved by us as to fairness.

In our opinion, neither the failure of applicants to register under the Act nor the termination of the settlement prior to our determination of the Section 17 application is an adequate reason for granting a hearing, denying the applications, or imposing the requested conditions.[9] After having been authorized by their shareholders to conduct their businesses so as not to be investment companies, applicants in our opinion were not then required, by reason of their earlier statements, to register under the Act and, at the same time, to file applications requesting that they be deregistered. Moreover, since an order pursuant to Section 3(b)(2) speaks as of the time of the order, we see no merit in the contention that a company which once was or may have been an investment company cannot be declared not to be an investment company until it has registered.

Whatever rights the shareholders of U&I may have as a result of the Rosenthal agreement are not created by the Act but by applicable state law, and any such rights are enforceable in the Courts and are presently the subject of litigation. In connection with our notice of, and order for hearing on, the Section 17 application, we exercised jurisdiction over transactions that were to be effected in connection with an offer that had been negotiated at a time when Carter Group and others were subject, by reason of our temporary exemption order, to

[9] *Cf. A.V.C. Corporation*, 44 S.E.C. 133 (1969).

Section 17 of the Act. However, at the present time, there is no offer pending.[10]

On the basis of the foregoing, we conclude that a sufficient showing has not been made to order a hearing on or to warrant denial of the applications, or to condition the order entered herein.

Accordingly, IT IS ORDERED that the requests for a hearing or for dismissal of the application be, and they hereby are, denied.

IT IS FURTHER ORDERED, pursuant to Section 3(b)(2) of the Act, that each of the applicants be, and it hereby is, declared to be primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding or trading in securities either directly or through majority-owned subsidiaries or controlled companies conducting similar types of businesses.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM, HERLONG and LOOMIS).

[10] We consider irrelevant or inadequate other contentions and assertions, whether factually correct or not, made in support of the requests for a hearing, for example, that Carter Group issued stock dividends without disclosing the source of the dividends, did not comply with good accounting procedures when it filed financial statements without qualifying certificates after it had declared dividends while having retained earning deficits, and did not make absolutely clear that a particular item in a financial statement was valued at cost, that affiliated persons of Carter Group who had purchased more than 5 percent of the stock of U&I failed to report such purchase within the time permitted under Section 13(d) of the Securities Exchange Act of 1934, and violated Section 17(d) of the Act by their recent purchases of U&I stock and by participating in an arrangement pursuant to which Carter Group is to invest in Landenburg, Thalmann & Co., a registered broker-dealer, on condition that Carter Group be declared not to be an investment company, that Carter Group wrongfully utilized a corporate investment opportunity of U&I, and that proxy soliciting materials failed to disclose the alleged violations of Section 17(d) and Carter Group's use of U&I's corporate opportunity.

In the Matter of

HERMAN M. SOLOMON

BURTON J. ROSENBLATT

File No. 3-2027. Promulgated June 21, 1972

Securities Exchange Act of 1934—Sections 15(b) and 15A

BROKER-DEALER PROCEEDINGS

Grounds for Bar from Association with Broker-Dealer

Inadequate Supervision

Fraud in Purchase and Sale of Securities

Failure to Comply with Bookkeeping Requirements

Failure to Comply with Net Capital Requirements

Injunction

Where principals of registered broker-dealer failed to exercise reasonable supervision to prevent violations of bookkeeping, credit, and free credit balance provisions of Securities Exchange Act of 1934 and applicable rules thereunder, and thereafter aided and abetted violations of antifraud, net capital and bookkeeping provisions of that Act and applicable rules and were enjoined from further aiding and abetting such violations *held*, appropriate in public interest to bar principals from association with broker-dealer but, in view of mitigative factors, principals may apply to Commission, after certain period, for leave to become associated with broker-dealer in non-supervisory and adequately supervised capacity.

APPEARANCES:

Lawrence M. Levy, of Brown, Rudnick, Freed & Gesmer, for Herman M. Solomon.

Fred B. Wilcon, of Michaels, Adler and Wilcon, for Burton J. Rosenblatt.

Willis H. Riccio and *Edward P. Delaney*, for the Division of Trading and Markets of the Commission.

FINDINGS AND OPINION OF THE COMMISSION

Following hearings in these proceedings pursuant to Sections 15(b) and 15A of the Securities Exchange Act of 1934, the hearing examiner filed an initial decision in which he concluded, among other things, that Herman M. Solomon and

Burton J. Rosenblatt, president and treasurer, respectively, and 50 percent stockholders of Mann and Company, Inc., then a registered broker-dealer,[1] should be barred from association with any broker-dealer. A petition for review filed by Solomon and Rosenblatt was granted, briefs were filed, and Solomon and the Division presented oral argument. Our findings are based upon an independent review of the record.

Petitioners do not dispute and we find, as did the examiner, that between January and June 1969 they failed to exercise reasonable supervision to prevent the firm's willful violations of:

1. Section 15(c)(3) of the Act and Rule 15c3–2 thereunder in failing to notify customers at least once every three months of the amounts of their free credit balances, and that such funds were not segregated, could be used in the operation of the firm's business, and were payable on demand;[2]
2. Section 17(a) of the Act and Rule 17a–3 thereunder in having failed, as of April 8, 1969, to make entries in its general and customers' ledger and to prepare trial balances and net capital computations since January 31, 1969; and
3. Section 7(c) of the Act and Section 4(c)(2) of Regulation T promulgated thereunder by the Board of Governors of the Federal Reserve System in failing promptly to cancel or otherwise liquidate purchase transactions where full cash payment was not made within seven business days.

Petitioners also do not dispute and we find, as did the examiner, that in 1970 they willfully aided and abetted the firm's violations of:

1. Section 17(a) of the Act and Rule 17a–3 thereunder in that, as of September 1, its general ledger had not been posted since June 30, and the customers' ledger not since July 31, and no trial balances or net capital computations had been prepared since April 30; and
2. Section 15(c)(3) of the Act and Rule 15c3–1 thereunder in that, from May 31 to August 31, it had month-end net capital deficiencies ranging from $25,572 to $67,189.

The record further establishes that, from May to September 1970, petitioners willfully aided and abetted the firm's violations of the antifraud provisions of Section 10(b) of the Act and

[1] Mann and Company, Inc. was a co-respondent in these proceedings but did not seek review of the hearing examiner's order revoking its broker-dealer registration and expelling it from membership in the National Association of Securities Dealers, Inc., and that order has become final.

[2] Rule 15c3–2 prohibits the use by a broker-dealer, in connection with the operation of its business, of any funds arising out of any free credit balance of a customer unless the required notice is sent to the customer.

Rule 10b–5 thereunder in impliedly representing to customers that it was able to consummate purchase and sell orders and make settlements when in fact, due to its precarious financial condition, it was unable to consummate such orders or deliver the securities promptly. Both petitioners claimed a lack of actual knowledge of the firm's adverse financial condition, and Rosenblatt contended that his lack of knowledge absolved him of any responsibility for the violations. However, as principals of the firm, petitioners were under a duty to keep informed of its financial condition.[3] Moreover, considering the state of the firm's books and records, petitioners were, at the least, irresponsible in continuing to do business. In any event, it appears that they were in fact aware that the firm was having financial problems by July 1970 at the latest,[4] yet they continued to permit the firm to accept purchase and sell orders from customers. Largely because of the inadequacy of the firm's books and records, it is not clear exactly when the firm became insolvent. It does appear, however, that as a result of the firm's precarious financial condition, perhaps in combination with its record-keeping deficiencies, the firm was unable to consummate transactions and make settlements with reasonable promptness during the relevant period. Thus, petitioners received purchase orders from two customers on August 27, 1970, four days before the firm suspended operations, and the firm thereafter accepted payment from the customers but delivered only part of the securities purchased by one of them.

On November 12, 1970, petitioners were enjoined with their consent from further aiding and abetting the above 1970 violations.[5] About two weeks later, the firm filed a bankruptcy petition. At that time the firm owed customers about $28,000, representing securities and free credit balances due to customers.

Public Interest

Petitioners contend that the bar imposed upon them by the examiner is unduly severe and not comparable to sanctions imposed in similar cases. They assert that they voluntarily

[3] See *Aldrich, Scott & Co., Inc.*, 40 S.E.C. 775, 778 (1961).

[4] In July 1970, the firm was unable to make prompt payment of the full amount of the $7,000 or $8,000 due for securities sold for a customer. Several checks totalling that amount were issued to the customer and Solomon requested the customer's attorney not to deposit one of them for two to three weeks. Following the deposit of the check, Solomon, at the rgquest of the firm's accountant, stopped payment because the balance in the firm's checking account included a substantial amount of uncollected funds. The stop order was lifted after the attorney complained to our staff. The non-liquid condition of the firm's checking account continued through August and the accountant daily informed petitioner of it. As a result, petitioners began actively to seek additional capital for the firm.

[5] *S.E.C.* v. *Mann and Company, Inc.*, *et al.*, Civil Action File No. 70–1503–W(D. Mass.).

suspended operations on September 1, 1970, when they became aware that the firm was not in compliance with the net capital rule, and the firm thereafter liquidated all its assets in order to reduce customer losses; that in attempting to raise funds to make restitution for the losses of $28,000 that remained, the firm applied to our staff for a so-called "no action letter" to enable it to sell restricted securities to obtain the necessary funds but the staff did not grant the application; that the firm offered to deliver restricted securities to three customers in lieu of the securities owed them as a result of unconsummated orders; that this is the first disciplinary proceeding against petitioners, who entered the securities business in 1961; and that their infractions stemmed primarily from backoffice problems and their inability to obtain sufficient capital at a time of adverse market conditions, and reflect only on their ability to act as principals.

The remedial action which is appropriate in the public interest depends on the applicable facts and circumstances of a particular case and cannot be measured precisely on the basis of the action taken in other cases.[6] Under all the circumstances, we think the bar imposed by the hearing examiner is warranted by the misconduct found.[7] However, in view of petitioners' prior clean record, the lack of evidence of any intent to defraud customers, their apparently good faith attempts to raise funds to make restitution, and their voluntary cessation of business, our order will not preclude them from applying to us, after a period of six months, for leave to become associated with a broker-dealer in a non-supervisory and adequately supervised capacity.[8]

An appropriate order will issue.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM, HERLONG and LOOMIS).

[6] See *Dlugash* v. *S.E.C.*, 43 S.E.C. 371, 384 (1967), 373 F.2d 107, 110 (C.A. 2, 1967); *Century Securities Company, aff'd sub. nom Nees* v. *S.E.C.*, 414 F.2d 211 (C.A. 9, 1969).

[7] We note that in May 1971 the National Association of Securities Dealers, Inc., based on the same net capital deficiencies charged in the instant case, censured petitioners, suspended them from association with any member for six months, and barred them from further association with any member as registered principals or in a supervisory capacity.

[8] The exceptions to the initial decision of the hearing examiner are sustained to extent that they are in accord with our decision and overruled to the extent that they are inconsistent therewith.

☆ U.S. GOVERNMENT PRINTING OFFICE: 1974 O—549-784

INDEX TO DECISIONS

The index is divided into six parts: Part I relating to decisions under the Securities Act of 1933; Part II, the Securities Exchange Act of 1934; Part III, the Public Utility Holding Company Act of 1935; Part IV, the Investment Company Act of 1940; Part V, the Investment Advisers Act of 1940; Part VI, Practice and Procedure.

SECURITIES ACT OF 1933

1. Examination Pursuant to Section 8(e)

Failure to Cooperate
588, 613
- Relationship to Stop-Order Proceedings
  613

2. Regulation A Proceedings

Generally
- Amendment of Filing, Absence of Right
  303, 432
- Deficiency Letter, Absence of Entitlement to
  303, 432

Deficiencies in Material Filed
- Assets
  432
- Cautionary Language in One Part of Offering Circular, Not Curing Misleading Impression Conveyed in Others
  303
- Expenses of Offering
  432
- Mining Properties, History
  303
- Notification
  - Jurisdictions in Which Securities to be Offered
    303
  - Offering Circular, Disclosures in Not Curative of Defects in Notification
    303
  - Prior Sales of Unregistered Securities
    303, 432
- "Ore" or "Deposits"
  303
- Properties and/or Facilities
  432
- Statement in Lieu of Offering Circular
  432

Disposition
- Permanent Suspension Ordered
  303, 432

3. Stop Order Proceedings

Registration Statement, Deficiencies
- Accounting
  - Intangible Property
    - 613
  - Promotional and Development Costs, Unrecovered
    - 613
  - Revenue Recognition
    - 750
  - Stock Distributions
    - 626
- Business Description
  - 206, 613, 750
- Disclosure Claimed Consistent with that in Other Registration Statements
  - 613
- Distribution Plan
  - 206, 893
- Insiders, Interest in Transactions
  - 750
- Inventions
  - 613
- Investment Company
  - Portfolio Transactions, Recapture by Affiliates
    - 442
- License Agreements
  - 613
- Management, Experience or Background
  - 206, 310
- Patents
  - 206
- Sales, Income or Profits
  - 750
- Use of Proceeds
  - 206, 613

Registration Statement, Disposition of Stop-Order Proceedings
- Proceedings Discontinued
  - On Condition of Distribution of Corrective Information
    - 310
- Proceedings Dismissed
  - Corrective Amendment Filed
    - 626

Stop-Order Issued
206, 558, 613, 750, 893
Withdrawal permitted: Commission Decision to be Distributed to Shareholders
750

PART II

SECURITIES EXCHANGE ACT OF 1934

1. Broker-Dealer Proceedings

Application for Registration
- Denied
  - 472
- Misconduct by Principal of Applicant While Associated with Another Broker-Dealer, as Basis for Denial
  - 472

Application for Registration [Form BD]
- Amendment to, Failure to File (See Also: Appropriate Headings Reflecting Items in Form BD, this title)
  - 567
- Associated Persons, Responsibility of
  - 481
- Officers, Directors and Persons with Similar Status or Functions, Failure to Disclose or Misstatement as to
  - 481, 567
- Willfulness of Violations
  - 481

(Associated Persons, Duties and Responsibilities of, (See: Headings Under Particular Types of Violations)

Associated Persons, Sanctions Imposed On
- Bar from Association with Broker-Dealer
  - 8, 45, 104, 153, 216, 230, 320, 336, 472, 481, 523, 709, 725, 745
  - Proviso Permitting Return to Securities Business After Specified Period Upon Showing of Adequate Supervision
    - 45, 153, 230, 350, 567, 910
- Cause, Findings of
  - 100, 104
- Supervisory Duties, Limitation on
  - 39, 588, 630
- Suspension from Association with Broker-Dealer
  - 216, 285, 461, 579, 588, 596, 630, 666, 719, 725, 738

Back-Office Problems, Duties Regarding
- Generally
  - 39

Books and Records

Associated Persons, Responsibility
725, 910

Compliance with Specific Requirements of Applicable Rules, Necessity
472, 567

Current, Failure to Keep
104, 350, 472, 567, 738, 910

Defenses Asserted

Advice of Accountant or Counsel, Reliance On
104

Employee Maintaining Records, Asserted Concealment of True Status of Records from Principals
567

Information which was False Not Specifically Required
523

Personnel Difficulties
350, 472

Staff Guidance, Asserted Inadequacy of
104

Volume of Business
350

False and Fictitious Records, Making of
481, 523

Information Not Specifically Required
523

Importance of Requirements Regarding
472, 738

Loans, No Proper Record of
539

Position Records, Failure to Maintain
539, 738

Principals, Responsibility
567

Salesman, Responsibility for Deficiencies in Own Trading Account
350

Time of Entry and Execution of Orders, Failure to Keep Appropriate Records as to
104, 709

Willfulness of Violations
104, 350, 523

Broker-Dealer Proceedings
Nature of, as Remedial Rather than Penal
350

Capacity
Mutual Fund Sales
805

Censure of Broker-Dealer
Ordered
39

Censure of Persons Other Than Broker-Dealer or Associated Person
Ordered
633, 652

Clearing Firm, Responsibilities
Generally
320

Confirmation
Associated Persons, Responsibility
725
Capacity in Sales of Mutual Fund Shares
805
False or Misleading
523
Required Information, Failure to Include
709

Control
Control, Factors Showing Existence of
666

Credit, Extension of (Regulation T)
Associated Persons, Responsibility
320, 350
Principals
567
Section 4(c)(1) of Regulation T (Agreement to Pay Promptly, etc.)
Non-Compliance
320
Section 4(c)(2) of Regulation T (7-day Provision)
Non-Compliance, Generally
320, 350, 567, 709, 738

Defenses Asserted: Books Inaccurate
539
Defenses Asserted: Funds Available in Other Accounts
738
Defenses Asserted: Unissued Securities
738
Section 4(c)(8) of Regulation T (90-day Provision)
Non-Compliance, Generally
320, 350
Willfulness of Violations
350

Distribution
Bids or Purchases During
216, 285, 709
Aiding and Abetting of Violations
285
Willfulness of Violations
285
Participant in, Under Rule 10b–6
285
Participation in Distribution, Failure to Disclose (Rule 15c1–6)
350
Process, Nature of
285, 567
Registered Secondary "Time-to-Time" offering as, Under Rule 10b–6
285

(Evidence
See: Practice and Procedure Index)
(Excessive Mark-Up or Mark-Downs
See: Price of Securities, Fairness)

Excessive Trading
Generally
8

False or Misleading Representations in Sale of Securities:
General Principles
Associated Persons, Responsibility
Principal
153
Principal, Asserted by Inactive
472

Salesmen, Reliance on Statements of Broker-Dealer Principals or Others
8, 45
"Caveat Emptor", Inapplicability of Doctrine to Sale of Securities
45
Existing Customer, Fact that Purchaser Is, Not Excusing Misrepresentations
45
Experience of Investor, No Defense
8
Misrepresentations After Sale as Violation
481
Opinions, Statements in Form of
567
Predictions of Substantial Price Increases with Respect to Speculative Security, Inherently Fraudulent
8, 45, 153, 216, 481
Reasonable Basis for Representations, Requirement
8, 153, 567
Recommendations to Customers
Duty of Reasonable Inquiry by Persons Making
45
Failure to Disclose Adverse Information
8, 472, 481, 467
Investment Objectives Expressed by Customers, Reasonable Basis for Believing Recommendations Meet
8, 481
Reliance on Information Provided by Others, as Defense
Another Broker-Dealer
45, 153
Issuer Management
45, 153, 216
Reliance or Loss by Customer, Showing Not Required
8, 104, 472, 709
Salesman, Purchases by, Not Excusing Misrepresentations
8, 45
Small Number of Customer—Witnesses, No Defense
472
Sophistication of Customer, Not Excusing Misrepresentations
104, 709

Speculate, Customer's Desire to, Not Excusing Misrepresentation
8
Speculation, Customer's Recognition of Securities As, Not Excusing Misrepresentations
45
Staff Advice Regarding Accuracy of Literature, Asserted
104

False or Misleading Representations in Sale of Securities:
Subject Matter of Misrepresentations
Assets of Issuer
216, 472
Availability of Securities
481
Business of Issuer, Nature
153, 481
Comparison with Other Issuers or Securities
104, 216
Contracts Obtained or to be Obtained by Issuer
481
Dividends, Prediction
45, 481
Earnings, Past or Present
8, 153, 472
Earnings, Prediction
8, 45, 153, 216
Financial Condition of Issuer
216, 472, 709
Guarantee Against Loss
481
Investment by Broker-Dealer or Others in Securities Offered
45
(Investment Company Shares
See: Investment Companies)
Investment Objections of Customers, Securities as Meeting
8
Listing on Exchange
153, 216
Litigation Involving Issuer
8
Merger, Prospective
8

Mortgage Notes, Amount of Mortgage in Relation in Property Value
104
Offering Price in Prospective Offering
481
Price of Securities, Prediction of Rise
8, 45, 153, 216, 472, 481, 567
Products of Issuer
481
Seizure by Authorities
8
Projects or Properties to be Acquired
709
Prospects of Issuer, Generally
8, 45, 216, 472, 481, 709
Public Offering by Issuer, Prospective
481
Recoupment of Investment, Assurance of
481
Refinancing of Indebtedness
153
Safety of Investment
8, 104, 216
Sales of Issuer, Prediction
45, 153
Stock Split, Possibility
481
Underwriter, Firm Commitment, Failure to Disclose Inability to Meet Contractual Obligations
453

False or Misleading Representations in Sale of Securities: Other Matters
Willfulness of Violations
472

Financial Reports, Broker-Dealers
Associated Persons, Responsibility
Principal
350
Importance of Requirements
692, 738
Inaccurate
350, 630

Late Filing
692, 738
Willfulness of Violations
692

Fraud
Agency Orders Executed on Principal Basis
666
Agent, Duty Not to Prefer Own Interest
666, 709
Consummate Transactions, Continuation of Business Despite Financial Inability
910
Associated Persons, Responsibility
910
(Distribution
See: Distribution)
(Excessive Trading
See: Excessive Trading)
Execution of Orders, Duty to Make Effort to Obtain Best
523, 666, 805
Failure of Broker-Dealer to Meet Financial Obligations (See also: Insolvency of Broker-Dealer, this title)
692
Fair Dealing, Implied Representation and Obligation
8, 45, 216, 481
(Inside Information, Improper Use
See: Inside Information, Improper Use)
Insolvency of Broker-Dealer
Failure to Disclose
692
Representation of Solvency Implied from Conducting Business
692, 910
Interpositioning
523
Disclosure as Not Obviating Fraud
523
Manipulation
246, 320, 709
Associated Persons, Responsibility
709

Payments Received in Connection with Underwriting, Transmission or Maintenance (Rule 15c2–4)
481, 692
Associated Persons, Responsibility
692
Reciprocal Arrangements Between Brokers
523
Scheme to Defraud
Express Agreement Unnecessary to Existence
481
Other Customers, Absence of Evidence as to Transactions With, as Not Precluding Finding
481
Participation or Lack of, Circumstances Showing
481, 666
Recommendations to Clients Based on Self-Interest Rather Than Financial Planning as Represented
481
Secret Profits
805
Sham Agency Sales, and Repurchases by Broker
666

Injunction

Consent Injunction as Basis for Sanction
1, 45

Inside Information, Improper Use

Generally
246
Tippees
633

Investment Companies

(See also: Investment Company Act Index)
Misrepresentations Concerning Investment in Restricted Securities and Performance of Fund
246
Portfolio Transactions
Executing Brokers, Participation with Affiliates in Rebate Arrangements
442, 810
Investment Adviser, Fiduciary Position
442, 810

Persons Responsible for Directing Execution, Abusing Position
442, 810
Tender of Portfolio Securities, Receipt of Fees by Affiliates
442
Prospectus, Misrepresentations
Benefits Received by Adviser and Affiliates from Executing Brokers
442
Restricted Securities, Duty to Make Reasonable Investigation Preceding Purchase
810

Investment Company Act, Violations
(See also Investment Company Act Index)
Section 2(a)(39)—Valuation of Securities
246, 810
Section 13—Changes in Investment Policy
810
Section 15(a)—Compensation of Adviser, Failure to Describe
810
Section 17(e)(1)—Acceptance of Compensation for Sale or Purchase of Property for Investment Company
442, 810
Section 20(a)—Inadequate Disclosure in Proxy Material
442
Section 22(d)—Uniform Price Provision
212, 810
Section 31(a)—Accounts and Records
442, 810
Section 34(b)—Inadequate Disclosure in Documents Filed with Commission
442

Mails or Interstate Facilities, Use of
Quotations in "sheets," Insertion
285

NASD: Review of Disciplinary Proceedings
Books and Records, Failure to Comply with NASD Rule Concerning (See also: Book and Records, above)

Customers' Accounts, Required Information, Failure to Maintain
539
Customers' Complaints, Failure to Maintain Separate File or Record of
539
Commissions, Sharing with Expelled Member
129
(Confirmations
See: Confirmation)
Emergency Rules of Fair Practice Regarding Fail Items
Validity
701
Violations
701
Examinations, Improper Practices in Preparing Candidates
801
(Financial Reports
See: Financial Reports: Broker-Dealers)
(Fraudulent Representations in Sale of Securities
See: False or Misleading Representation in Sale of Securities)
"High Standards of Commercial Honor"
Filing Violation, as Contravening
412
"Just and Equitable Principles of Trade"
Conduct Which is Inequitable but Not Illegal as Basis for Sanction
622
Securities Acts and Rules Thereunder, Violations of, as Conduct
Inconsistent with Just and Equitable Principles of Trade
539
Vagueness of Standards Claimed
622
Net Capital Rule, Violation of as Basis for Disciplinary Action
(See also: Net Capital Requirements)
539
Non-Member Broker-Dealers, Dealing with on Preferential Terms
539

Procedure Before NASD
 Bias, Claim
  212
(Public Interest Factors
 See: Public Interest Factors)
Rebates to Customers on Sales of Mutual Funds
  212
Sanctions Imposed by NASD, Commission Action as to
 Affirmed
  412, 539, 701, 801, 805
 Reduced
  129, 212, 539
Subordination Agreements, Failure to File with NASD
  539
 Delegation of Responsibility for Filing to Another Principal
  539
Supervision of Customer Accounts
  539
Supervisory Procedures, Failure to Maintain Written
  539
Underwriting Arrangements, Fairness of
  412
 Filing of Pertinent Documents, Late
  412

NASD: Suspension from by Commission
 Ordered
  320, 461, 596, 738

National Securities Exchange: Expulsion or Suspension from by Commission
 Expulsion
  336, 481, 738

Net Capital Requirements
 Associated Persons, Responsibility
  567, 692, 910
 Elimination of Deficiency, as Not Curing Earlier Deficiency
  472
 Funds Borrowed for Short Period to Conceal Deficiencies
  453
 Importance
  539

"Net Capital", Computation
Fixed Assets and Assets Not Readily Convertible Into Cash: Securities
630
Open Contractual Commitments, Deductions Required
453
Securities Valuation
692
Non-Compliance, Generally
453, 472, 567, 910
Purpose
567
Subordination Agreements
539
Failure to File as Precluding Exclusion of Indebtedness
539
Failure to File No Independent Violation
539
Willfulness of Violations
567

Offer of Settlement
Factors Considered in Acceptance
39, 320, 442, 579, 630, 652

Price of Securities, Fairness
Generally
216

Public Interest Factors: Factors Relating to the Nature and Consequences of the Violation
Advice of Counsel or Other Expert, Reliance on
539, 567, 579, 719
Books and Records, Inability to Keep Current as Cause of Violations
910
Cessation of Unlawful Activity
212, 350, 719, 801, 910
Corrective Action Taken
709
Expelled NASD Member, Dealings With as Partially Nullifying Sanction
129
Experience in Securities Business
212, 579, 709, 805

Experience, Lack of
8, 216, 481, 523, 567, 596, 709
Failure to Correct Deficiencies
805
Fraud, Absence of
805
Fraudulent Scheme
523
Fraudulent Scheme Not Originated by Respondents
666
Gravity and Extent of Violations
8, 45, 100, 104, 129, 153, 216, 285, 320, 336, 461, 472, 481, 523, 567, 588, 666, 701, 709, 738, 745, 801
Ignorance of Applicable Requirements
212, 596, 805
Inadvertent or Unintentional, Violations as, Claimed or Found
709, 805, 910
Intent or Attitude, Generally
523
Good Faith, Actual or Claimed
481
Indifference to Requirements
8, 104, 350
Intent to Violate, Absence of
129, 212
Loss to Customers or Others, Absence or Existence
285, 350, 588, 596, 666, 709, 725
Management Skills, Violations Attributable to Lack of
539
Managerial, Nature of Violation
692, 910
Personal Problems
567
President or Other Head of Business, Violations Claimed Attributable to
481, 709
Principal, Assertedly Without Authority
725
Principals, No Actual Knowledge of or Participation in Violations
630
Principals, Violations Condoned by
725

Prior Injunction Against Same or Similar Misconduct
472
Prior Warning Regarding Similar Inadequacies
567
Profit or Personal, Benefit from Misconduct, Asserted Absence
805
Reliance on Others
45, 153, 216
Repetition of Misconduct After Admonition
725
Restitution or Recission
461, 567, 725, 805, 910
Salary or Wages of Employee, Inadequate
523
S.E.C. Staff, Asserted Inquiry Directed to
212
S.E.C. Staff, Disregard of Warnings of
336, 350, 567, 709
Supervision
Failure to Exercise Adequate
725
Unregistered Securities, Sale Only to Market-Maker
666
Violations Found by NASD Set Aside in Part
539
Violations Involved Only Part of Business or Small Number of Transactions
212
Voluntary Disclosure of Improper Practices
212, 630, 709
Youth
8, 523

Public Interest Factors: Likelihood of Future Violation
Cessation of Business
285, 461, 738
Cessation of Securities Activities
481
Disassociation of Wrongdoer from Registrant
285, 350, 481, 579, 709, 738
Future Compliance, Representation
472, 805

Future Compliance, Steps Takes to Assure
350, 481, 567
Internal Procedures, Adoption of Improved
461, 567, 709, 805
Limitation of Future Business Activity
8, 216, 350
Retraining as Proper Supervision by New Employer
100

Public Interest Factors: Conduct Aside from Violations Found; Character; Reputation
Application for Registration Misleading
472
Candor, Lack of
725
Conduct Since Violations
8, 45, 100, 336, 350, 481
Cooperation
285, 725
Efforts to Achieve Compliance Only After Violations Uncovered
472, 567
False and Evasive Testimony
104, 725
Injunction
539, 745
Previous Misconduct
Found by NASD
588
Previous Misconduct, No Record
513, 579, 666
Prior Disciplinary Action
45, 539, 805
By NASD
745, 805
By Securities Exchange
320
Prior Disciplinary Action, Absence
8, 45, 153, 212, 285, 350, 461, 481, 630, 666, 910
Production of Records, Pursuant to Subpoena, Reluctance in
104
Public Service
45

Records, Destruction
104
Reputation
336

Public Interest Factors: Effect of Past or Proposed Sanctions
Bar as "Cruel and Unusual Punishment", Claimed
104
Hardship Already Suffered Because of Proceedings
8, 45, 412, 481, 579
Hardship Involved in Sanction
350, 801, 805
Local Securities Market, Impairment
336
NASD, Sanctions Imposed by For Same Misconduct
701
Public Stockholders, Impact of Sanction
738
State, Sanctions Imposed by For Same Misconduct
725
Suspension as Tantamount to Exclusion, Claimed
100, 350

Public Interest Factors: Miscellaneous
Abstention from Securities Business Pending Outcome of Proceedings
725
Bankruptcy of Broker-Dealer
692
Comparison with Sanctions Imposed in Other Proceedings
8, 350, 472, 481, 523, 738, 805, 910
Comparison with Sanctions Imposed in Same Proceedings
45, 320, 666, 738, 745
Death of Principal
719
Ill Health
719
Successor, Substantial Identity with Violating Predecessor
461
Time Elapsed Since Violations
481

Registration Requirements as to Securities Violations, Generally
472

Associated Persons, Participation in Violations
Partners or Officers
481, 567, 725
Salesmen
320, 350
Bank, Obligations with Respect to Use of Its Brokerage Accounts
652
Brokers' Transactions, Unsolicited
588, 745
(Distribution
See: Distribution; Public or Private Offering, What Constitutes)
Distribution by Issuer or Underwriter, Participation in
461, 666, 709, 745
Exemption From Registration, Burden of Proving Availability
461, 588, 666, 745
Exemption From Registration, Duty to be Aware of Requirements for
461, 588
Exemption From Registration, Strict Construction
745
Exemptions From Registration Under Section 4 as Attaching to Transactions, Not Securities
320
Investigation as to Identity or Status of Seller, Duty of
320, 350, 461, 588, 886
Investigation, Duty of Broker-Dealer Asked to Sell Substantial Amounts of Ltitle Known Security to Make
461, 886
Salesman, Same Duty
666
"Offer to Sell", What Constitutes
579
Prospectus, Failure to Deliver (Section 5(b)(2))
285
Prospectus, Failure to Comply
579
Public or Private Offering, What Constitutes
481, 567, 725
Restrictive or Cautionary Legend
461, 588, 666

Rule 154
745
(Sale, What Constitutes
See: Sale of Securities)
Section 3(a)(1) Exemption
709
Section 4(1) Exemption
(See Also: Underwriter)
285, 461
Section 4(2) Exemption
(See also: Public or Private Offering, What Constitutes)
481, 567
Section 4(3) Exemption
285, 461
Section 4(4) Exemption
(See also: Brokers' Transactions, Unsolicited)
461, 588, 666, 745
Shell Corporation, Special Care to be Exercised in Sale of Securities
709
Staff Interpretation, Asserted Reliance on
104, 481
Underwriter, Asserted Inability to Bring About Registration
104
Underwriter, Sales by
104, 216, 285, 320, 350, 567, 709
Willfulness of Violations
104, 216, 285, 320, 461, 567, 588, 666, 709, 745
Advice of Counsel, Reliance of
461, 481
Advice of Employee, Asserted Reliance on
725
Advice of Issuer's Counsel, Reliance on
104, 567
Staff Interpretation, Asserted Reliance on
104

Revocation
Ordered
8, 45, 104, 153, 336, 350, 472, 481, 567, 630, 709, 745

Securities Exchange Act
Different Remedies, Simultaneous Pursuit by Commission, as Permissible
8

Section 15(b)(5)
Dissolution of Broker-Dealer, as Not Precluding Sanction
285
Sanctions, Purpose and Philosophy of
100, 567
Violations by Associated Person Prior to Association, as Basis for Sanction
8, 285, 461

Security
Investment Contract, What Constitutes
104

Statute of Limitations, State, Applicability of
8

Supervision, Duty of
Generally
709
Clearing Firm
320
Compliance Director
230
Credit, Extension of (Regulation T)
738
False or Misleading Representations
472
Manipulation
320
Misappropriation of Customers' Funds or Securities
725
Person Subject to Supervision, No Need for Specific Allegation of Violation by
567
President
588, 738
Principal, Assertedly Inactive
472
NASD Principal Registration, Obligations Notwithstanding Failure to Obtain
472
Registration Requirements as to Securities, Violations of
320, 472, 588

Suspension of Registration
Ordered
216, 588, 596, 666, 738
Subject to Earlier Termination upon Compliance with SECO Requirements
719

Suspension of Registration Pending Final Determination
Ordered
472

Underwriter
Status of, Facts Giving Rise to
104, 216, 285, 320, 350, 461, 567, 666
Fraud of Issuer, Effect
461
Rule 141 Definition
285

Willfulness
Meaning, Under Section 15(b), Generally
1, 8, 285, 350, 461, 472, 481, 567, 719

Words and Phrases
Limit Order
666

2. Proceedings Other Than Broker-Dealer Proceedings

Section 12(d)—Delisting of Securities
Grounds for Delisting
Listing Agreement, Failure to Comply with Disclosure Requirements in
273
Net Losses
33, 734

Section 12(b)—Application for Exemption Under
675

Section 15(c)(4) Proceedings
Reporting Requirements, Failure to Comply With
260, 266, 379, 535, 750, 860

Part III

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

Section 3—Exemptions
- Section 3(a)(1)—Intrastate Company
  - 140

Section 7—Authorization of Security Issues
- Antitrust Laws, Municipalities' Allegations of Violations, Not Justifying Withholding of Section 7 Order
  - 457
  - Issuance of Bonds and Preferred Stock to Pay Bank Loans and Finance Corporation
    - 457
  - Issuance of Shares in Exchange for Shares of Non-Affiliated Utility Company
    - 115, 548
  - Issuance of Stock to Permit Subsidiary to Acquire Non-Associate Utility Company
    - 28

Section 9—Acquisition of Securities, Utility Assets and Other Interest
- Section 9(c)(3)—Exemption for Acquisitions Appropriate in "Ordinary Course of Business"
  - 361, 406, 422

Section 10—Approval of Acquisitions
- Assets of Non-Associate or Non-Affiliated Utility Company
  - 28, 340
- Securities of Non-Associate or Non-Affiliated Utility Company
  - 115, 140, 189, 548
- Securities of Non-Utility Subsidiary
  - 361, 406, 422
- Securities of Nuclear Generating Company, by Sponsors
  - 396

Section 11—Simplification of Holding Company System
- Section 11(b)(1)—Integration Standards
  - "Other Business" Clauses
    - 361
- Section 11(b)(2)—Simplification Standards
  - Distribution of Voting Power
    - 515

Section 11(c)—Time for Compliance with Section 11(b)
227
Plan under Section 11(e)
Necessity
75, 515
Fairness and Equity
75, 515
Other Matters
Additional Time to Make Tender Offer Denied
282
Hearings, Request Denied
(See also: Practice and Procedure Index)
457, 532
Rule 24
282

Part IV

INVESTMENT COMPANY OF 1940

Section 3—Definition of Investment Company
Section 3(b)(2)—Primary Engagement in Non-Investment Company Business
134, 314

Section 6(b)—Exemption for Employees' Securities Company
87

Section 6(c)—Exemptions
(See also: Various substantive provisions)
Purpose and Application of Section
761

Section 7(d)—Prohibition on Public Offering by Foreign Company
889

Section 8(f)—Deregistration of Investment Company
Denied
235
Granted
134, 428

Section 9(c)—Exemption from Ineligibility to Serve Investment Company in Certain Capacities
202

Section 13—Changes in Investment Policy
235, 428

Section 17—Transactions of Certain Affiliated Persons and Underwriters
Capacity of Affiliate of Investment Company in Executing Portfolio Purchases of Mutual Fund Shares
680, 761

Section 17(a)—Prohibited Principal Transactions Between Affiliated Persons
165

Section 17(b)—Exemption of Transactions Between Affiliated Persons
Attorneys' Fees and Expenses of Participants, Jurisdiction to Require Payment
126

Exemption Conditioned on Amendment of Merger Plan
165
Exemption Denied
560
Exemption Granted
655, 879
Overreaching, Proposed Transactions as Involving
165
Withdrawal of Application
126

Section 17(e)—Acceptance of Compensation or Renumeration by Affiliated Person Acting as Agent or Broker
389, 680

Section 22—Distribution, Redemption and Repurchase of Redeemable
Section 22(d)—Uniform Price Provision
761
Other Matter
Portfolio Turnover, Excessive
680

PART V

INVESTMENT ADVISERS ACT OF 1940

[See also: Corresponding headings under

SECURITIES EXCHANGE ACT OF 1934]

Application for Registration
Address of Business, Misstatement of
347
Application Denied
347
Desist and Refrain Order, Failure to Disclose
347

Fiduciary Nature of Investment Advisory Relationship
246

Fraud
246, 347

Part VI

PRACTICE AND PROCEDURE

Additional Evidence
Motion to Adduce
Conduct Since Violations
481
Events Subsequent to Close of Hearings
126

Adjudication, Proceeding by Rather Than by Rule
Antifraud Provisions, Interpretation
523

Administrative Procedure Act
Section 5(d) (5 U.S.C. §554(e))
Declaratory Order, Issuance
680
Section 6(a) (5 U.S.C. §555(b))
Reasonable Time, Conclusion of Matter Within
481
Section 7(a) (5 U.S.C. §556(b))
Disqualification of Presiding Officer
438
Section 7(c) (5 U.S.C. §556(d))
"Reliable, Probative and Substantial" Evidence, Requirement That Commission Order Be Supported By
104, 567
Section 8(b) (5 U.S.C. §557(c))
Initial Decision, Contents
481
Section 9(b) (5 U.S.C. §558(c))
Opportunity to Achieve Compliance
8, 104, 567
Reasonable Time, Determination of License Application Within
8
Section 10(e) (5 U.S.C. §706)
Unreasonable Delay, Power of Reviewing Court to Compel Agency Action
8

Attorney, Suspension or Disbarment

Conviction of Felony
374

Jurisdiction of Commission to Discipline Attorney
600

Layman, Participation in Improper Arrangements With
600

Broker-Dealer Proceedings

Nature of, as Remedial Rather Than **Penal**
8, 104, 567

Commission or Commissioners, Asserted Disqualification

(See also: Prejudgment and Prejudice)

Bias or Prejudice, Claimed
438, 523

Continuance

Grant or Denial of by Examiner, Sustained
216

Delay

Institution of Proceedings
8, 320, 481

Due Process, Claimed Denial

Failure of Staff to Interview, Call as Witness, or Name as Respondents, Certain Persons
104

Records of Respondents, Retention by State Authorities
153

Estoppel, Applicability of Doctrine

Commission
8, 104, 481, 613

Evidence

Admissibility of Particular Evidence

Summary of Documentary Material
1

Testimony in Prior Proceedings, as Admissions
8

Burden of Proof or Going Forward

Shift to Respondent
523

- Credibility of Witnesses
  - Generally
    - **8, 481, 567**
  - Customers Who Lost Money
    - **8, 104**
  - Customers Who Testified to Misrepresentations, Credibility Not Impaired if no Misrepresentations Made to Others
    - **8, 153**
  - Memories Claimed Faulty
    - **8**
  - Newspaper Account of Prior Proceedings, Witnesses Reading
    - **8**
  - Perjurer
    - **567**
- Proof, Quantum of Requried in Administrative Proceedings
    - **8, 104, 567**
- Recollection of Witnesses, Refreshing
  - Memoranda of Interview, or Witness' Statement
    - **8**
- Witnesses, No Inference from Staff's Failure to Call Certain Persons
    - **285**

Hearing Examiner

- Bias or Prejudice, Claimed
    - **216, 350, 613**

Hearings, Fairness of

- Cross-Examination, Request by Respondent Absent During Direct Testimony for Recall of Witnesses for
    - **216**
- Delay in Institution of Proceedings, Death of Person Whose Statements Were Testified to
    - **320**

Initial Decision

- Narrative Form as Permissible
    - **481, 613**

Intervention as Parties

- Untimely Notice of Appearance
    - **532**

Investigation
Privilege Against Self-Incrimination, Advice to Respondents Concerning
104

Notice of Issues, Adequacy
87, 285, 481, 567

Oral Argument
Public or Private Proceedings, Denial of Argument on Issue
481
Sanction Issue on Court Remand, Denial of Argument
336
Second Argument, Request for
285

Order for Proceedings
Amendment
1, 45, 350, 738

Pleadings
Responsive Pleading, Right to by Applicant for Declaratory Order
680

Prejudgment
481

Privilege Against Self-Incrimination
Corporate Records
104, 613

Production of Information or Documents, Request for
Confidential Files
285
Documentary Evidence, in Advance of Hearings
8
Investigative Material
285, 481
Witness List
8, 481

Public, Determination to Make Proceedings
585

Res Judicata
8

Severance

Denial Sustained
666

Stay of Proceedings
8

☆ U.S. GOVERNMENT PRINTING OFFICE: 1974 O—549-784

UNIVERSITY OF ILLINOIS-URBANA
3 0112 070124646

Google