ADMINISTRATIVE PROCEEDING
FILE NO. 3-4283

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

| | |
|---|---|
| In the Matter of | : |
| MIDLAND SECURITIES CORPORATION<br>RICHARD B. BERDAHL<br>ROBERT O. KNUTSON<br>WILLIAM H. HARRISON<br>BRUCE L. HANKERSON<br>JAMES R. EHLEN | : |



# INITIAL DECISION

August 2, 1974
Washington, D.C.

David J. Markun
Administrative Law Judge

ADMINISTRATIVE PROCEEDING
FILE NO. 3-4283

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

| | | |
|---|---|---|
| In the Matter of | : | |
| MIDLAND SECURITIES CORPORATION<br>RICHARD B. BERDAHL<br>ROBERT O. KNUTSON<br>WILLIAM H. HARRISON<br>BRUCE L. HANKERSON<br>JAMES R. EHLEN | : | INITIAL DECISION |

APPEARANCES: William M. Hegan and William G. Kelly, Chicago Regional Office, attorneys for the Division of Enforcement.

Robert O. Knutson, Edina, Minnesota, attorney for all respondents other than Respondent Ehlen.

BEFORE: David J. Markun, Administrative Law Judge

## THE PROCEEDING

This public proceeding was instituted by an order of the Commission dated April 19, 1973 ("Order"), pursuant to Sections 15(b) and 15A of the Securities Exchange Act of 1934 ("Exchange Act") to determine whether particular respondents wilfully committed or wilfully aided and abetted

(a) violations of the antifraud provisions of Section 17(a) of the Securities Act of 1933 ("Securities Act"), Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Section 15(c)(2) of the Exchange Act and Rule 15c2-4 thereunder in connection with the handling of escrow funds in two underwritings,

(b) violations of Section 15(b) of the Exchange Act and Rule 15b3-1 thereunder by failure to file promptly with the Commission amendments on Form BD with respect to changes in Midland Securities Corporation's (Registrant) officers, directors, owners, and principal place of business,

(c) violations of Section 7(c)(1) of the Exchange Act and Regulation T thereunder concerning the extension of credit to customers,

(d) violations of Section 17(a) of the Exchange Act and Rule 17a-3 thereunder in connection with Registrant's books and records,

(e) violations of Section 15(c)(3) of the Exchange Act and Rule 15c3-1 thereunder in connection with Registrant's net-capital position,

(f) violations of Section 17(a) of the Exchange Act and Rule 17a-5 thereunder in connection with Registrant's failure timely to file certified financial information required annually on Form X-17A-5 for 1971 and 1972,

(g) violations of Section 17(a) of the Exchange Act and Rule 17a-5(f) in connection with Registrant's reporting to the Commission a change in its accountants,

(h) violations of Section 17(a) of the Exchange Act and Rules 17a-5(m) and 17a-5(n) thereunder through Registrant's failure to send to its customers information respecting its financial condition,

(i) violations of Section 17(a) of the Exchange Act and Rule 17a-11 thereunder through Registrant's failure to send the Commission telegraphic notices of its net-capital deficiencies and to file accurate reports of its financial condition within the prescribed times, and

whether various respondents failed reasonably to supervise persons subject to their supervision with a view to preventing the previously alleged violations, and the remedial action, if any, that might be appropriate in the public interest. At the outset of the hearing, on motion of the Division, an amendment to the Order was allowed, which amendment alleges the entry on March 21, 1973, by the U.S. District Court for the District of Minnesota, 4th Division, of an order[1/] permanently enjoining Registrant from violating certain statutes and rules and requiring it to give certain notices, file certain reports, and to send its customers certain information.

The evidentiary hearing was held on June 11 through June 13, 1973 at St. Paul, Minnesota. All parties other than Respondent Ehlen[2/] have been represented by counsel throughout the proceeding.

---

1/ Exhibit 2. See also Exhibit 1. The Division's exhibits are numbered and Respondents' exhibits are lettered.

2/ Ehlen filed no appearance or answer in the proceeding and did not attend the hearing except when called by the Division to testify (Tr. pp. 381-2, 418, 423). He also filed no proposed findings, conclusions, or brief. However, so far as appears, he was examined fully concerning his participation in the alleged violations, as well as on the question of appropriate sanctions. (The hearing record was held open for 30 days to give Ehlen time to petition to reopen the hearing to cross examine witnesses and to adduce evidence (Tr. p. 499), but he chose not to avail himself of that opportunity.) Accordingly, in the absence of any motion for a default judgment against Ehlen, and in light of the uncertainty as to whether Ehlen intended to "default" or merely throw himself upon the "mercy of the Commission", findings and an order will be made and issued herein concerning Ehlen.

The findings and conclusions herein are based upon the record and upon observation of the demeanor of the various witnesses. Preponderance of the evidence is the standard of proof applied.

## FINDINGS OF FACT AND LAW

### The Respondents

Midland Securities Corporation ("Registrant"), a Minnesota corporation with offices in Edina, Minnesota, has been registered with the Commission as a broker-dealer pursuant to Section 15(b) of the Exchange Act continuously since July 3, 1971. While not established as an evidentiary fact, it appears from representations of Registrant's counsel in his brief and in his motion (letter) of December 6, 1973, for an extension of time that Registrant terminated its operations as a broker-dealer in or about September, 1973, because of adverse economic conditions and because of its regulatory difficulties.[3/] The period within which the various alleged violations by Registrant and others and the issuance of the injunction against Registrant and its officers, agents, and employees occurred ("the relevant period") extends from in or about January, 1972, to on or about April 19, 1973.

On March 21, 1973, the U.S. District Court for the District of Minnesota, 4th Division, entered an order[4/] permanently enjoining Registrant and its officers, agents, and employees from violating Sections 15(c)(3) and 17(a) of the Exchange Act and Rules 15c3-1, 17a-5(m), 17a-5(n) and 17a-11 thereunder and ordering Registrant to file with the Commission within 10 days,

---

3/ Registrant's termination of broker-dealer activities is also adverted to in Respondent Harrison's ex parte communication of January 29, 1974 to the presiding officer, which communication of course does not have the status of evidence but is, instead, more in the nature of a personal statement of that Respondent's views on the question of sanctions.

4/ Exhibit 2.

pursuant to said Rule 17a-11, telegraphic notice of its net capital deficiencies as of June 30, 1972, July 31, 1972, August 28, 1972, and to file reports of its financial condition as of such dates as well as of its financial condition on August 31, 1972, September 30, 1972 and October 31, 1972. The Court further ordered Registrant to send to its customers, within 10 days, the statements and information required by Rules 17a-5(m) and 17a-5(n), promulgated pursuant to the Exchange Act. Under Section 15(b)(5)(c) of the Exchange Act the entry of such injunction by the Court constitutes a basis for imposing sanctions upon Registrant, and, under Section 15(b)(7) of that Act, the entry of such injunction against other individual, respondents herein, i.e. officers, agents and employees of the Registrant subject to the Court's injunctive order,[5/] constitutes a basis for the imposition of sanctions against them.

On May 14, 1973, the Securities Division, Department of Commerce, State of Minnesota, entered an order suspending for a period of 10 business days commencing at 12:01 a.m., on May 11, 1973, and terminating at 12:01 a.m., on May 24, 1973, Registrant's broker-dealer license granted by the Commissioner of Securities of the State of Minnesota. The order further provided that for a period of 12 consecutive months commencing May 14, 1973, Registrant would have to provide to the Minnesota Commissioner of Securities a report for the prior month consisting of a net capital computation and a computation of aggregate indebtedness.

In about February, 1973 Registrant was fined $500 by the NASD for failure to file certain reports.

---

5/ Respondent Ehlen was no longer an employee of Registrant at the time the Court's injunction was issued and was therefore evidently not subject thereto.

Registrant is a member of the National Association of Securities Dealers, Inc., (NASD), a national securities association registered with the Commission pursuant to Section 15A of the Exchange Act.

Respondent Richard B. Berdahl ("Berdahl"), from the formation and registration of Registrant with the Commission in July, 1971 until about November, 1971, was Registrant's president, treasurer and a director. These titles were essentially nominal, because Registrant did not begin transacting business until about November, 1971, at which time Berdahl was replaced as president and treasurer and became board chairman, a position he held continuously thereafter. For a period of approximately one month only, i.e. October, 1972, he again held the office of president, this time in a functional, albeit interim, capacity. At the outset, in July, 1971, Berdahl was either a 90% or a 100% owner of Registrant. If 100%, this was reduced to 90% by or before November, 1971. In or around November, 1971, his ownership was reduced from 90% to 45%; during the Winter of 1972-1973 this ownership was further reduced to about 33%; (Tr. 52-53, 313-315); and at the time of the hearing it was 30%.

In addition to being Chairman of Registrant's Board of Directors, Berdahl was active in soliciting underwritings for the firm; indeed, he regarded that as his principal function. Although Berdahl was not concerned with the details of the firm's daily operations during most of the relevant period (except as respects underwritings) he was, nevertheless, aware of and consulted on all major matters because of his position as Board chairman, which, in turn, was a reflection of the strong ownership interest he held in the firm. As an example of his active involvement in management decisions, it was Berdahl, not the then President of the firm, Hankerson,

who hired Respondent Ehlen as back-office manager.[6/] Berdahl's strong interest in the Registrant is further apparent from the fact that he made subordinated loans to the firm, along with others, during periods when Registrant required more capital. As of the time of the hearing, Berdahl had responsibility over the firm's trading department.

From about June, 1964, until he organized the Registrant in July, 1971, Berdahl had been a registered representative with various broker-dealer firms but he did not obtain his credentials as a registered principal until he was with the Registrant.

Respondent Robert O. Knutson ("Knutson"), an attorney, handled the incorporation of Registrant and, from the date of the firm's registration with the Commission in July, 1971, has continuously been both its general counsel and its secretary until May 8, 1973 when he resigned as secretary. In or around November, 1971 he became a 10% owner of Registrant by virtue of stock delivered to him in payment of past legal services rendered to the corporation. By the time of the hearing herein, his ownership interest had increased to 15%. During the latter part of the relevant period Knutson supplied Registrant with needed capital in the form of a subordinated loan, and at some point induced his brother to do likewise.[7/]

Since about November 4, 1972, after having persuaded Respondent Harrison to take an ownership interest in Registrant in September, 1972, and to become its president on November 3, 1972, Knutson became part of a

---

6/ Ehlen was with Registrant from approximately June 1, 1972 to September 1, 1972. Because Berdahl had hired him, he "reported" to Berdahl about as much as to then-president Hankerson, even though, according to Ehlen's testimony, Berdahl wasn't present at the firm's offices as much as Hankerson was.

7/ Knutson testified he feels morally responsible for the repayment of his brother's investment in the firm.

management committee or triumvirate that included Harrison, Knutson, and Brad Pester, an executive Vice President who had been engaged by the firm to take over the duties of Respondent Ehlen when he left the firm about September 1, 1972.

Even before becoming a part of Registrant's management trio in early November, 1972, Knutson had spent 8 weeks in September and October of that year working full time days[8/] for Registrant in an effort to identify and resolve various problems that had afflicted and were besetting Registrant at that time. Since Harrison had essentially no prior background in the securities industry, it was clear that by early November Knutson, along with Pester, became vital figures in the effort to take Registrant out of the regulatory difficulties it found itself in at the time and to put it on an even compliance course for the future.[9/] From September, 1972, and certainly from early November, 1972, forward, Knutson's duties with Registrant transcended the duties customarily performed by a general counsel, or even a Secretary,[10/] and became managerial within the framework of the mentioned troika-type management team.[11/] Knutson testified he was willing to learn and to do anything necessary to keep the firm functioning. Among the things he did was to take and pass his examination as a registered principal.

---

8 / Knutson reported in a letter dated October 31, 1972, to the Commission (Exh. 21) that he'd been working "night and day" during this period.

9 / From about Mid-November and into December, 1972, Knutson was away in Denver, Colorado, for about 4 to 5 weeks.

10/ Knutson described his duties as Secretary as essentially nominal, and it does appear that initially he was given that title largely because he was functioning as the firm's general counsel.

11/ Knutson testified he did not become part of the management trio until about the first of the year, but Harrison's testimony, which pins the date to the time he (Harrison) took over as president, is found to be more credible.

Respondent William H. Harrison ("Harrison") has been president, treasurer and a director of Registrant since November 3, 1972, and since about November 4, 1972, he has been a member of a three-man management committee that has managed the Registrant. Prior to that date, in September, 1972, at the urging of Knutson, he had become a 15% owner of Registrant. In late October or early November, 1972 his ownership interest was increased to 31%; in December, 1972 this was increased to 51% and on May 31, 1973 to 55%. In addition to his ownership interest in Registrant, (for which he'd paid $40,000) Harrison also contributed capital to the firm in the form of a subordinated loan ($7,000) and about $8,000 in furniture. Thus his total capital "invested" in the firm was some $55,000.

While Harrison had had a variety of business executive experience prior to coming to the Registrant, he had had no prior experience in the securities industry; this accounted for the need for a three-man management team or committee and for his need to rely heavily upon Knutson and Pester, particularly as respects compliance matters.

Harrison, a high-school graduate, qualified as a registered principal with the NASD in May, 1973. Under Harrison's presidency the firm had increased its registered representatives to 17 from a considerably smaller number, and as of the time of the hearing the firm had some 25 people in all, were market makers in 12 stocks, and did some underwritings.

Respondent Bruce L. Hankerson ("Hankerson") served as president and a director of Registrant from about November, 1971 through about September, 1972. From the latter date to the time of the hearing herein he continued to serve as a director and as a registered principal of the firm. He became a 45% owner of Registrant in about November, 1971. This ownership was

reduced to 15% in about August, 1972 and to zero in about late May, 1973. Hankerson "turned back" his stock as a "contribution" to the Registrant. At the time of the hearing Hankerson had $12,000 at risk in the Registrant in the form of a subordinated loan.

Respondent James R. Ehlen ("Ehlen") was employed as manager of Registrant's back office operations during the period from approximately June 1, 1972 to September 1, 1972. He was at no time an officer, director or owner of Registrant. As already noted, he "reported" to both Hankerson and Berdahl, and at times they had 4-way discussions including Knutson.

Ehlen suggested, and the firm approved, going to a computer system while he was with the firm.

Before coming to Registrant, Ehlen had been an NASD registered representative from 1960 to 1968 and again became such commencing in April 1970. In April, 1970, Ehlen also became a registered principal, organized a broker-dealer firm that went broke after 3 months,[12/] and on April 3, 1973, was barred by the NASD[13/] as a result of violations incident to the failure of his firm.

Fraudulent Failure by Registrant Promptly to Escrow Proceeds of Underwritings.

The record establishes, as the Order charges, and as Respondents concede, that Registrant failed promptly to escrow into a separate bank account the proceeds of two underwritings in which Registrant participated.

---

12/ In June of 1970 the State of Minnesota ordered his firm to cease operations.

13/ Exhibit 32.

Such failures expressly violated Rule 15c2-4 [14/] under Section 15(c)(2) of the Exchange Act.

During March, 1972, Registrant was the principal underwriter of a public offering of 111,000 shares of Sentinel Industries, Inc., ("Sentinel") common stock at $2.25 per share. The Offering Circular, dated March 13, 1972, used in this offering, provided that the "proceeds of this offering will be held in escrow by Marquette National Bank of Minneapolis, Minnesota" (Marquette Bank). The offering circular further provided that in the event that 66,600 (60 percent) of the shares offered thereby were not sold within 120 days of the date thereof, all amounts paid by the purchasers would be refunded promptly.

---

14/ Rule 15c2-4 provides in pertinent part as follows:

> Rule 15c2-4. Transmission or Maintenance of Payments Received in Connection with Underwritings.
>
> (a) It shall constitute a "fraudulent, deceptive or manipulative act or practice" as used in Section 15(c)(2) of the Act, for any broker or dealer participating in any distribution of securities, other than a firm-commitment underwriting, to accept any part of the sale price of any security being distributed unless:
>
> * * *
>
> (2) if the distribution is being made on an "all-or-none" basis, or on any other basis which contemplates that payment is not to be made to the person on whose behalf the distribution is being made until some further event or contingency occurs, (A) the money or other consideration received is promptly deposited in a separate bank account, as agent or trustee for the persons who have the beneficial interests therein, until the appropriate event or contingency has occurred, and then the funds are promptly transmitted or returned to the persons entitled thereto, or (B) all such funds are promptly transmitted to a bank which has agreed in writing to hold all such funds in escrow for the persons who have the beneficial interests therein and to transmit or return such funds directly to the persons entitled thereto when the appropriate event or contingency has occurred.

A "Proceeds Impoundment Agreement" dated February 3, 1972, entered into between Registrant and Marquette Bank in connection with the Sentinel offering, provided in part that "All proceeds, or good funds representing the same, received from the sale of the securities subject to this Impoundment Agreement on or after the date hereof shall be transmitted to the Impoundment Agent within two business days from the date of receipt by the Underwriter and deposited with the Impoundment Agent in a special escrow account."

Registrant's books and records show that Registrant did not comply with the terms of this Impoundment Agreement. Upon receiving monies from the sale of Sentinel securities Registrant deposited these funds in its own regular bank account at Marquette Bank. The Sentinel offering was begun March 13, 1972, and finally completed on or about May 5, 1972. Meanwhile, between March 20, 1972 and March 29, 1972, Registrant deposited to its own general bank account sums which on the latter date totaled $161,465. It was not until April 5, 1972 that any deposit was made by Registrant of funds received in the Sentinel offering into the escrow account at the Marquette Bank, this being represented by a check in the amount of $150,000.

Details of the handling by Registrant of the receipts of the Sentinel underwriting between March 20, 1972 and March 29, 1972, are reflected in the following table, "Custodian Account" therein being Registrant's designation for its general bank account used in the general operations of its securities business.

| Date | Amount Received By Registrant From Sentinel Offering | Accumulated Amount From Sentinel Offering | "Custodian Account" Bank Balance |
|---|---|---|---|
| 3-20-72 | $12,293.75 | $ 12,293.75 | $114,835.86 |
| 3-21-72 | 4,512.50 | 16,806.25 | 124,745.11 |
| 3-22-72 | 6,875.00 | 23-681.25 | 113,429.11 |
| 3-23-72 | 4,827.50 | 28,518.75 | 70,660.93 |
| 3-24-72 | 8,700.00 | 37,218.75 | 99,077.36 |
| 3-27-72 | 39,618.75 | 76,837.50 | 154,011.74 |
| 3-28-72 | 66,532.50 | 143,370.00 | 199,651.87 |
| 3-29-72 | 18,095.00 | 161,465.00 | 183,158.24 |

Berdahl, then Registrant's Chairman of the Board and officer principally concerned with bringing underwritings to the firm, knew of the impoundment agreement but personally took no steps to assure compliance with it. He knew or should have known that it was not complied with during the relevant March period.

Hankerson, Registrant's president at the time, knew that the proceeds of the Sentinel offering were going into Registrant's own bank account and not into escrow but testified, incredibly, that such practice did not violate the impoundment agreement.

Three months later, beginning in June, 1972, Registrant was the principal underwriter of a public offering of 125,000 shares of Port Industries, Inc. (Port) common stock at $4 per share. The Offering Circular used in connection with this underwriting, dated June 6, 1972, provided that "The proceeds from this offering will be held in escrow by Marquette National Bank of Minneapolis, and in the event that 93,750 (75 percent) of the shares offered hereby are not sold within 120 days of the date hereof, all amounts paid by purchasers will be refunded promptly."

Registrant's books and records disclosed that Registrant entered into an Impoundment Agreement with Port, Marquette Bank, and one Walter L. Holmgren, selling shareholder, dated May 30, 1972, which provided that in the Port underwriting "All proceeds received from the sale of the securities subject to this Impoundment Agreement on or after the date hereof shall be paid to the Impoundment Agent within two business days from the date of sale and deposited by Impoundment Agent in an escrow account."

Registrant's books and records disclosed that it did not comply with the terms of such Impoundment Agreement. Registrant, upon receiving

monies from the sale of the Port securities, deposited the funds in its own regular bank account. The Port offering was begun June 6, 1972, and finally completed on or about August 17, 1972. Meanwhile, between June 22, 1972 and July 20, 1972, Registrant deposited to its own general bank account sums which on the latter date totaled $312,603.60. During this period Registrant made numerous withdrawals from its general bank account, which was used in the general operations of its securities business and which was designated at its bank as "Custodian Account". Thus, during a substantial portion of the period June 22, 1972, to July 20, 1972, the bank balance in Registrant's "Custodian Account" aggregated less than amounts accumulated at the time through Port underwriting receipts, and in fact, as of July 20, 1972, this account was overdrawn by $26,037.92 despite the fact that by that date Registrant had received proceeds from the Port offering totaling $312,603.60. It was not until July 20, 1972, that Registrant deposited three checks aggregating $291,800 in an attempt to make its initial deposit in the escrow account at Marquette National Bank of Minneapolis. However, one of the checks, in the sum of $100,000 dated July 20, 1972, was returned by the bank marked "NONSUFFICIENT FUNDS." It was not until on or about July 26, 1972, that Registrant deposited a $100,000 check drawn against its regular account payable to the Marquette escrow account that the initial deposit in this escrow account was made.

Details of the handling by Registrant of the receipts of the Port underwriting are shown, for the dates indicated, in the following table, "Combined Bank Balance" therein including balances in all of Registrant's bank accounts plus petty cash.

| Date | Amount Received by Registrant from Port Offering | Amount Accumulated from Port Offering | Combined Bank Balance |
|---|---|---|---|
| 1972 | | | |
| June 22 | $ 3,700.00 | $ 3,700.00 | $ 9,842.20 |
| " 23 | 14,800.00 | 18,500.00 | 42,541.76 |
| " 26 | 44,906.98 | 63,406.98 | 59,245.06 |
| " 27 | 10,675.00 | 74,081.98 | 64,345.07 |
| " 28 | 12,216.02 | 86,298.00 | 74,375.65 |
| " 29 | 14,744.90 | 101,042.90 | 97,390.90 |
| " 30 | 20,225.00 | 121.267.90 | 108,825.99 |
| July 3 | 14,713.12 | 135,981.02 | 121,448.99 |
| " 5 | 5,600.00 | 141,581.02 | 112,114.49 |
| " 6 | 16,719.78 | 158,300.80 | 116,778.16 |
| " 7 | 12,500.00 | 170,800.80 | 115,712.21 |
| " 10 | 10,000.00 | 180,800.80 | 135,782.21 |
| " 11 | 12,140.30 | 192,941.10 | 123,326.91 |
| " 12 | 8,400.00 | 201,341.10 | 151,226.57 |
| " 13 | 3,725.00 | 205,066.10 | 158,588.99 |
| " 14 | 12,000.00 | 217,066.10 | 154,160.53 |
| " 17 | 16,087.50 | 233,153.60 | 138,227.28 |
| " 18 | 800.00 | 233,953.60 | 134,989,81 |
| " 19 | 1,400.00 | 235,353.60 | 115,547.38 |
| " 20 | 77,250.00 | 312,603.60 | (26,037.92) |

Ehlen was given the responsibility of handling monies received in the Port underwriting as a part of his responsibilities as manager of the firm's back-office operations. At the outset of the Port underwriting he called Hankerson's attention to the fact that "money should be put in a separate escrow account because it says so on the front page of the prospectus" and Hankerson said "put it in the other account and we will transfer it in a couple of days and set up the escrow account." After many deposits of Port underwriting receipts into Registrant's regular account, Ehlen "bugged" both Hankerson and Berdahl to have the funds transferred to the escrow account. Ultimately, either Hankerson or Berdahl instructed Ehlen to transfer the funds to the escrow account when Ehlen said to one or the other "We have got to start transferring Port."

Rule 15c2-4, promulgated under Section 15(c) of the Exchange Act, set forth above at p. 11, specifically defines as constituting a "fraudulent, deceptive or manipulative practice" (without the requirement of any material misrepresentation) the failure of an underwriter, under circumstances such as existed in the Sentinel and Port underwritings, to promptly deposit proceeds in a separate bank account. There was no such prompt deposit in either case. The clauses in the two Proceeds Impoundment Agreements, which Registrant signed, may be taken as recognition on its part that anything beyond the "two business days" allowed therein for depositing proceeds of the underwriting would not constitute prompt deposit. Apart from that, it cannot be soundly maintained that the proceeds here were "promptly transmitted." In Haight & Co., Inc. et al., Exchange Act Release 9082, February 19, 1971, it was held that the transmittal was "not prompt at least with respect to 46 sales where it occurred 11 to 15 days after receipt of the funds."

Respondents' argument that the Rule is not violated when the delay in the initial escrow deposits resulted in no losses is without merit, because the requirements of the Rule "constitute important specific safeguards which must be strictly followed." Weston and Company, Inc., et al., Exchange Act Release 9312, August 30, 1971. The point is that the potential investors' funds, which should have been reposing safely in a separate escrow bank account, were "at risk" subject to the financial fortunes of Registrant, particularly as to the Port underwriting.

Registrant's handling of the underwriting receipts also violated additional antifraud provisions of the Securities Act and the Exchange Act, as alleged in the Order.

Both Section 17(a) of the Securities Act and Rule 10b-5 promulgated under Section 10(b) of the Exchange Act, which deal generally with fraudulent interstate securities transactions, in their pertinent portions render it unlawful, among other things, for any person to make any untrue statement of a material fact or to engage in any transaction, act, practice or course of business which operates or would operate as a fraud or deceit, in connection with the purchase or sale of any security.

Registrant made an untrue statement of a material fact to purchasers and prospective purchasers of Sentinel and Port securities in the Offering Circulars by which the offerings were made in stating that the proceeds of the offerings would be held in escrow by Marquette National Bank of Minneapolis, Minnesota. Implicit in these statements was an assurance to purchasers that their funds would be promptly and safely segregated in a national bank pending completion of the underwriting and not subjected to the very real risks involved in having their funds placed in the underwriter's (Registrant's) own general bank account subject to use by the underwriter for its ordinary business operations.

Registrant's antifraud violations in connection with the Sentinel and Port underwritings were wilful.[15/]

Registrant's violations were wilfully aided and abetted by Berdahl and Hankerson. Ehlen, who was with the firm only during the Port underwriting, also wilfully aided and abetted Registrant's violations, but his

---

15/ All that is required to support a finding of willfulness is proof that a respondent acted intentionally in the sense that he was aware of what he was doing and either consciously, or in careless disregard of his obligations, knowingly engaged in the activities which are found to be illegal. Hanley v. Securities and Exchange Commission, 415 F. 2d 589, 595-6 (2d Cir. 1969); NEES v. Securities and Exchange Commission 414 F. 2d 211, 221 (9th Cir. 1969); Dlugash v. Securities and Exchange Commission, 373 F. 2d 107, 109-10 (2d Cir. 1967); Tager v. Securities and Exchange Commission, 344 F. 2d 5, 8 (2d Cir. 1965).

culpability is of a far lesser order than that of Berdahl's and Hankerson's, since Ehlen early and repeatedly warned the latter two of the necessity for placing the underwriting proceeds into an escrow account. But Ehlen should have gone further, even to the point of disassociating himself from the firm if his advice went unheeded.

Failure to File Required Form BD Amendments Reflecting Changes in Registrant's Officers, Directors, Owners and Principal Place of Business.

The application for registration of a broker-dealer, Form BD, is designed to provide the Commission and the public with material facts about the management, ownership, exchange memberships, and nature of the business of a broker-dealer registrant. The Form BD is a public document, and available for inspection by the public. Rule 15b3-1 under the Exchange Act requires that the facts set out on Form BD be current, i.e. accurate, and that when the statements therein become inaccurate for any reason, the Form BD be promptly amended to reflect the current facts. Registrant's Form BD with appropriate related schedules was filed with the Commission June 3, 1971. On the basis of this filing the broker-dealer registration was permitted to be effective July 3, 1971, although it was not until July 8, 1971, that the Commission received requested amendments to Page 1 of Form BD, and Schedules A and D of Form BD. To date of the hearing there had been no amendment received by the Commission of Form BD or schedules A and D, despite the fact that information shown on Form BD and schedules A and D thereto as filed June 3, 1971 and amended July 8, 1971, has in numerous respects incorrectly reflected important basic information concerning Registrant because of many changes which occurred during the relevant period, some dating back to the Fall of 1971 and some as recent as late May 1973.[15a/]

---

15a/ Amendments were received ultimately on June 21, 1973.

Registrant's violations of Section 15(b) of the Exchange Act and Rule 15b3-1 thereunder were numerous, indeed.

Thus, the address of Registrant's principal place of business, as shown on its Form BD, which was never thereafter amended in this respect,[15b/] is 5329 Wooddale, Edina, Minnesota 55424, although in fact Registrant's address changed in about January or February 1972 to 4510 West 77th Street, Edina, Minnesota 55435.

Berdahl is still shown as president, treasurer, and a 75 percent to 100 percent owner of Registrant's common stock in Form BD, which was never amended in these respects,[15b/] though in fact he was replaced as president and treasurer in about November 1971, reassumed the presidency again for a period of approximately one month in October, 1972, reduced his ownership interest in Registrant to 45 percent in or around November 1971, and later, as found above, further reduced his ownership in successive steps to 33%, then 30%.

Knutson, shown as secretary and a "zero to ten percent" owner of registrant's common stock on the Form BD filed July 8, 1971, which has never been amended in these respects,[15b/] in fact, as found above, resigned as Registrant's secretary on May 8, 1973. Actually, his ownership interest did not begin until November 1971 when he became a ten percent owner. Prior to the time of the hearing herein, his ownership interest had increased to fifteen percent but none of the foregoing changes were reported by appropriate Form BD amendments.[15b/]

Harrison, not shown in any capacity in the Registrant's Form BD or in any amendment thereto became president, treasurer and a director on[15b/]

---

15b/ See footnote 15a above.

November 3, 1972. Prior to that date, in about September 1972, he became a fifteen percent owner of Registrant. In late October or early November 1972, his ownership interest was increased to thirty-one percent; in December 1972 this was further increased, to fifty-one percent and in May, 1973, to 55%.

Hankerson, who is also not shown in any capacity on Registrant's Form BD or in any amendment thereto served as president and a director of Registrant from about November 1971 through about September 1972. From the latter date to the time of the hearing herein he continued to serve as a director and as a registered principal of the firm. In about November 1971 he became a forty-five percent owner of Registrant, which ownership was reduced to fifteen percent in about August 1972 and to zero percent in about late May of 1973.

Michael Anderson, who is not shown in any capacity on Registrant's Form BD or in any amendment thereto, became Registrant's treasurer in about November 1971. He was also a principal of Registrant, was a director of Registrant in August 1972, and did not leave as an officer until about the beginning of 1973.

Pester, who is not shown in any capacity on Registrant's Form BD or in any amendment thereto, became vice president of Registrant after August 1972 and was still holding this office at the time of the hearing herein.

Marvin Susemihl, who is not shown in any capacity on Registrant's Form BD or in any amendment thereto, was a vice president of Registrant at one time during the relevant period.

Berdahl was aware of the requirement to file an amendment to reflect any change in officers, directors, ownership and principal place of business, and he asked Hankerson and Knutson to make the necessary changes by amendment. Berdahl assumed they had done so but never followed up by inquiring.

Hankerson discussed with Knutson the need to file an amendment concerning the Registrant's change of business address and he assumed Knutson took care of this but never followed up by checking.

Hankerson became president of Registrant in November 1971, replacing Berdahl, and continued in this office through September 1972. He "assumed" an amendment concerning this was filed but didn't direct anyone to do so and did not inquire as to whether this had in fact been done.

Harrison was not aware of the requirement to amend Form BD to reflect changes of address and of officers, directors and ownership until about May 1, 1973, but takes full responsibility for this since the time he became president on November 3, 1972.

Knutson takes full responsibility for failures to amend Form BD. Although he testified he didn't become aware of the need for filing such an amendment until around February or March 1973, this testimony is contradicted by the above mentioned testimony of both Berdahl and Hankerson, which is credited, concerning their discussions of the need with him.

Harrison and Knutson acknowledged responsibility for filing an amendment to reflect changes made in the restructuring of Registrant around June 1, 1973. They were in the process of doing this at the time of the hearing herein.

On the basis of the record it is concluded that Registrant's wilful violations resulting from its persistent failure to amend its Form BD as required by numerous changes in officers, ownership, etc. were wilfully aided and abetted by Berdahl and Knutson, by Hankerson during the time he was president, and by Harrison from the time he commenced being president.

Regulation T Violations

Section 7 of the Exchange Act provides generally that for the purpose of preventing the excessive use of credit for the purchase or carrying of securities, the Board of Governors of the Federal Reserve System shall prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any securities (other than an exempted security). Subsection (c)(1) of Section 7 provides in pertinent part that it shall be unlawful for any broker or dealer, directly or indirectly, to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer on any security (other than an exempted security) in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System shall prescribe.

Pursuant to Section 7 of the Exchange Act, the Board of Governors of the Federal Reserve System promulgated Regulation T (12 CFR 220), the pertinent provisions[16/] of which at all times material herein were as follows:

> (c) Special Cash Account. --(1) In a special cash account, a creditor may effect for or with any customer bona fide cash transactions in securities in which the creditor may:

---

16/ Section 4(c).

(i) Purchase any security for, or sell any security to, any customer, provided funds sufficient for the purpose are already held in the account or the purchase or sale is in reliance upon an agreement accepted by the creditor in good faith that the customer will promptly make full cash payment for the security and that the customer does not contemplate selling the security prior to making such payment.

(ii) Sell any security for, or purchase any security from, any customer, provided the security is held in the account or the creditor is informed that the customer or his principal owns the security and the purchase or sale is in reliance upon an agreement accepted by the creditor in good faith that the security is to be promptly deposited in the account.

(2) In case a customer purchases a security (other than an exempted security) in the special cash account and does not make full cash payment for the security within 7 days after the date on which the security is so purchased, the creditor shall, except as provided in subparagraphs (3)—(7) of this paragraph, promptly cancel or otherwise liquidate the transaction or the unsettled portion thereof.

None of the exceptions referred to in Section 4(c)(2) has application here.

During an inspection of Registrant's books and records conducted by personnel of the Commission's Chicago Regional Office during the period October 16, 1972, to October 24, 1972, and covering the period from September 1, 1972, to October 16, 1972, the investigators examined approximately 894 purchase transactions. This examination disclosed violations of Regulation T in twenty-five transactions involving twenty-one individual customers in that the customers did not pay in the time permitted by Regulation T, and such late payments ranged from one day late to in excess of fifty days late. Additionally, the examiners discovered eighty-one accounts out of approximately 1,000 active accounts at the time which should have been restricted because of Regulation T violations involving free-riding, sell outs by the firm or cancellations, but only forty-six of these eighty-one accounts were actually found to have been restricted by the Registrant.

Of the forty-six accounts restricted, thirty were accounts in which the customers were nevertheless allowed to continue trading thereafter in violation of Regulation T.

In addition, the record establishes that there were some Regulation T "violations" by Registrant in an approximate three-month period prior to late May or mid-May 1972, but these were very few — perhaps ten to fifteen. But the Order does not charge Regulation T violations prior to June 1, 1972.

These violations of Regulation T by Registrant were wilful.[17/]

Hankerson was president of the firm during 1972 through September, and Berdahl took over during October as an interim president. Within those respective periods, Hankerson and Berdahl failed reasonably to supervise persons subject to their supervision with a view to having prevented the Regulation T violations found herein, within the meaning of Section 15(b)(5)(E) of the Exchange Act.

The Division urges that Knutson, as secretary of the firm, should also be held responsible for the Regulation T violations of the Registrant. However, the record does not support a conclusion that Knutson as secretary had operational or supervisory responsibility for compliance with Regulation T. While the record, as previously found herein, establishes that Knutson was present on a full-day basis at the firm's offices for about 8 weeks during September and October of 1972, it appears that his efforts were directed to identification and resolution of various financial and regulatory problems Registrant had been found to be suffering from, rather than to management of the firm. His management role, as part of a three-man management team, did not commence until about November 1972.

---

17/ See footnote 15 above for cases defining "wilfulness" as used in the Securities laws.

Books and Records Violations

Section 17(a) of the Exchange Act and Rule 17a-3 thereunder require in pertinent part that every registered broker or dealer make and keep current specified books and records relating to its business. The Commission stated in Midas Management Corporation, 40 S.E.C. 707, 709 (1961): " . . . our bookkeeping rules go to the very heart of the enforcement of the provisions of the [Exchange] Act and our rules thereunder concerning the conduct of securities brokers and dealers." Expanding on that view, the Commission stated in Security Planners Associates, Inc. et al., Exchange Act Release 9421, at p. 3, December 17, 1971: " . . . 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 statutory and rule provisions which we are charged with enforcing, or to answer inquiries of customers in respect of their accounts."

Paul Smerstik ("Smerstik"), a broker-dealer compliance investigator with the Chicago Regional Office ("CRO") of the Commission, pursuant to assignment by his superiors, conducted four separate inspections of the books and records of Registrant at Registrant's office beginning in August, 1972. The first inspection took place from August 14 to August 18, 1972; the second, from August 28 to September 7, 1972; the third, from October 16 to October 24, 1972, the fourth, from May 22 to May 24, 1973; on this last inspection Smerstik was accompanied by Clarence Placek ("Placek"), an accountant with the CRO, who worked under Smerstik's supervision.

At the time of Smerstik's inspection of Registrant's books and records in October 16-24, 1972, the record discloses, the receipt and delivery blotter, during an approximate forty-five day period from about September 1 to about October 16, 1972, indicated ten instances in which Registrant had failed to record the receipt or delivery of securities to customers and ten other instances in which Registrant had failed to record the movement of securities from one position to another — i. e., from the box to safekeeping or safekeeping to transfer, etc.

In the records reviewed in the same inspection covering the same period of time as above, the record shows, the Registrant's Security Position Record reflected nine instances in which the securities did not balance, i.e., where the long position did not agree with the total short position. Additionally, fifteen instances had occurred in respect to the Securities Position Record in which Registrant had not recorded the receipt or delivery of securities to customers, the records showing long or short positions where actually the securities in question were received by the customers and those accounts should have been shown as even. Further, the record establishes that in another twelve instances the Securities Position Record had failed to record the movement of securities from box to safekeeping and safekeeping to transfer. No net-capital computations for the months of January 1972 or March 1972 were included in the company's records at the time of the inspection, and Registrant couldn't produce them upon request.

Smerstik's inspection of the Registrant's books and records during the period August 14 to August 18, 1972, found the books and records in a

"chaotic" condition. The books were only posted to June 30, 1972. There were approximately fifty-four journal entries from January 1 to May 31, 1972, that were not posted to the records but only shown in the trial balances. The unposted journal entries affected the firm's income and expense accounts and the customer and broker control accounts. This made it impossible to make a reliable net capital computation without extensive adjustments to or updating of the books and records.

When Smerstik made his second inspection about two weeks later, he found Registrant's books and records still in "bad shape". The books were posted as currently as possible, but there were still a lot of journal entries to be put through. Although cash blotters indicated cash disbursements on a given day, the postings were not always accurate. For example, on July 20, 1972, cash disbursements of approximately $39,000 were shown, but cancelled checks issued on this date were in excess of $306,000.

During the Summer of 1972, Registrant's books were in "chaotic" condition and this made it impossible to make trial balances or reliable net capital computations without extensive adjustments to or updating of the books and records. Exemplifying the sorry state of Registrant's books and records, Registrant never knew exactly how much money it had lost during the period of July and August 1972.

Since the Order charges books-and-records violations only for a period commencing "on or about" October 1, 1972, bookkeeping and record-keeping deficiencies prior to such date cannot be used to support findings of violations,[18/] but they will be taken into account in assessing the sanctions, if any, that should be imposed.

---

18/ No motion to conform the pleadings to the proof was filed herein.

For reasons parallel to those expressed above at p. 24 in connection with the Regulation T violations, it is concluded that Berdahl failed reasonably to supervise persons subject to his supervision with a view to preventing the wilful violations of the books-and-records requirements found to have been committed by Registrant subsequent to October 1, 1972, and that, as to books-and-records deficiencies prior to such date, Hankerson's supervisory deficiences in connection therewith must be taken into account on the question of the sanctions, if any, that should be imposed against him.

Net Capital Violations

Rule 15c3-1 promulgated under Section 15(c)(3) of the Exchange Act, the "Net Capital Rule", provided generally that a broker-dealer might not effect securities transactions when it had an aggregate indebtedness in excess of 2,000 per centum of its net capital or when it had or maintained net capital of less than $5,000.

The net capital rule is one of the most important weapons in the Commission's arsenal to protect investors. Blaise D'Antoni & Associates, Inc. v. Securities and Exchange Commission, 289 F. 2d 276, 277, (C.A. 5, 1961).

In discussing the seriousness of noncompliance with the net capital rule, the Commission stated in Churchill Securities Corp., 38 SEC 856 (1959) at p. 860: " . . . Registrant subjected its customers to undue financial risks by conducting its business while in violation of the net capital rule." The fact that no losses were sustained by customers as a result

of violations of the net capital rule is no defense. Midas Management Corp., 40 SEC 707, 709 (1961); Blaise D'Antoni & Associates, Inc., 39 SEC 835, 837-838 (1960). "Exposure of customers to the risk posed by violations of the Rule is in itself the abuse at which the Rule is aimed." M. V. Gray Investments, Inc., et al., Exchange Act Release 9180 May 20, 1971, p. 6.

Following his several previously-identified inspections of Registrant's books and records, Smerstik made computations of Registrant's net capital in accordance with the net capital rule, Rule 15c3-1 of the Exchange Act, as of July 31, 1972; August 22, 1972; August 28, 1972; November 30, 1972; December 31, 1972; and January 31, 1973.

His net-capital computations reflect the following respect to Registrant's net capital on the dates shown:

| Date | Aggregate Indebtedness | Capital Required for Aggregate Indebtedness | Adjusted Net Capital (Deficit) | Additional Capital Required |
|---|---|---|---|---|
| 07-31-72 | $351,786.26 | $17,589.30 | $(11,227.32) | $28,816.62 |
| 08-22-72 | 352,126.39 | 17,606.31 | ( 9,165.35) | 26,771.66 |
| 08-28-72 | 727,016.05 | 36,350.80 | 3,397.16 | 32,953.64 |
| 11-30-72 | 299,478.09 | 14,973.90 | (60,115.00) | 75,088.90 |
| 12-31-72 | 203,650.59 | 10,182.53 | ( 5,699.90) | 15,882.43 |
| 01-31-73 | 266,967.33 | 13,348.37 | ( 5,229.40) | 18,577.77 |

In making the net capital computations as of July 31, 1972, August 22, 1972, and August 28, 1972, Smerstik used Registrant's general ledger, the journal entries available from Registrant at the time, and the subsidiary records. In computing Registrant's net capital as of November 30, 1972, Smerstik used a Form X-17A-5 Report filed with the CRO which included a certified audit. In making this net capital computation,

Smerstik made an adjustment consisting of showing as a liability a bank overdraft by Midland in the sum of $7,700 which was not listed as a liability in the Report, the auditors having netted this with the balances in Registrant's other bank accounts.

In making his net capital computations as of December 31, 1972, and January 31, 1973, Smerstik based his computation on the general ledger and on the subsidiary records of Registrant as they existed at the time he took trial balances.

The three net capital computations referred to above that were made for dates in July and August, 1972, were made on the basis of Registrant's records as of those respective dates. Those records, as found above, were incomplete, inaccurate, and unreliable. Indeed, the CRO investigator described them as "chaotic". The Division did not attempt to reconstruct the records as of the given dates to show the true financial condition of Registrant as of such dates. Accordingly, it is concluded that the Division has failed to establish net capital violations as of those three dates. At the same time, for the purpose of determining any sanctions that may be imposed herein, it is significant that Registrant continued to do business on and about the three dates in question, when it knew or should have known that its books and records were so seriously deficient that it could not have known with any reliability its true net capital position.

Registrant's net capital as of November 30, 1972, computed by Knutson and Pester, showed compliance with the Commission's net capital rule, while an audit report prepared by the CPA firm of Segal, Sudit,

Rochlin and Lurie (Segal) showed noncompliance as of the same date. The difference was accounted for mainly by Segal's giving no value (while Knutson and Pester did) to certain "New Era" securities in firm inventory which Registrant had bought as agent for a customer who failed to pay for same. The auditors accordingly set up a reserve of approximately $40,000 for uncollectable funds on this item. There was no market for these securities on November 30, 1972.

A net capital computation made by Knutson for Registrant as part of a Form X-17A-11 as of December 31, 1972 differs from Smerstik's net capital computation as of this same date because Smerstik took as a charge to capital, and Knutson didn't, $17,882.50 for certain "New Era" (Tr. at p. 378 erroneously shows "Nuclear") stock for which no published market could be found at the time.

A net capital computation made by Knutson for Registrant as part of Form X-17A-11 as of January 31, 1973 differs from Smerstik's net capital computation as of this same date because Smerstik included in aggregate indebtedness a bank overdraft in the amount of $38,122.95, while Knutson netted this out with balances in other bank accounts. There was a difference in retained earnings shown in Smerstik's and Knutson's computations, the former showing $73,943.33 and the latter showing approximately $66,000. Knutson could not account for the difference.

The Commission has frequently held that securities for which there is no independent market are not readily convertible into cash and are given no value in computing net capital.[19/]

---

19/ Don D. Anderson & Company, Inc., Exchange Act Rel. No. 8477, Dec. 26, 1968, pp. 2-3; John W. Yeaman, Inc., et al. Exchange Act Rel No. 7527, February 10, 1965, pp. 4-5; S.E.C. v. C. H. Abraham & Co., Inc., 186 F. Supp. 19 (S.D.N.Y. 1960); Whitney-Phoenix Co., Inc., 39 SEC 245, 249 (1959); Pioneer Enterprise, Inc.., 36 SEC 199, 207 (1955).

Likewise, on the question of treating a bank overdraft, Smerstik's treatment is clearly correct because by definition in the Rule "aggregate indebtedness" is deemed to mean "the total money liabilities of a broker or dealer arising in connection with any transaction whatsoever . . ." A bank overdraft is certainly such a liability.

Registrant effected transactions in non-exempt securities in the Over-the-Counter Market while in non-compliance with the Commission's Net Capital Rule on and about November 30, 1972; December 31, 1972 and January 31, 1973. Its violation of the rule was wilful.[19a/]

Berdahl was Registrant's board chairman and a major owner on November 30, 1972, December 31, 1972, and January 31, 1972. Knutson was Registrant's secretary, legal counsel and part owner on all these dates, and most importantly, was a member of the three-man executive committee then managing Registrant. Harrison was Registrant's president, treasurer, a major owner and a member of the three-man managment team. Accordingly, it is concluded that Berdahl, Knutson, and Harrison each wilfuly aided and abetted Registrant's Net Capital violations. In addition, from the standpoint of imposition of sanctions, only, Berdahl and Hankerson shared responsibility for allowing the Registrant to continue doing business during July and August of 1972 at times when its net capital position could not reliably be ascertained because of the condition of its books and records.

---

19a/ See footnote 15 above.

Late Form X-17A-5 Filings

Rule 17a-5 promulgated under Section 17(a) of the Exchange Act provides generally that a registered broker or dealer shall annually file with the Commission a report of its financial condition within 45 days of the "as of" date of the report.[20/] This financial report provides information for investors as to the financial condition of the brokerage house with which they are doing business, and it also provides the Commission with information vital to its regulatory and enforcement obligations. Securities Investors Corporation, 41 S.E.C. 618, 619 (1963); W. E. Leonard & Co., Inc. 39 S.E.C. 726, 727 (1960).

Registrant violated this Rule for the calendar years 1971 and 1972 and Berdahl, Knutson, Hankerson and Harrison aided and abetted these violations (Hankerson's and Harrison's aiding and abetting, however, being only in relation to one of these two calendar years — Hankerson for 1971 and Harrison for 1972). In each of these two years, Registrant's violation resulted from its failure to file a report of financial condition within 45 days after the "as of" date of the report as required by said Rule, such "as of" date being November 30 in each year. For the calendar year 1971, Registrant filed its report of financial condition late by fourteen days and for the calendar year 1972 Registrant filed its report of financial condition late by two days. In neither case was an extension of time for the filing of the report granted.

Berdahl and Knutson handled Registrant's X-17A-5 Report for 1971, which was prepared by Robert H. Harding, then an independent CPA,[21/] on instructions from Knutson. It was Hankerson, as president, who signed a

---

20/ Amended to 60 days now, but effective only for financial reports for calendar and fiscal years ending on or after December 31, 1972. Exchange Act Release 9658.

21/ Harding later worked for the firm as an employee.

letter dated January 13, 1972, requesting of the CRO an extension of time for filing this report, which request was denied by letter dated January 19, 1972. The Report was ultimately filed on January 28, 1972.

Knutson was familiar with the time limit on filing the X-17A-5 Report for 1971, but thought there was a verbal extension granted by a Mr. Froelich of the CRO. He never verified this with Mr. Froelich.

There was no excuse for the lateness of filing Registrant's X-17A-5 Report for 1972 except that the auditors, whose selection was required by Minnesota State regulatory authorities, did not complete it until the date it was to be filed.

Harrison was not familiar with the time requirements concerning X-17A-5 filing until after the Report for 1972 was filed late.

The Commission stated in Security Planners Associates, Inc. et al[22/] that "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." See also Weston and Company, Inc., Securities Exchange Rel. 9312, pp. 5-6 (August 30, 1971); W. E. Leonard & Co., Inc., 39 S.E.C. 726, 727 (1960); Wesley S. Swanson, 41 S.E.C. 697, 698 (1963).

---

22/ Exchange Act Release 9421, December 17, 1971, at p. 4.

Failure to Report Change in Accountants

Sub-paragraph (f)(2) of Rule 17a-5 promulgated under Section 17(a) of the Exchange Act, effective as to any change of accountant made after July 31, 1972, generally provides for filing with the Regional Office of the Commission for the region in which its principal place of business is located a notice giving specified information within a prescribed time concerning replacement of a registered broker-dealer's accountant. The portions of this rule applicable to Registrant, in view of a change of Registrant's accountants during the late Fall of 1972, required that its notice should state

> "(i) the date of notification of the termination of the engagement or engagement of the new accountant as applicable and
>
> (ii) the details of any problems existing during the 24 months (or the period of the engagement if less) preceding such termination or new engagement relating to any matter of accounting principles or practices, financial statement disclosure, auditing procedure, or compliance with applicable rules of the Commission, which problems, if not resolved to the satisfaction of the displaced accountant, would have caused him to refer to them in his opinion. The member, broker or dealer shallalso request the displaced accountant to furnish the member, broker or dealer with a letter addressed to the Commission stating whether he agrees with the statements contained in the notice of the member, broker or dealer and, if not, stating the respects in which he does not agree. The member, broker or dealer shall file three copies of the notice and the accountant's letter, one copy of which shall be manually signed by the sole proprietor, or a general partner or a duly authorized corporate officer, as appropriate, and by the accountant, respectively."

Berdahl, Knutson and Harrison were all familiar with the Rule as is evidencedby the following in the record:

Berdahl was familiar with the Rule concerning change of accountants. Registrant's accountants were changed in late 1972[23/] and Berdahl "assumed" an attempt was made to comply with the applicable rule.

Harrison had read the Rule relating to changes of accountants prior to writing a letter dated December 18, 1972 concerning this to the CRO and realized at the time that this letter was not all that was required by the Rule. Pester had given Harrison a draft of a letter which Harrison thinks complied with the Rule, but after talking with Harding, Harrison changed the letter to the form in which it was sent to the CRO.

Harrison did not know of the letter of December 27, 1972 directed to Knutson by the CRO pointing out deficiencies in Harrison's letter concerning change of accountants.

Knutson was aware of the Rule relating to change of accountants before Registrant changed its accountants in late 1972, but did nothing about the letter he received pointing out deficiencies.

There was thus a wilful violation, as charged, of Rule 17a-5(f)(2) by Registrant, aided and abetted, in varying degrees, by Berdahl, Knutson and Harrison.

Failure to Send Required Information to Customers

Sub-paragraphs (m) and (n) of Rule 17a-5 promulgated under Section 17(a) of the Exchange Act, effective September 30, 1972 generally provide in pertinent portions that registered brokers and dealers send to

---

23/ The need for changing auditors resulted from the fact that Harding, who had done the firm's certified audit for 1971, had become employed by the firm and was therefore no longer "independent".

their customers within specified time limits annual and quarterly reports containing financial and other related information concerning the brokers and dealers.

The record establishes that none of Registrant's principals were aware of these rules until the Commission filed an injunctive action against Registrant during March 1973 and that none of the required reports were mailed until on or about March 30, 1973.

Under the Rule, the reports required by sub-paragraph (m) should have been sent on or before January 17, 1973, and those required by sub-paragraph (n) should have been sent on or before February 9, 1973.

Knutson and Harrison, along with Pester,[24/] were actively managing Registrant during the periods when these reports should have been sent.

Accordingly, it is concluded that Registrant wilfuly violated, and Knutson and Harrison wilfuly aided and abetted violations of, Section 17(a) of the Exchange Act and Rules 17a-5(m) and 17a-5(n) thereunder, as charged.

Failure to Comply with the "Early Warning Rule."

Rule 17a-11, promulgated under Section 17(a) of the Exchange Act, the "early warning rule", is designed to alert the Commission and other regulatory bodies to financial and operational difficulties of broker-dealers before such difficulties become so critical as to constitute actual violations of the securities laws and regulations.

---

24/ Pester is not a respondent in this proceeding.

Two of the four major provisions of Rule 17a-11 relate to the net-capital rule. Rule 17a-11 provides that when the net capital of a broker-dealer is less than required by any capital rule to which it is subject (in total or relative to the firm's aggregate indebtedness), immediate telegraphic notice must be given to the Commission and the self-regulatory organizations to which it belongs, and a report setting forth the firm's financial condition must be filed with them within 24 hours after such net capital deficiency occurs.

Rule 17a-11 further provides than when a broker-dealer's net capital computation, made and recorded pursuant to Rule 17a-3(a)(11), indicates that its aggregate indebtedness exceeds 1200% of its net capital or that its total net capital is less than 120% of the minimum net capital required of it, measured under any net capital rule to which the firm is subject, the firm must file a report on Form X-17A-11, furnishing data as to its financial and operational condition. Such report must be filed within 15 days after the end of any month for which the net capital computation showing a net capital ratio in excess of 1200% (or total net capital less than 120% of the minimum required) was made, and within 15 days after the end of each month thereafter until three successive months have elapsed during which the net capital computation does not reflect a net capital ratio in excess of 1200% (or total net capital less than 120% of the minimum required).

The Rule also provides that at any time when a member, broker or dealer subject to Rule 17a-3 fails to make and keep current the books and records specified therein, he shall immediately give telegraphic

notice of such fact, specifying the books and records which have not been made or which are not current, and within 48 hours of the telegraphic notice file a report stating what steps have been taken to correct the situation.

The record here establishes that none of the requirements of the Rule concerning books and records deficiencies was ever complied with.

The record also establishes that the Rule's provisions relating to net capital were not complied with at all in some cases and not complied with within the time required by the Rule in other cases, i.e.:

Telegraphic notice was filed with the CRO January 22, 1973, concerning Registrant's November 30, 1972, net capital violation.

Telegraphic notice was filed with the CRO March 8, 1973, concerning Registrant's January 31, 1973, net capital deficiency.

Form X-17A-11 Reports were filed with the CRO March 1, 1973, for the financial and operational conditions of Registrant as of December 31, 1972, and January 31, 1973.

Accordingly, it is concluded that Registrant, as charged, wilfuly violated, and Berdahl, Hankerson, Knutson and Harrison (in varying degrees) wilfully aided and abetted violations of Section 17(a) of the Exchange Act and Rule 17a-11 thereunder.

Failure Reasonably to Supervise

Section 15(b)(5)(E) of the Exchange Act, as added by the 1964 amendments to it, provides an independent ground for the imposition of a sanction against a broker-dealer or a person associated with a broker-dealer who ". . . . has failed reasonably to supervise, with a

view to preventing violations of such [Securities Laws] statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision."[25/] The Order charges all respondents except Ehlen with a failure to supervise.

As already found above, Hankerson and Berdahl failed reasonably to supervise in connection with Registrant's violations of Regulation T and Berdahl failed reasonably to supervise in connection with Registrant's books-and-records violations. Where particular respondents have been found guilty of aiding and abetting violations Registrant committed, as is the case in numerous instances above, it would be a "confusion of concepts" to also find them in violation of the requirement reasonably to supervise.[26/] Likewise, to hold the Registrant responsible for a failure to supervise in connection with violations found to have been committed by Registrant[27/] would involve a "confusion of concepts" and a pyramiding of offenses stemming from the same acts or omissions that would add nothing meaningful to the findings and conclusions.

Conclusions

In general summary of the foregoing, it is concluded that within the relevant period from about January, 1972 to April 19, 1973, the

25/ Armstrong, Jones & Co. et al., 43 S.E.C. 488, 899, footnote no. 27.

26/ Anthony J. Amato et al., Exchange Act Release No. 10265, p. 5, June 29, 1973, 2 SEC Docket 90; Fox Securities Company, Inc. Exchange Act Release No. 10475, November 1, 1973, at pp. 6-7.

27/ Registrant acted, of course, through its officers and employees and was responsible under the concept of respondeat superior for their conduct in the course of employment. Armstrong, Jones & Co., v. S.E.C. 421 F. 2d 359, 362 (C.A. 6, 1970) cert. den. 398 U.S. 958 (1970).

indicated respondents committed the following violations, as more particularly found above:

(1) Registrant wilfully violated and Berdahl and Hankerson wilfully aided and abetted 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 Section 15(c)(2) of the Exchange Act and Rule 15c2-4 thereunder in connection with the Sentinel underwriting.

(2) Registrant wilfully violated and Berdahl, Hankerson, and Ehlen wilfully aided and abetted violations of the antifraud provisions mentioned in paragraph (1) next above in connection with the Port underwriting.

(3) Registrant wilfully violated and Berdahl, Hankerson, Harrison and Knutson, at varying times and in varying degrees, wilfully aided and abetted violations of Section 15(b) of the Exchange Act and Rule 15b3-1 thereunder in connection with Registrant's failure to file required Form B-D amendments.

(4) Registrant wilfully violated Section 7(c)(1) of the Exchange Act and Regulation T promulgated thereunder by the Board of Governors of the Federal Reserve System, and Berdahl and Hankerson failed reasonably to supervise persons subject to their supervision with a view to preventing such violations.

(5) Registrant wilfully violated Section 17(a) of the Exchange Act and Rule 17a-3 thereunder in connection with its failure properly to maintain its books and records, and Berdahl failed reasonably to supervise persons under his supervision with a view to preventing such violations.

(6) Registrant wilfully violated and Berdahl, Harrison and Knutson aided and abetted violations of Section 15(c)(3) of the Exchange Act and Rule 15c3-1 (the net capital rule) thereunder.

(7) Registrant wilfully violated and Berdahl, Hankerson, Harrison and Knutson wilfully aided and abetted violations of Section 17(a) of the

Exchange Act and Rule 17a-5 thereunder in connection with Registrant's failure to file with the Commission duly certified reports of Registrant's financial condition containing the information required by Form X-17A-5 for calendar years 1971 and 1972 within the prescribed time.

(8) Registrant wilfully violated and Berdahl, Harrison and Knutson wilfully aided and abetted violation of Section 17(a) of the Exchange Act and Rule 17a-5(f) thereunder in connection with Registrant's failure to give all required information concerning its change of accountants.

(9) Registrant wilfully violated and Harrison and Knutson wilfully aided and abetted violations of Section 17(a) of the Exchange Act and Rules 17a-5(m) and 17a-5(n) thereunder in connection with Registrant's failure timely to give required information to its customers.

(10) Registrant wilfully violated and Berdahl, Hankerson, Harrison and Knutson wilfully aided and abetted Registrant's violations of Section 17(a) of the Exchange Act and Rule 17a-11 thereunder (the "early warning" rule).

(11) Hankerson and Berdahl failed reasonably to supervise persons under their supervision with a view to preventing Registrant's Regulation T violations and Berdahl failed reasonably to supervise in connection with Registrant's books-and-records violations.

PUBLIC INTEREST

The violations here found are serious, numerous, varied, and many of them persisted over prolonged periods. When "new management" came in, new violations cropped up, and some were not corrected even as of the date of hearing. It is entirely clear that revocation of Registrant's

broker-dealer registration is required in the public interest, as the Division recommends.

As to the sanctions appropriate for the individual respondents, two recommendations by the Division deserve special examination.

The Division recommends that Ehlen be barred from association with any broker dealer on the ground that he has defaulted by failing to answer or to appear at the hearing. However, as indicated above at p. 3 Ehlen did testify at the hearing, apparently fully, and it would thus not seem entirely appropriate to treat him as a "default" case in the absence of a motion for a default judgment. The violations found against Ehlen in this proceeding, coupled with the NASD's expulsion of him from membership following his unsuccessful effort to organize and manage his own broker dealer firm, suggest that in his case an appropriate sanction in the public interest would be a bar with the provision that after seven months he may apply to the Commission for permission to become associated with a broker dealer in a non-proprietary, non-supervisory capacity upon a satisfactory showing that he will be adequately supervised.

Except for Ehlen, the most severe sanction recommended by the Division is against Knutson—a bar with a proviso that after 1 year he may reapply for association with a broker-dealer in a non-supervisory capacity. The Division recommends this more severe sanction against Knutson in part on the theory that as secretary and general counsel of Registrant he was responsible for considerably more violations of the Registrant than he has been found to be implicated in by this initial decision, and in part because they regard some of his testimony as less than candid and bordering on perjury.[27a/]

---

27a/ While the Division's brief talks of "suspensions", the conditions it recommends following the "suspensions" require that bars be imposed.

The dispute concerning the veracity of Knutson's testimony is an outgrowth of the fact that after an investigation of Registrant by the office of the Minnesota Commission of Securities, the Registrant, through Harrison and counsel other than Knutson, worked out a settlement a part of which involved an agreement, which was to remain confidential and undisclosed to the public, whereby Registrant would restrict the scope and nature of Knutson's relationship with Registrant for a stated period. One of the things Registrant was obliged to do was to dismiss Knutson as its secretary and to bar or restrict Knutson's legal representation of the Registrant.[28/]

During the hearing Knutson testified that he was still Secretary of Registrant though he had earlier "resigned" in accordance with Registrant's settlement with the Minnesota Securities Department ("MSD"), and in response to questions as to whether he had ever been the subject of any sanction in connection with securities matters he responded in the negative.

In testifying that he was still Secretary, it is not crystal clear whether Knutson, as he claims, merely misspoke himself by understanding the question to relate to the time of the alleged violations, or whether he was simply trying to keep the Minnesota "sanction" confidential, as it was supposed to have remained. Based on Knutson's testimony as a whole,

---

28/ The negotiators, as it happened, didn't come to a meeting of the mind in all respects. The Commissioner's understanding was that, among other things, Registrant would not retain Knutson as counsel in any forum, but Registrant's undertaking (the last thing in writing on the subject) was only that Knutson would not represent Registrant before the Minnesota Securities Department. The Commissioner never saw this last undertaking, but his deputy did and filed it in confidential files without protest.

and his demeanor, it is concluded that the latter is more probable.

In defense of his failure to disclose the MSD restrictions on him, Knutson argues that he was not a party to any proceeding before the MSD, that he signed no undertaking with that Department, and that in bowing out as secretary and counsel (before the MSD) he was merely accepting the inevitable power of Harrison to impose such restrictions on him so that Harrison, for the Registrant, could make his peace with the MSD.

It is concluded that Knutson's testimony on the question of "sanctions" was defensible as being literally correct, though it was certainly less then candid. The whole question of the veracity of his testimony points up one of the vices of non-public sanctions, whatever other justifications may support their use.

While Knutson's less-than-candid testimony on these two points will be given some weight in assessing sanctions, it will not be given nearly the strong weight that the Division contends would be warranted.

Among the individual respondents, Berdahl and Hankerson committed (among other violations) antifraud violations whereas Knutson and Harrison did not. Taking this differentiating factor into account, as well as the record as a whole and all factors that have been urged in mitigation, the Division's recommended sanctions as to Berdahl and Hankerson — a bar with permission to apply to become associated after 9 months in a non-supervisory capacity — is deemed appropriate in the public interest.

Knutson's sanction, it is concluded, should be a bar with permission to reapply for the right to become associated in a non-supervisory capacity after six months.

Harrison, who appears to have underestimated the complexity of compliance requirements in the securities industry and who assumed a management role in the Registrant without any prior securities-industry experience,[29/] should, it is concluded, be barred with permission to apply for the right to become associated in a non-supervisory capacity after 3 months.

ORDER

Accordingly, IT IS ORDERED as follows:

(1) The registration of Midland Securities Corporation with the Commission is hereby revoked and the firm is hereby expelled from membership in the National Association of Securities Dealers, Inc.;

(2) Respondent James R. Ehlen is hereby barred from association with a broker dealer with the proviso that after seven months from the effective date of this order he may apply to the Commission to become associated with a registered broker-dealer in a non-proprietary, non-supervisory capacity upon a satisfactory showing to the staff of the Commission that he will be adequately supervised;

(3) Respondents Richard B. Berdahl, Bruce L. Hankerson, Robert O. Knutson, and William H. Harrison are each hereby barred from association with a broker-dealer with the proviso that after periods of nine, nine, six and three months, respectively, following the effective date of this order, they may apply to the Commission for permission to become associated with a registered broker-dealer in a non-supervisory capacity.

This order shall become effective in accordance with and subject to Rule 17(f) of the Commission's Rules of Practice, 17 CFR 201. 17 (f).

---

29/ He has, however, passed his principal's exam.

Pursuant to Rule 17(f), this initial decision shall become the final decision of the Commission as to each party who has not within fifteen days after service of this initial decision upon him, filed a petition for review of this initial decision pursuant to Rule 17(b), unless the Commission, pursuant to Rule 17(c) determines on its own initiative to review this initial decision as to him. If a party timely files a petition for review, or the Commission takes action to review as to a party, the initial decision shall not become final with respect to that party.[30/]

David J. Markun
Administrative Law Judge

Washington, D.C.
August 2, 1974

30/ To the extent that the proposed findings and conlusions submitted by the parties, and the arguments made by them, are in accordance with the views herein they are accepted, and to the extent they are inconsistent therewith they are rejected. Certain proposed findings and conclusions have been omitted as not relevant or as not necessary to a proper determination of the issues presented.