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UNITED STATES OF AMERICA

before the

SECURITIES AND EXCHANGE COMMISSION

In the Matter of	
Measurements Spectrum, Inc. 733 South Fremont Avenue Alhambra, California	
File No. 24SF-2959	

RECOMMENDED DECISION

Sidney Ullman
Hearing Examiner

Washington, D. C.
April 15, 1963

UNITED STATES OF AMERICA

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SECURITIES AND EXCHANGE COMMISSION

In the Matter of Measurements Spectrum, Inc. 733 South Fremont Avenue Alhambra, California File No. 24SF-2959	:	RECOMMENDED DECISION

BEFORE: Sidney Ullman, Hearing Examiner

APPEARANCES: W. Steven Tucker and Robert A. Eisenberg, Esqs., for the Division of Corporation Finance.

Martin S. Stolzoff, Esq., Stolzoff & Koenig, 404 North Roxbury Drive, Beverly Hills, California, for issuer.

H. Bradley Jones, Esq., Jones & Maupin, 611 Wilshire Boulevard, Los Angeles 17, California, for Adams and Company (underwriter).

NATURE OF PROCEEDINGS

This is a public proceeding instituted by the Securities and Exchange Commission ("Commission") pursuant to Rule 261 of Regulation A under the Securities Act of 1933 ("Act") for the purpose of determining:

1. Whether a notification and an offering circular issued by Measurements Spectrum, Inc. ("issuer"), pursuant to the provisions of Section 3(b) of the Act and Regulation A thereunder, omitted to state material facts and contained misleading and untrue statements of material facts;[1/]

2. Whether the underwriter of the issue had any "culpable responsibility" as to the alleged defects in the offering circular;

3. Whether the offering in other respects was made in violation of the terms of the Act[2/] and of Regulation A;

1/ Regulation A, adopted under Section 3(b) of the Act, provides for an exemption from registration when an issuer offers securities with an aggregate public offering price not exceeding $300,000, provided that the issuer, among other things, files with the Commission a notification and offering circular containing certain minimum information.

2/ Section 17 of the Act, as applicable to this case, provides that it shall be unlawful in the offer or sale of any securities by use of means of communication or transportation in interstate commerce or the mails:

"(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

and

4. Whether an order of the Commission issued under Rule 261, suspending the Regulation A exemption should be vacated or should be made permanent.[3/]

On October 9, 1961, issuer filed with the Commission a notification on Form 1-A and an offering circular. As thereafter amended at various times, these documents related to an offering of 60,000 shares of common stock at $5 per share for a total amount of $300,000, for the purpose of obtaining an exemption from the registration requirements of the Act pursuant to Section 3(b) thereof and Regulation A thereunder. Adams and Company ("underwriter"), Los Angeles, California, was named as underwriter on an all-or-nothing best-efforts basis.

On May 25, 1962, the Commission issued an order pursuant to Rule 261, temporarily suspending the issuer's exemption under Regulation A and affording to any person having an interest therein an opportunity to request a hearing. A hearing was requested by the issuer. The underwriter also requested a hearing, stating that it desired an opportunity to show that it had no culpable responsibility as to the failure of the offering

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3/ Rule 261 provides for the issuance of an order temporarily suspending an exemption if the Commission has reason to believe that the terms and conditions of the Regulation have not been complied with, that any sales literature contains any untrue statements of material fact or omits to state a material fact necessary in order to make the statements made therein not misleading, or that the offering would be made in violation of Section 17 of the Act. The rule further provides that where a hearing is requested, the Commission will, after notice and opportunity for such hearing, either vacate the order or enter an order permanently suspending the exemption.

circular to state material facts truthfully, and also to present such other testimony and evidence as seemed appropriate.

On July 10, 1962, in response to the requests of the issuer and of the underwriter, the Commission ordered a hearing at Los Angeles, California, pursuant to Rule 261. The allegations of omissions and misstatements in the offering circular were modified on July 25, 1962, by an order of the Commission which altered a dollar amount in one alleged misrepresentation in the offering circular and added another alleged misrepresentation. This order also added allegations to the effect that the offering exceeded the $300,000 limitation of Regulation A by reason of allocations of promotional stock, and that these allocations were not disclosed in the notification filed on Form 1-A.

The issuer was represented at the hearing by counsel only on the first day, at which time Mr. Stolzoff, its counsel, stated for the record that all of the allegations in the amended order (with the exception of one which was subsequently withdrawn by the Division of Corporation Finance ("Division")) appeared to be substantially true; that the acts of the president of the company and some of the other officers "appear to have been quite improper"; and that the interest of present management and its purpose in appearing at the hearing was only to protect innocent victim stockholders.

The underwriter, Norman Adams, also was represented by counsel at the

hearing. Although Adams testified in defense of his activity as underwriter of the issue, he in effect also conceded that the allegations of the order, as of the commencement of the hearing, were true and correct, with the exception of the charge that the $300,000 limitation had been exceeded because of the allocation of promotional stock. These concessions were made in the underwriter's testimony, in a statement by his counsel at the conclusion of the Division's presentation of evidence in support of its case,[4/] and in a letter dated December 5, 1962, written by the underwriter to the Commission after his counsel had withdrawn from the proceeding, which set forth proposed findings and conclusions and urged the rejection of some of those previously submitted by counsel for the Division.

It is apparent, accordingly, that no issues of any substance persist as to those allegations of the order, as it existed at the commencement of the hearing, which relate to the offering circular's omissions and misstatements of material facts. The issue of "culpable responsibility" of the underwriter for the offering circular's omissions and misstatements remains, however, as do other issues relating to the application

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4/ Counsel for the underwriter made an opening statement to the effect that:

> ". . . it would appear from the statement of Martin Stolzoff, counsel for the company and from the testimony. . . that as to the fact[s] alleged respecting the company, and its responsibilities for false and misleading statements or omissions to state material facts in the offering circular, that the order . . . should be made permanent in suspending the Regulation A exemption. . . "

of the proceeds of the offering, and questions as to two agreements between the issuer and the underwriter not disclosed in the offering circular. Allegations as to the proceeds and the two agreements were added to the order by the Examiner during the hearing, on motion of the Division.

As indicated above, proposed findings and conclusions were submitted by the Division and by the underwriter. The Division also submitted a brief and a reply to the proposed findings and conclusions submitted by Adams in his letter to the Commission. No post-hearing documents were submitted on behalf of the issuer.

The following findings and conclusions are based on the record, including the documents and exhibits, and the Hearing Examiner's observation of the witnesses.

FINDINGS OF FACT AND CONCLUSIONS OF LAW

1. Issuer was incorporated in the State of California on February 15, 1960, under the name of Otterman-Dempsey Electronics. Its present name was adopted on February 28, 1961. At all times material to this proceeding, its offices and plant were at Alhambra, California, its business was that of certifying, calibrating and repairing electronic measuring equipment, and Charles E. Otterman was its president, a director, a promoter and its managing officer.

2. On October 9, 1961, the issuer filed with the Commission a notification and offering circular under Section 3(b) and Regulation A, which, after various amendments, related to a public offering of 60,000 shares of

issuer's $5 par value common stock at $5 per share.

3. Adams and Company, a sole proprietorship of Norman Adams, was named as underwriter of the offering and Norman Adams served as a director of the company until his resignation in February 1962.

4. An offering circular dated December 18, 1961, was used in the public offering. Charles Otterman, William Buchanan, Eric Ward and Robert Lynam were named therein as promoters of the issuer. Buchanan was also named therein as Secretary-Treasurer.

5. From its inception issuer sustained continuous operating losses and never earned a profit for any period. For the three months of September, October and November 1961, operating losses in excess of $33,000 were incurred. These losses were reflected in its books and records and in trial balances for August 31, 1961 and November 30, 1961, prepared by issuer's bookkeeper.

6. The offering circular of December 18, 1961 contained statements of financial condition of issuer as of August 31, 1961, but failed to disclose that issuer had sustained operating losses for the period September through November 1961.

7. On and subsequent to August 31, 1961 but prior to the date of the offering circular, issuer borrowed money and issued promissory notes in the amount of $56,000.

8. These promissory notes were issued to the following payees,

on the dates and in the amounts indicated below:

Air-Space Devices, Inc., August 31, 1961, $15,000,
Jack G. Kuhrts, October 12, 1961, $15,000,
Herb Dixon, November 6, 1961, $16,094,
James Morton, December 14, 1961, $10,000.

9. The promissory note payable to Air-Space Devices was issued by Otterman for the company on August 31, 1961 and the funds were received on the following day. The note provided for a chattel mortgage on all of the company's assets, as security. The note was not mentioned to issuer's certified public accountant, who was conducting an audit at that time.

10. The loan from Kuhrts was arranged by the underwriter, and the note which evidenced the loan was guaranteed by the underwriter and by Otterman on October 12, 1961. The Dixon loan was arranged by Jerry Ross, an employee of the underwriter. The Morton loan was arranged by Otterman shortly before the underwriting.

11. The offering circular does not disclose the issuance of any of the above promissory notes issued on and after August 31, 1961.

12. The offering circular states that in the event all shares being offered are sold, promotional shares would be issued, as follows:

29,900 shares for services to the issuer, in the following amounts:

20,900 to Otterman, 1,000 to Buchanan, 4,000 to Eric Ward and 4,000 to Robert Lynam. 5/

100 shares previously issued to Otterman, to be treated as promotional shares.

5/ 2,000 of the shares to Ward and 2,000 of the shares to Lynam were to be issued in cancellation of issuer's indebtedness to these men.

In addition, the offering circular stated that 4,000 shares were being issued to the underwriter in cancellation of an indebtedness.

13. The following re-allocations of promotional shares and offers of sale of the stock were made:

a. On August 31, 1961, Otterman gave to Air-Space Devices a right to purchase 5,000 shares of his promotional stock at 5¢ per share in consideration of the $15,000 loan to the issuer. The option had a life of 180 days. In February 1962 and in March 1962, Ronald Freemond, Secretary of Air-Space Devices and a member of the law firm of Freemond, Glynn and Maizlish, counsel for the underwriter prior to and during the offering period, offered these shares on behalf of Air-Space Devices to Globus, Inc., a brokerage firm in New York City, at $1.50 per share.

b. In September 1961, Otterman agreed to assign 3,750 of his promotional shares to the underwriter after the underwriting was closed, to be used in settlement of a claim under an agreement the underwriter had previously made with Linne Nelson, in the name of Hazel Nelson, for the sale to Nelson, of a 25% interest in the issuer. 6/ On September 21, 1961, the underwriter agreed to transfer the 3,750 promotional shares to Hazel Nelson (and made a payment of $5,050)in settlement of Nelson's claim, which was evidenced by a receipt from the underwriter dated June 19, 1961, reading as follows: "Bought 25 per cent of Measurements Spectrum, Inc. Amount $5,000.00", and by a memorandum of that date from Adams stating in part "Further, Mrs. Nelson will receive 750 shares at the time of the underwriting from the stock being appointed management." The September 21 agreement provided for the delivery of the 3,750 shares within 90 days of the commencement of the public offering. It also provided that the transfer should be subject to approval of the Commission and of the California Commissioner of Corporations, and that the shares should be held in escrow pending release by the California Commissioner.

6/ Otterman apparently misled the underwriter into believing that he owned 50% of the issuer in June 1962, and the underwriter made this agreement to dispose one-half of his interest.

c. Prior to the effective date of the offering circular, the underwriter agreed to transfer 1,100 shares to Jack Zillman in consideration of the above-mentioned $15,000 loan from Kuhrts to the issuer.

d. On October 12, 1961, Otterman agreed to transfer to Kuhrts 400 shares of the promotional stock and 250 shares of issuer's marketable stock in lieu of interest on Kuhrts' loan to the issuer.

e. On October 6, 1961, Otterman agreed to transfer to the underwriter 6,250 promotional shares, to be distributed to members of the selling group, to underwriters' salesmen, and to some of the issuer's directors in consideration of their serving in that capacity. Thereafter, but prior to the effective date of the offering circular, the underwriter executed assignments and options for the purchase of these shares. A tabulation of these assignments and options was presented by the underwriter to Otterman on December 28, 1961.

f. On November 6, 1961, Otterman agreed with Dixon to transfer 500 shares of promotional stock in consideration of the loan of $15,000 to the issuer.

g. On November 7, 1961, Otterman agreed to transfer to Jerry Ross 500 shares of his promotional stock in consideration of the Dixon loan, arranged by Ross. (Ross also received an option to purchase 455 shares at 10¢ a share as part of underwriter's disposition of the 6,250 promotional shares received from Otterman.)

h. On October 6, 1961, the underwriter offered Kuhrts 3,000 shares at $5 per share.

14. None of the above transactions was disclosed in the offering circular.

15. Certificates were issued for 8,100 of the above 34,000 shares, as follows:

100 to Otterman, 2,000 to Ward, 2,000 to Lynam and 4,000 to the underwriter.

Certificates were not issued for the balance of the 34,000 shares.

16. The offering circular further states that the above-described 34,000 shares would be escrowed and that the escrow would carry restrictions against the sale or transfer of the shares or of any interest therein and restrictions against the receipt of any consideration therefor, until written consent obtained from the California Commissioner of Corporations.

17. Escrow agreements were filed by the issuer on November 9, 1961, December 14, 1961 and December 26, 1961, with the Commission, signed by the parties to receive the 34,000 shares. These agreements provided that no transfer or any other disposition of any of the shares or of any interest therein would be made within 13 months from the date of the offering circular.

18. The above re-allocations, options and assignments were not disclosed by the issuer in its responses to pertinent questions in items 9 and 10 of the notification on Form 1-A filed with the Commission on October 9, 1961, nor in amendments thereto filed on November 9, 1961, November 27, 1961, and December 14, 1961. Conversely, the notification, as amended on November 9, 1961, stated with regard to 30,000 shares of promotional stock, 25,000 of which were to be issued to Otterman, that:

> "Further, each person acquiring said shares is acquiring the same for investment . . . "

The subsequent amendment of December 14, 1961 changed the amount to 29,900 shares, to be issued to Otterman (20,900), to Buchanan (1,000), to Ward (4,000) and to Lynam (4,000), but did not withdraw or modify the representation as to acquisition for investment. In fact, however, it was anticipated from the outset that Otterman's shares would be widely distributed by himself and by the underwriter in consideration of cash and services to the issuer.

19. The offering circular stated, with regard to issuer's business, that:

> " . . . at the end of September, 1961, the Company had a current backlog of orders for approximately $278,000 of business itemized as follows: $178,000 open purchase orders; $48,500 by contract; and $51,500 in miscellaneous orders."

20. Actually, according to William Buchanan, originally Vice-President and thereafter Secretary-Treasurer of issuer, the backlog of purchase orders at the end of September amounted to a maximum of $20,000. Moreover, as the term "purchase orders" was used by the issuer, it merely denoted arrangements under which customers could send work to the issuer, but without any obligation or commitment on the part of the customer to have such work done. As of the end of September 1961 the backlog of orders under contract was closer to $10,000 than to the $48,500 amount represented in the offering circular. Although it is not possible to estimate accurately the true size of the backlog of miscellaneous orders, the figure of $51,500 in the offering circular was clearly a gross exaggeration.

21. The offering circular represented that the proceeds of the

offering would be expended approximately as follows:

"Increased Working Capital	$112,853.00
Costs to Establish Palo Alto Laboratory	9,700.00
Acquisition of Trailer for Servicing Palo Alto Laboratory	10,000.00
Purchase of Additional Inventory Stock	15,000.00
Purchase of Additional Electronic Test Equipment	62,828.00
Reduction of Bank Note and Payment of Other Current Liabilities	36,619.00
TOTAL	$247,000.00".

22. The books and records of the issuer show that $225,000 was received from the proceeds of the offering on December 22, 1961 and was totally disbursed by March 9, 1962.

23. No expenditures were made for a laboratory at Palo Alto, for a trailer for such laboratory, or for inventory stock.

24. Expenditures for equipment totalled $12,901, rather than the $62,828 as represented in the offering circular. The item "Reduction of Bank Note and Payment of Other Current Liabilities" contemplated payment of a bank note in the amount of $15,000 and of accounts payable in the amount of $21,619. Actually, issuer expended $43,705 in payment of accounts payable and $83,885 in payment of notes payable, including the notes issued on and after August 31, 1961 and prior to the effective date of the offering circular. Other expenditures of the proceeds of the offering amounted to approximately $33,000, including an advance of $19,280 to Otterman.

25. The offering circular states, under a heading entitled: "INTEREST OF MANAGEMENT IN CERTAIN TRANSACTION" that in 1961, Adams acquired for the sum of $20,000 a promissory note in the principal amount of $43,000 made by issuer in favor of C. R. Graham for a loan of $43,000: that Adams agreed to reduce the principal amount of the note to $20,000 and to cancel this indebtedness in exchange for 4,000 shares of common stock which would be subject to escrow conditions imposed by the California Commissioner of Corporations.

26. The issuer wrote a letter to the underwriter on December 8, 1961, in which an indebtedness to the underwriter in the amount of $20,000, to be paid by January 1, 1962, was acknowledged "for his many important arranged contributions to Measurements Spectrum, Inc. . . ." On February 5, 1962, the underwriter wrote to Otterman requesting that this indebtedness as well as other obligations be honored. Thereafter, the underwriter wrote Otterman on February 11, 1962, that his letter of February 5, 1962 "expressed agreements that are illegal and must be considered void henceforth. These are the mention of payments to me that to be valid must have appeared in the Offering Circular." In his testimony the underwriter contended that the letter of February 5 was written without serious effort to collect the sum, but rather was written in a sarcastic vein to rebuke Otterman. The Examiner rejects the underwriter's testimony regarding the purpose and intent of the

letter of February 5, 1962. The letter of February 11, 1962 from the underwriter to Otterman in no way alters but rather reaffirms the Examiner's conclusion that as of February 5, 1962 and prior to that date, the underwriter regarded the issuer's obligation to pay the $20,000 as a binding obligation.

27. The offering circular failed to disclose the existence of the above obligation.

28. On October 6, 1961, the issuer and the underwriter entered into a retainer agreement by which the issuer employed the underwriter as Financial Consultant for a period of three years beginning November 1, 1961, for a total salary of $18,000, payable $500 per month. The agreement gave to the issuer the option of discounting the consideration due to Adams by payment, on or before December 1, 1961, of the amount of $15,000, inclusive of any payments made under the agreement prior to the exercise of the option. Underwriter's letter of February 5, 1962 to Otterman refers to a contract under which he was to be paid $15,000 and requests performance of this agreement. His testimony to the effect that about one week after the retainer agreement was made it was negated by Otterman and himself and that "nothing was ever done to collect any funds from them" is unsupported by credible evidence, is contrary to the import of the letter of February 5, 1962, and is expressly discredited and rejected by the Examiner.

29. The offering circular made no mention of the retainer agreement.

30. In the letter of December 8, 1961 from Otterman to the underwriter, acknowledging issuer's indebtedness of $20,000, Otterman stated in part that:

> "Mr. Adams has acquired for the Company its present Vice-President of Sales and is currently endeavoring to find a suitable Corporate Treasurer. Further, he has presently arranged needed short term loans for the Company totalling over $60,000, over and beyond his own $20,000 cash input. He has also effectively aided the Company in obtaining necessary purchase credit and has served repeatedly as liaison between the Company and potential clients. It should be added that,in general, Mr. Adams has been as close to Measurements Spectrum, Inc., in its recent incubation period as any one person with the only possible exception of myself, and Measurements Spectrum, Inc., and I am sure the future stockholders are deeply indebted to him."

Although no credence can be given anything said by Otterman, evidence of whose distortions of truth and exaggerations pervades the testimony and documentary evidence,it is the fact that the underwriter was very close to the administrative affairs of the issuer prior to and during the period of the public offering. The closeness of this relationship is indicated in many of the above findings, and much other evidence of Adams' activity on behalf of the issuer appears in the record but is not related or detailed herein inasmuch as it is cumulative and not necessary to an understanding of the relationship.

31. The underwriter was also conversant with the offering circular and either was aware or should have been aware of the omissions and misstatements therein. It is entirely apparent that he was aware of the

issuance of the promissory notes in the amount of approximately $56,000, most of which were negotiated directly or indirectly through his efforts. The obligations reflected by these notes materially affected the financial condition of the issuer and, were, of course, basic matters which should have been disclosed in order to inform potential investors of the hazards as well as the potential advantages of an investment in issuer's stock. The Examiner finds that the omission was intentional on the part of both issuer and underwriter. The latter made an effort in his testimony to place the entire blame for the omission on his counsel (who admittedly knew of one loan but may not have known of the others). It appears that at least one and possibly several of the loans were not disclosed by the underwriter to his counsel, and his effort to avoid blame for the omission is rejected as a matter of fact as well as law. 7/

32. It is equally apparent that the underwriter knew of the intentional omission from the offering circular of any mention of the

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7/ The Commission has heretofore rejected the defense of reliance on the advise of counsel even where it was urged to contravene willful violation of the Securities Act. The Whitehall Corporation, 38 S.E.C. 259, 270 (1958); Thompson Ross Securities Co., 6 S.E.C. 1111, 1112 (1940). Cf. Dennis vs. United States, 171 F.2d 986, 991 (C.A. D.C., 1949) in which the Court rejected the defense of reliance on counsel with the remark that if it were a valid defense "many corporations, organizations, and even individuals would maintain counsel permanently for the purpose of advising them against doing anything they did not wish to do".

proposed distribution of promotional stock, and in a letter of April 22, 1962, to Otterman he stated:

> "You will remember that you suggested not putting this 6,250 shares in the offering circular since it was to be varying in amounts with the sales volume."

33. Underwriter also was aware of the omissions of issuer's agreements to pay him $20,000 and to employ him as Financial Consultant. Knowing of these obligations and of the promissory notes, he also knew that the stated application of proceeds could not be followed. And if he was not aware of operating losses sustained by the issuer between August 31, 1961 and the date of the offering circular, or of the inaccuracies in the representations of issuer's backlog of business, his ignorance of these facts was the product of a mind which closed conveniently against the reception of information which might impede or frustrate the sale of the issuer's stock, but which accepted eagerly and published widely and without verification all information which would promote the issue.

34. Adams failed consistently to correct the misstatements compounded by his publications, after he learned of their falsity and inaccuracy. He knew, at least as early as September 1961, that he had been misled by Otterman into believing that he owned one-half of the issuer,[8/] but he continued to accept and publish Otterman's sales figures

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8/ The letter to Otterman of April 22, 1962, written after the halcyon days had passed, stated, in part:

> "Charles, right from the beginning when you 'sold' me your company and then told me it couldn't be sold, through your letter to me of November 27, 1961, when you stated your backlog to be in excess of $2 million and it wasn't 10% of that, your actions have been immoral and misleading, a character that is not compatible with the investment industry which is

and projections without effort to examine the corporate books and records. In October 1961 he wrote to James Cantlen, who was induced to become a director of issuer, and to Howard Dawson of Morgan & Co., a broker-dealer in Los Angeles, transmitting to each a "Confidential" summary sheet on the underwriter's letterhead, which stated that the issuer "is already operating in the 'black'", and that its capitalization included "no underwriter's options." He wrote to Edgar Schmued, who was also induced to serve as director, that as of July 27, 1961 "Measurements Spectrum, Inc. is continuing to grow monthly. We have apparently now passed the break-even point of operations and the future may well be quite exciting." If he was not deliberately falsifying and intentionally deceiving, he was eagerly and most unreasonably accepting and publishing information which to him should have been suspect. His consistent pattern of freely accepting information which would promote the sale of stock and failing to correct the distorted facts he published are strongly suggestive of intentional and purposeful participation in the fraudulent scheme in which Otterman was engaged. At the least, the underwriter was grossly negligent in his participation in the offering with knowledge that omissions and misstatements of material facts existed in the offering circular.

35. The underwriter accepted from Otterman, and thereafter published and distributed to his salesmen and mailed to members of the selling group

and to other brokers, figures given him by Otterman, purporting to reflect past sales and anticipated sales of the issuer's products, without examination of the books and records of the company or adopting other reasonable methods of corroboration. These figures were gross exaggerations of past sales and backlog of orders and were fantastically out of touch with reality as regards anticipated sales.

36. It was stipulated at the hearing that the offering was completely sold between the approximate dates of December 18, 1961 and December 22, 1961.

37. Inasmuch as the issuer was incorporated more than one year prior to the filing of the notification on Form 1-A, but had not had a net income from operations of the character in which it intended to engage, for at least one of the last two fiscal years, 9/ the offering was subject to the provisions of Rule 253(c) under Regulation A. This rule provides, with respect to such offerings, that:

> "(1) all securities issued prior to the filing of the notification, or proposed to be issued, for a consideration consisting in whole or in part of assets or services and held by the person to whom issued; and
>
> (2) all securities issued to and held by or proposed to be issued, pursuant to options or otherwise, to any director, officer or promoter of the issuer, or to any underwriter, dealer or security salesman;"

shall be included in the aggregate offering price, which shall not exceed

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9/ See Rule 253(a)(2) under Regulation A.

$300,000,

> "Provided, that such securities need not be included to the extent that effective provision is made, by escrow arrangements or otherwise, to assure that none of such securities or any interest therein will be reoffered to the public within one year after the commencement of the offering hereunder and that any reoffering of such securities will be made in accordance with the applicable provisions of the Act."

This rule applies to the 100 shares issued to Otterman prior to the filing of the notification. According to the offering circular these shares had been issued in consideration of his payment of $1,000. It also applies to the promotional shares proposed to be issued to Otterman, to Ward and to Lynam, and to the shares to be issued to the underwriter.

38. The above findings of fact relating to these shares indicate not only that no effective provision was made to assure that they or an interest in them would not be reoffered to the public, but also that the shares and interests in them actually were reoffered and sold to the public, all in violation of the $300,000 limitation of Regulation A.[10/] Sales and reofferings of these securities and interests therein were effected even before the offering itself commenced, and continued after the offering period, all as contemplated by Otterman and the underwriter from the outset.

39. The language in some of the contracts of sale of the shares or of interests therein, to the effect that the contracts or in some cases the delivery of the securities would be subject to the approval of the

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10/ The definition of the term "sale" in Section 2(3) of the Act includes "every contract of sale or disposition of a security or interest in a security, for value." And the term "offer" is defined to include "every attempt or offer to dispose of . . . a security or interest in a security, for value."

Commission and of the California Commissioner of Corporations, or subject to the particular escrow agreement relating to the shares, was perhaps an attempt to suggest that the escrow arrangements were effective to assure that none of the securities or any interest therein was being offered to the public in violation of Rule 253(c). If so, such provisions were ineffectual to accomplish their purpose, for they could not and did not effectively provide or assure against the danger of reoffer to the public which the Rule was designed to prevent.

40. Counsel for the underwriter urged in his opening statement that the "redistribution of the 6,250 Otterman shares which were [held in] escrow as promotional shares . . . did not, as a matter of law constitute a distribution to the public within the meaning of Rule 253(c)," because of the small number of persons involved in the redistribution. In S.E.C. vs. Ralston Purina Co., 346 US 119 (1953), however, the Supreme Court discussed a claimed exemption from registration under Section 4(1) of the Act, stating that the design of the Act is to promote full disclosure of information thought necessary to informed investment decisions; that the relationship of the investors and their knowledge of the issuer's business rather than the number of investors determines their need for the protection of the Act. It is concluded that the persons to whom shares of issuer's stock and the options and other interests therein were offered and sold during the so-called escrow period did not have access to the information which full disclosure in the offering circular would have revealed,

and that the reoffers and sales of the stock and interests therein to the public evidenced the unavailability to issuer of the Regulation A exemption. Moreover, it is entirely clear that, within the language of the Supreme Court in the Ralston Purina case, the burden imposed upon an issuer who would claim an exemption from the disclosure reqirements was not sustained.[11/] Conversely, as stated above, the many transactions involving the promotional stock of Otterman and the underwriter's stock demonstrate that no exemption was available.

41. In addition, the reallocation of the promotional stock and the disposition of interests therein were not disclosed in the notification on Form 1-A. Conversely, as indicated above, Otterman's shares were incorrectly represented therein as being taken for investment. As charged in the order for proceedings, the information required to be disclosed by items 9 and 10 of the notification was not included in the responses by the issuer.

42. The underwriter's testimony and his proposed findings and conclusions urge that he was fooled and misled by Otterman's lies, that he was not guilty of intentional non-disclosure in the offering circular, and

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11/ See The Whitehall Corporation, supra, at 270, stating that "Exemptions from the general policy of the Securities Act requiring registration are strictly construed against the claimant of such exemption and the burden of proof is on the person who would plead an exemption." Cf. N. Pinsker & Co., Inc., Securities Act Release No. 6401 (1960) and cases cited in footnote 5 thereof.

that he did not intend to defraud the public. However, the Examiner interprets the inquiry ordered by the Commission on the issue whether the underwriter had any "culpable responsibility" as to the failure of the offering circular to contain true and accurate statements, as a search for an answer to the question whether the underwriter must share with the issuer the blame for the defects in the offering circular. The answer is an emphatically affirmative finding that the underwriter must share the blame; that he intentionally and knowingly participated in the omission from the offering circular of material facts and the presentation therein of materially misleading statements relating to:

> The issuance of promissory notes in the amount of $56,000 on and after August 31, 1961 and prior to the date of the offering circular; the transactions under which promotional stock was re-allocated to members of the selling group, to salesmen employed by the underwriter, to directors of the issuer, to the underwriter and his designee, Hazel Nelson, and to lenders of money to the issuer; the agreement of December 8, 1961 by the issuer to pay to the underwriter an indebtedness of $20,000; the existence of a contract for employment of the underwriter as Financial Consultant for $18,000, and representations as to the proceeds of the offering.

43. It is also concluded that if the underwriter did not have actual knowledge, during the period the offering circular was being distributed, of the losses sustained by the issuer between August 31, 1961 and December 18, 1961, or of the inaccuracies in the representation of issuer's backlog of business, this resulted from his failure to carry

out the responsibilities of an underwriter to the investing public.[12/] His failure to examine the books and records of the issuer, to confirm the accuracy of information received from Otterman, or to explore avenues of doubt which most certainly would have led to more accurate knowledge and information of the issuer's business constitute a clear failure to exercise the reasonable care imposed upon the underwriter under the circumstances.

44. Clearly, the offering was made in violation of Section 17 of the Act in that the offering circular and literature sent through the mails by the issuer and the underwriter were misleading and untruthful in stating

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12/ Cf. Heft, Kahn & Infante, Inc., Securities Exchange Act Release No. 7020 (February 11, 1963) citing, at page 5, Charles E. Bailey & Co., 35 SEC 33, 41, 42 (1953), where the Commission stated:

> "In offering the . . . stock, registrant, as underwriter, owed a duty to the investing public to exercise a degree of care reasonable under the circumstances of this offering to assure the substantial accuracy of representations made in the prospectus and other sales literature . . . [His] purported substantial reliance on information furnished him by the issuer . . . did not constitute discharge of [that] duty . . . Moreover, where, as here, an issuer seeks funds from the public to finance a new and speculative venture, the underwriter must be particularly careful in verifying the issuer's obviously self-serving statements as to its operations and prospects."

See also The Richmond Corporation, Securities Act Release No. 4584 (February 27, 1963) on the nature of an underwriter's responsibility and the consequences of failure to discharge the responsibility adequately.

material facts and in omitting to state other material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. All of the omissions and misstatements mentioned were material facts, basic to any decision whether to purchase the issuer's stock.

45. The Examiner also concludes that the offering violated the terms and conditions of Regulation A in the respects indicated above, and recommends that an order of permanent suspension be issued. 13/

Respectfully submitted,

Sidney Ullman
Hearing Examiner

Washington, D. C.
April 15, 1963

13/ To the extent that the proposed findings and conclusions submitted to the Hearing Examiner are in accord with the views set forth herein they are sustained, and to the extent that they are inconsistent therewith they are expressly rejected.