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UNITED STATES OF AMERICA

before the

SECURITIES AND EXCHANGE COMMISSION

In the Matter of

Del Consolidated Industries, Inc.
631 North Central Avenue
and 1645 Court Place
Phoenix, Arizona

File No. 24SF-3102

FILED
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SECURITIES & EXCHANGE COMMISSION

RECOMMENDED DECISION

Sidney Ullman
Hearing Examiner

Washington, D. C.
April 22, 1964

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In the Matter of Del Consolidated Industries, Inc. 631 North Central Avenue and 1645 Court Place Phoenix, Arizona File No. 24 SF-3102	RECOMMENDED DECISION

BEFORE: Sidney Ullman, Hearing Examiner.

APPEARANCES: Patrick J. Griffin, Jr. and Lawrence Lefkowitz, Esqs., on behalf of the Division of Corporation Finance.

Leo A. Levy, Esq., 26 Broadway, New York, New York, on behalf of Del Consolidated Industries, Inc.

I. NATURE OF PROCEEDINGS

These are proceedings pursuant to Rule 261 of Regulation A under the Securities Act of 1933 ("Act") to determine whether to vacate an order of the Commission temporarily suspending an exemption from registration with respect to a public offering of securities by Del Consolidated Industries, Inc. ("respondent"), or to enter an order permanently suspending the exemption.[1/]

By order dated December 7, 1962, the Commission temporarily suspended the exemption for the stated reason, among others, that there was reason to believe that the offering circular, which respondent filed with the San Francisco Regional Office of the Commission on August 27, 1962, omitted to state material facts with respect to certain oil and mining properties of respondent. The order provided an opportunity for a hearing, and following an appropriate

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

Rule 261, as applicable here, provides for the issuance of an order temporarily suspending an exemption if the Commission, among other things, has reason to believe that the terms and conditions of Regulation A have not been complied with, that the offering circular contains any untrue statements of a material fact or omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or that the offering is being made or 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.

request by respondent the Commission issued its order of January 11, 1963, setting forth the matters complained of with respect to the offering and fixing the time and place of a hearing. Pursuant thereto, the hearing was held before the undersigned at Washington, D. C., on January 28 and 29, 1963, and thereafter adjourned to February 11, 1963, and closed on that date. 2/

Under the order, the specific facts placed in issue for hearing were:

> "A. Whether the offering circular omits to state material facts necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, with respect to:
>
> 1. The geographical location, type and potential of accumulations of oil and gas, production data, estimated reserves and secondary recovery potential on its oil properties.
>
> 2. The nature, content, basis of estimated costs and quality of beryllium in its mining properties.
>
> 3. The report of its geologist, which omitted his qualifications and experience, and included unsubstantiated conclusions as to the value of minerals in issuer's properties.
>
> "B. Whether the terms and conditions of Items 8A (disclosure relating to the mining properties and to expert's report) of Schedule I of Form 1-A required by Rule 255 of the General Rules and Regulations under the Securities Act of 1933 have not been complied with, as noted above.
>
> "C. Whether the offering would be made in violation of Section 17 of the Securities Act of 1933, as amended." 3/

2/ The adjournment from January 29, 1963 to February 11, 1963 was for the purpose of affording respondent an opportunity to adduce testimony from its consulting geologist. However, on being advised by counsel for respondent that such testimony would not be forthcoming, the Hearing Examiner closed the record on February 11, 1963, in accordance with prior arrangements.

3/ The order raised two additional issues relating to alleged omissions from the offering circular. They pertained to (1) the experience of issuer's officers and directors and their interests in the properties and (2) the disclosure of such interests in Schedule I of Form 1-A. Both issues have been waived by the Division of Corporation Finance in its brief.

Both the Division of Corporation Finance ("Division") and respondent were represented by counsel at the hearing. A recommended decision by the Examiner was requested, and proposed findings of fact, conclusions of law and briefs in support thereof were submitted by both parties. The Division submitted a reply brief following the receipt of respondent's documents.

In its brief, respondent not only argues against the charges but also requests that the Commission permit it to withdraw the filing. It predicates this request primarily on the circumstance that certain income-producing oil properties on which it held an option at the time of the filing became unavailable when the option expired and the properties were acquired by Gulf Oil Company. It supports the request also by pointing out that the issue never got off the ground, none of the stock having been sold pursuant to the filing, nor any of the allegedly deficient offering circulars or other literature having been distributed,and by its contention that any deficiencies in the offering circular were unintentional. The Division urges, conversely, that for reasons discussed below, the request for withdrawal should be denied and the suspension made permanent.

Based upon the entire record in these proceedings and the Hearing Examiner's observation of the witnesses and evaluation of their testimony, he makes the following findings of fact and conclusions of law.

II. FINDINGS OF FACT

A. The Offering

1. Respondent was incorporated on October 19, 1960 under the laws of Delaware, with its principal place of business in Phoenix, Arizona. Its authorized capital consists of 2,000,000 shares of $0.25 par value common stock, of which 50,000 shares were issued and outstanding as of July 31, 1962.

2. Respondent was organized for the purpose of engaging in diversified activities involving oil, gas and minerals. On August 27, 1962, it filed with the San Francisco Regional Office of the Commission a notification on Form 1-A and certain exhibits, including an offering circular, relating to a proposed offering of 70,000 shares of respondent's common stock at $2.50 per share, or an aggregate offering of $175,000, for the purpose of obtaining an exemption from the registration requirements of the Act, pursuant to Section 3(b) of the Act and Regulation A thereunder.

3. Louis N. Marbry is President of respondent as well as a promoter and controlling stockholder.

4. Harlow H. Loomis, Jr., was named in the notification and offering circular as respondent's geologist. Filed as exhibits to the notification were two reports by Loomis, one relating to certain producing oil properties in which interests were to be acquired by respondent and one relating to its mineral or beryllium properties.

5. Respondent represented in the offering circular that as of the date of filing its notification under Regulation A its properties consisted primarily of the following:

a. An option to purchase for $50,000:

(1) the working interests of certain producing oil properties in Chaves County, New Mexico, owned by Manhattan Consolidated Mines Company ("Manhattan"), along with the well equipment and inventory of the wells. [These wells are four in number and they are sometimes hereafter referred to as the Crest-Gulf Wells];

(2) five unproven oil and gas leases in Wyoming.

b. A semi-proven oil lease containing 2,080 acres in Montezuma County, Colorado;

c. A one-half interest in an unproven lease in Kane County, Utah;

d. Six unpatented mining claims in Colorado for the mining of beryl ores; and

e. A real estate company in Phoenix, Arizona.

The order charges and the Division contends that the offering circular was deficient with respect to descriptions of all of the above properties with the exception of the real estate company.

6. The offering circular states that if all 70,000 shares covered by the notification were sold, respondent proposed to spend $50,000 of the net proceeds to exercise the above-mentioned option with respect to the Crest-Gulf Wells on which Manhattan owned working interests; (cf. a, above); $7,000 to commence secondary recovery by water flooding of said wells; $40,000 for the purchase of equipment and commencement of mining operations on the beryl claims in Colorado (cf. d, above); and $9,000 to drill on its semi-proven oil lease in Colorado (cf. b, above). The remaining $61,500 of the net proceeds was to be retained as working capital.

B. Charges with Respect to the Working Interests in the Crest-Gulf Wells [4]

7. The Division contends that in two basic respects the offering circular is deficient and misleading in its description of the working interests proposed to be acquired by respondent in the four Crest-Gulf wells. Firstly, it urges in its brief, the offering circular omits material facts indicating with sufficient clarity that the working interests to be acquired are less than the total production of the wells. Secondly, it urges, the figures relating to production and reserves of oil in the wells are misleading. Each of these contentions is discussed below.

(i) The Alleged Failure to Describe Adequately the Working Interests

8. At page 3 of the offering circular, under an earlier caption "Introductory Statement", the properties to be purchased for $50,000 under the option mentioned above are described to include "working interests in four proven oil leases in Chaves County, New Mexico, which produced approximately 15,000 barrels of oil in 1961. . . " Although it is conceded by both parties that the working interests subject to Manhattan's option constituted only 33 7/8% of the production of the four wells, the Division contends that the quoted language stands as a representation that the entire output of the four wells was subject to the option and would be acquired by respondent, and that the above language was intended to mislead.

4/ The term "working interests" is defined in the Regulations under the Act as fractional undivided interests in an oil or gas leasehold which are subject to any portion of the expense of development, operation, or maintenance. Cf. Mon-O-Co Oil Corporation, 38 S.E.C. 833, 834 (1959).

As indicated below, there are several material deficiencies in the offering circular, as charged by the Division. However, inasmuch as respondent has requested authorization to withdraw the filing, it appears that relatively extended discussion and findings on the issue of respondent's alleged intention to mislead potential investors are necessary to a determination whether it would be appropriate for the Commission to authorize the withdrawal in lieu of ordering the suspension to be made permanent.

9. As pointed out in respondents' brief, the various businesses and properties mentioned briefly in the Introductory Statement are more fully described in a subsequent portion of the offering circular. In the Introductory Statement itself, immediately following the above-quoted language appears the statement "These various business and properties are more fully described in Section 'Business and Properties'".

10. Thereafter, on page 8 of the offering circular, under the caption "Business and Property", appears the language:"Option to Purchase Four Producing Wells and Five Unproven Leases in Wyoming", and there follows a description of the option and details concerning the four producing Crest-Gulf wells. The production of each of the wells during the year 1961 and for the first six months of the year 1962 is set forth in tables on page 9 of the offering circular, and following the tables appears the language:

> "Manhattan owns 27% interest in Well A-1; 27% in Well A-2; 52% in Well A-3; 29½% interest in Well A-4. Since each of the wells produced approximately the same number of barrels of oil, the average working interest in the 4 wells is 33.7/8%. The net revenue derived from their working interests totalled $10,497.55 for the year 1961 and $5,181.32 for the first six months of 1962."

Immediately thereafter, appears the following, in the text and format set forth below:

"Summary of Production for Preceding Years.

1958			
31,450.26	Barrels -	Working Interest	10,653.78 Barrels
1959			
34,835	Barrels -	Working Interest	11,800.36 Barrels
1960			
2,106	Barrels-January	"	
633	" February	"	927.84 Barrels
2,739			

Shut-in for balance of year because oil and gas ratios were not prepared by engineers.

As additional revenue, the Company will receive $4,800 per year for the supervisory operation of these wells or a net, after deducting 33 7/8% working interest, if it exercises its option, of $3,174.

The reserves, net to Company's interest and less royalty, on primary recovery has been estimated by Harlow H. Loomis, Jr., consulting geologist, to be as follows:

Well A-1 -	19,139 barrels
Well A-2 -	19,037 barrels
Well A-3 -	79,773 barrels
Well A-4 -	35,671 barrels
Total	153,674 barrels."

11. The description of the working interests to be acquired in the wells is not precise or articulate, nor an example of particularly good draftmanship. However, the Examiner does not find an intention to deceive or mislead the potential investor into believing that respondent would acquire the total output of the Crest-Gulf wells or the entire working interests therein.

12. It is desirable, of course, that an offering circular present at a single place within the document all important facts relating to the same subject rather than interspersing them in a way which may be misleading. Cf. Mon-O-Co Oil Corporation, 38 S.E.C. 833, 841 (1959). But it does not follow that an obviously preliminary and prefatory description of the Crest-Gulf wells in the Introductory Statement on page 3 is materially misleading or any more misleading for its omissions than are the obviously preliminary and prefatory descriptions of the other properties of the issuer, made in the same Introductory Statement. These include, for example, property described only as "a semi-proven oil lease containing 2,080 acres in Montezuma County, Colorado". No charge is made by the Division that this incomplete prefatory description in the Introductory Statement is either misleading or intentionally deceptive. (Testimony at the hearing and argument in the briefs does pertain to the more extensive description of this semi-proven oil lease appearing in the offering circular at pages 5 and 6 thereof, and to its allegedly misleading nature, as discussed, infra.)

13. The Examiner does not agree with the Division's contention that at page 3 a misleading statement pertaining to the working interests was designed to bait the prospective investor and improperly stimulate his interest. The following cases cited by the Division to support the principle that "subsequent qualifying and negative statements of prior

optimistic representations do not obviate their misleading effect" are not support for the assertion that the page 3 description was intentionally deceptive. In National Educators Mutual Association, Inc., 1 S.E.C. 208 (1935), a registration statement prominently displayed enticing figures in large print, with small figures in parentheses subsequently reflecting the true facts. It was obviously and purposely misleading. In Income Estates of America, Inc., 2 S.E.C. 434 (1937), the Commission reiterated the view that the use of a term throughout the registration statement in a substantially different sense from its generally accepted meaning has in itself the capacity to mislead. There it was also found that through artful arrangement, notwithstanding all of the essential facts were presented at some point or another in a prospectus, the presentation was intentionally misleading. The Examiner cannot agree that respondent's offering circular was artfully prepared to accomplish the same purpose. And in the case of Austin Silver Mining Company, 3 S.E.C. 601 (1938), the separation of items which would have given a less favorable impression if properly juxtaposed was one of the several methods by which registrant intentionally created a false picture of the issue. The Commission stated at page 442 that ". . . registrant has availed itself of additional insurance against the chance that a persistent reader may uncover the important facts" by italicizing and printing in bold face type warnings to the effect that the correct information was required by the Securities and Exchange Commission, and the effect of these statements was clearly that of reinforcing the impression that the correct material was purely in compliance with technical or formal administrative requirements and was not likely to be of interest to the reader. The case does not support the Division's contention.

14. In further support of its position, the Division urges that:

> "Respondent's failure to state the production of the [Crest-Gulf] wells for 1961 and the first six months of 1962 in amounts net to the interests subject to its option, as required by Item 8B(c), [of Schedule I, Form 1-A] cannot be considered a careless mistake in the preparation of its offering circular since it showed the production of the four wells net to the interests subject to its option for the years 1958, 1959 and 1960. This is especially so since it made belated disclosure of the net income to Manhattan from the interests subject to the option for 1961 and the first six months of 1962 and omitted disclosure of the production net to such interests for the same period." 5/

The Division contends that this failure to comply with the requirements of Item 8B(c) of Schedule I indicates a deliberate attempt to mislead prospective investors but the Examiner is unable to agree with this contention. He finds a failure to comply with the requirements of Item 8B(c), as asserted, but concludes that the failure was the result of carelessness and was not deliberate or intentionally misleading. He concludes, further, in light of the detailed production figures actually furnished for the wells, that a relatively simple mathematical computation would produce the required information, and that the omission was not one of material facts necessary to be stated in order to make the offering circular not misleading.

5/ The requirements of item 8B(c) of Schedule I, Form 1-A, include a statement for all productive properties, of the net production of oil and gas to issuer's interest from each of the properties by years for the past four years prior to the latest year, and by months for the latest year.

15. In summary, on the basis of his examination of the offering circular, his evaluation of the witness Marbry and his testimony, and the arguments of counsel in their briefs, the Examiner is of the view that the description of the working interests to be acquired was not intentionally misleading. Further, although the matter may become academic in light of the offering circular's material deficiencies disussed below, the Examiner also believes that the description of the working interests to be acquired by respondent in the Crest-Gulf wells was not misleading for the reasons asserted in the order.

(ii) The Reserves in the Crest-Gulf Wells

16. As indicated above on page 9, the offering circular represented that the primary recovery "net to Company's interest and less royalty, on primary recovery has been estimated by Harlow H. Loomis, Jr., consulting geologist" to total 153,694 barrels. Thereafter appears the statement "It is estimated that the secondary recovery will exceed the primary recovery by at least 30% . . . "

17. The Division's oil and gas engineer, Tell T. White, testified as an expert witness. His testimony indicates that the estimate of the primary reserves was grossly overstated.

18. According to Paine, Oil Property Valuation, 63, (1942):

> "Two principal methods are usually relied on for estimating oil and gas reserves. The volumetric or saturation method ascertains facts about the size and porosity of the strata, their oil and gas content, and the part believed to be obtainable. The decline-curve method uses plotted records of wells which have been drilled on the property or in the locality, and from projections of these curves secures ideas of the remaining obtainable oil from the wells already drilled and from those to be drilled."

At page 62, Paine states:

> "When the wells have been drawn on for a sufficient time at their approximate capacity, the most trustworthy estimates of the remaining reserves are obtained from curves which record diagrammatically the past production rates and the extrapolation of them in a pattern of probable future annual recoveries."

Mr. White testified to the same effect, and to the further effect that the volumetric method is improperly used to compute reserves where there is a history of production.

19. The evidence reflects, however, that the volumetric method was used by Mr. Loomis in computing the primary reserves. As indicated below, the Examiner finds that the offering circular was deficient, firstly in failing to advise that the volumetric method was used to compute the reserves, and secondly in grossly overstating such reserves.

20. Mr. White's computation of the primary reserves in the Crest-Gulf wells, made by plotting the past production of each of the wells, established a declining curve of production which reflected estimated

future primary recovery of 11,630 barrels for the four wells, as compared with the estimate of 153,674 barrels established by Mr. Loomis. The Loomis figure and the method by which it was computed are reflected in a geological evaluation report filed as an exhibit to the offering circular. However, there is no indication either in the report or in the offering circular of any reason for using this method rather than the more reliable decline-curve method.

21. Mr. Marbry testified for respondent, not as an oil expert but as one having knowledge of the history of the four Crest-Gulf wells and also of the area. He stated that inasmuch as the wells were shut down for an extended period in 1960 and were not cleaned thoroughly when production was re-commenced in 1961, the decline-curve method was an unreliable means of estimating reserves. This was so, he testified, because "these particular wells in this area will salt up and they will paraffine up" unless water-flushed periodically during a shut-in.

22. The validity of this contention as to the effect of the shut-in on production is subject to serious doubt. Firstly, the Examiner credits Mr. White's testimony, given on rebuttal, indicating that the decrease in production of the four wells did not differ substantially from the decrease in production of wells in the same area which were not shut-in, and that the alleged failure to flush or clean the wells would not account for the decline in production as plotted by Mr. White or for the gross variance between Mr. White's primary reserve estimate

and that of Mr. Loomis.[6/] Further, the Examiner credits the testimony of Mr. White that the volumetric method of estimating reserves ordinarily should be used only where past production figures are unavailable.[7/] Accordingly, the offering circular is also materially deficient in failing to explain that the volumetric method was used by Mr. Loomis to estimate the reserves and in failing to state the reason for its use. In the event that the shut-in period and failure properly to maintain the wells was in fact the reason why Mr. Loomis used the volumetric method rather than the decline-curve method, full disclosure to that effect should have been included. As indicated above, neither Mr. Loomis nor any oil expert testified for respondent.

23. The Division agrees that the estimate in the offering circular of secondary reserves at 130% of the primary reserves is proper in connection with this offering. However, the gross misstatement of the primary reserves became a compounded misstatement when used as a basis for estimating the secondary reserves. It follows, therefore, that the offering circular also grossly overstated the secondary reserves and was materially misleading in so doing.

24. The Division's brief also refers to the offering circular's deficiency in failing to indicate whether the 130% figure was represented

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6/ A graph introduced into evidence by respondent reflected production of the four wells, in the aggregate, for the period 1956-1961. The graph appeared to contradict Mr. White's decline-curve. However, as Mr. White pointed out, one of the wells came into production for the first time in April 1957 and one in 1958. Accordingly, the graph of aggregate production was not meaningful.

7/ Cf. Mon-O-Co Oil Corporation, supra.

as being applicable to the gross primary reserves of the wells, which would include their past production, or whether the figure was represented as being applicable only to the estimated present reserves. Inasmuch as past production of the wells was substantial, a large difference would result from the application of the 130% to one figure or the other. It follows that the offering circular was ambiguous and it was deficient in failing to make the representation of secondary reserves with the required clarity.

C. Charges with Respect to the Semi-Proven Oil Lease in Colorado

25. With respect to this lease of 2,080 acres in Montezuma County, Colorado, the offering circular stated, in part, that the leased land was located on:

> ". . . a structure where oil and gas is found at 750 to 900 feet. The Company can drill on the offset of a present producing oil and gas well just three hundred and fifty feet to its west for an expenditure of approximately $9,000. This shallow well should yield about 15 barrels per day, similar to the nearby producing well, although there is no assurance that it will do so."

26. The Division contends that the above language was misleading for several reasons. Firstly, it asserts through the testimony of Mr. White, the use of the word "structure" in relation to oil properties indicates a geological condition "favorable for the accumulation of oil and gas in paying quantities." The Division disputes the existence of a structure and contends that a map of the land, filed as part of the

offering, supports this position.[8/] Further, the Division contends, any accumulations of oil on the leased land are, in any event, stratigraphic rather than structural accumulations, and the use of the term "structure" was therefore misleading.[9/]

27. In contradiction of Mr. White's testimony that the leased land does not appear to be on a structure, Mr. Marbry testified without objection to the effect that the leased land is "classified as a structure by the U.S.G.S.[10/] and it is also on Petroleum Information's map as a structure, and in Rinehart Oil Reports it is classified as a structure, anticline." In light of this testimony, the Examiner finds that the leased land is located on a structure.

8/ Mr. White testified that he would call it a "partial structure map", indicating that "There's always structure everywhere", but that this is not a true structure as the term is used in the industry.

9/ The important fact, of course, is that a structural accumulation is more interesting to the prospective investor than is a stratigraphic accumulation. Perhaps the terms may be somewhat clarified for the non-geologist layman by the following classifications:

> "A structural trap is one whose upper boundary has been made concave, as viewed from below, by some local deformation, such as folding, or faulting, or both, of the reservoir rock. . . .
>
> "A stratigraphic trap is one in which the chief trap-making element is some variation in the stratigraphy or lithology, or both, of the reservoir rock such as a facies change, variable local porosity and permeability, or an upstructure termination of the reservoir or rock, irrespective of the cause. . . ."

Levorson, Geology of Petroleum, 142 (1954).

10/ United States Geological Survey.

28. However, there was no effective refutation of the testimony of Mr. White that the accumulations of oil in the leased area are stratigraphic rather than structural.[11/] His analysis of the map indicated that the known accumulations were neither the result of nor influenced by structural conditions, but were dependent upon sand conditions at depths which could not be determined except by drilling. Conversely, if the accumulations were structural, the contours of a map would indicate with reasonable certainty the probability of additional accumulations and there is, therefore, a substantial difference between the commercial potential of structural accumulations and stratigraphic accumulations.[12/] Accordingly, the Examiner finds that the offering circular was deficient and misleading in suggesting that the accumulations of oil were structural and in failing to reveal that they were, in fact, stratigraphic.

29. The Division further urges that the offering circular was also deficient in suggesting, without any basis or reasons appearing therein, that a shallow off-set well should yield about 15 barrels

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11/ Mr. Marbry testified that a Mr. V. J. Hendrickson wrote the geology of this structure "in the April 1937 issue of The Mines Magazine, or Mines Book that was put out by the Colorado School of Mines." Although the Examiner accepts this as additional testimony supporting respondent's contention that the leased land is on a structure, it is not convincing refutation of Mr. White's conclusion that in any event the accumulations thereon are stratigraphic rather than structural.

12/ Cf. Levorsen, Geology of Petroleum, 187 (1954): "Structural mapping of all kinds has been the most consistently successful method of locating traps."

a day. The Examiner is not unaware of the caveat included in the above-quoted language of the offering circular to the effect that "there is no assurance that it will do so", but agrees with the Division that absent some statement of the history of the nearby well or further detail and information with respect to the 15 barrels a day allegedly being produced by it, there was no sufficient basis for the suggestion in the offering circular of a 15 barrel daily yield. Cf. Magnolia-Metropolitan Life Tracts, 1 S.E.C. 866 (1936).

30. In addition, the Division contends that further language in the offering circular indicating that this Colorado lease has possibilities of production from deeper wells in certain specified areas of the 2,080 acres was misleading because it omitted to state that the issuer had no intention of drilling to such zones in the foreseeable future. The Examiner agrees that such statement would have been appropriate, but does not believe that the failure to so state was, under all the circumstances, an omission of material facts necessary to be made. It is noted that the statement of use of proceeds includes the item of $9,000 for drilling the shallow off-set well, but includes no item of expense for deeper drilling. It appears that a fair reading of the offering circular indicates that such deep drilling was not in contemplation in the reasonably foreseeable future and no express statement to that effect appears to have been required in order to make the discussion of the deeper well possibilities not misleading.

D. <u>The Unproven Oil Lease in Utah</u>

31. The offering circular states that the issuer owns a one-half interest in a lease of 1,200 acres in Kane County, Utah, and represents that:

> "This acreage is located on the west flank of the north end of the Kaibab. For wildcat acreage it is well located geologically in the structure."

32. The Examiner agrees with the Division's assertion that this description, even of wildcat acreage, is inadequate. It appears that respondent holds out the acreage as having prospects of value as oil property but presents no supporting data of any kind. The bare mention of a lease, with no indication of the length of time it has to run or any other conditions, affords no basis for a prospective investor to evaluate the potential of the property but permits the optimist to accord to it a value beyond that which exists or that which the issuer considers fair. Accordingly, the Examiner concludes that the offering circular was deficient in failing to state material facts regarding this Utah lease and supporting the asserted good location of the acreage.

33. The significance of the deficiency is mitigated by the description of the land as wildcat acreage, by the fact that no moneys were allocated from the proceeds of the offering for development of the acreage, and by the fact that this property obviously is a relatively unimportant part of the presentation.

E. Charges with Respect to the Five Unproven Oil Leases in Wyoming

34. Part of the property subject to acquisition by the issuer by payment of $50,000 and the exercise of the option from Manhattan was described in the offering circular as:

> "5 unproven Oil and Gas leases, consisting of approximately 1,634 acres in Natrona, Freemont, Converse and Weston Counties, Wyoming."

No information whatever was furnished concerning these leases. The offering was deficient in this respect even though no express representation was made that this property has potential as oil property, or that respondent intends to develop or exploit it, or to use any part of the proceeds on the property. Cf. Mon-O-Co Oil Corporation, supra, where the Commission said that a reference in a registration statement to a property as "undeveloped" should be accompanied by geological information or by a statement that no such information is available.

F. Respondent's Beryl Mining Claims: Representations in the Offering Circular and in the Geologist's Report

35. On June 1, 1962, respondent acquired from its President and promoter, L. N. Marbry, six unpatented mining claims in Colorado, known as Marbry Lode Claims No. 1 through No. 6. Harlow H. Loomis, Jr. had prepared a geological report on these claims for Mr. Marbry in 1957. A copy of this report, which is undated, was filed as an exhibit to the notification.

36. The offering circular stated that respondent intends to expend from the proceeds of the offering the sum of $40,000 to purchase equipment and to commence operations for mining beryl on the claims.

37. Much of the material in the offering circular concerning these mining claims was drawn or quoted from the Loomis report. The Division contends that certain statements in the offering circular and additional statements in the Loomis report are inaccurate and misleading, as indicated below.

38. The offering circular represents that there are 14 pegmatite dikes on the claims and that beryl occurs as an accessory mineral in pegmatites. It also states:

> "One highly interesting aspect of the Marbry Claims was the amount of beryl found as float on the downhill side of the dikes. The crystals found ranged in size from ½ inch to 2 inches in diameter and up to 4 inches in length. In order to determine the linear extent of the ore-bearing beryl, an exploratory phase of the operation was commenced somewhere toward the middle of the dike where there was no outer evidence of beryl content. An area of about 60 square feet was drilled with shot holes and blasted. Although the blast only penetrated to a depth of about three feet, beryl crystals ranging in size from ½ inch to 2 inches in diameter and several inches long were found among the rock debris.
>
> "A quantitative chemical analysis was made of the beryl to determine the percentage of beryllium oxide present. Two samples were taken, one which contained very little beryl that could be seen with the naked eye, and the other with obvious beryl crystals through-out. The analysis indicated 0.6% and 8.1% BeO respectively, with the average of the two samples being approximately 4.3% BeO.
>
> "A beryllium processing chemical plant, The Mineral Concentrates and Chemical Co., is now in operation in Loveland, Colorado, about 15 miles from the Company's mines. The chemical plant is buying beryl crystals at the present time and its President informed the Company it would enter into a contract with the Company if assured that the Company's mining operations were amply financed to set up an operation that would keep the chemical plant steadily supplied with ore.

> "The Company intends to commence operations by a hand-cobbing process to separate the crystals and high grade the ore. It is estimated that to mine and hand-cob the ore would run approximately $50 per ton and transportation costs to the Loveland mill would be about $2.50 per ton. The present market price for the ore with a 4% BeO (beryl oxide) content is approximately $215 per ton, although there is no assurance that the ore mined by the Company will average 4% BeO." . . .

39. All of the above representations in the offering circular were taken from the Loomis report, except those relating to the processing plant.

40. The Division's expert witness, Hubert W. Norman, a mining engineer employed by the Commission, testified at length regarding alleged inaccuracies and misleading representations in the above-quoted statements of the offering circular and similar and additional deficiencies in the Loomis report filed as an exhibit to the notification.

41. The Examiner credits the following testimony of Mr. Norman reflecting omissions, inaccuracies and misleading statements in the offering circular. Firstly, the discussion of beryl found as float on the down-hill side of the dikes and its characterization as "a highly interesting aspect of the Marbry Claims" was misleading, absent further explanation of the material fact that the amount of beryl found as float bears no direct relationship to the amount of beryl presently in the dike. ("Float" is defined as decomposed or fractured material that has broken away from a pegmatite formation and has been scattered at lower levels through gravity.) Nor was any quantitative information given to support the implication that the beryl content is commercially favorable.

Secondly, inasmuch as beryl does not occur as a continuous mass throughout a pegmatite dike but is sporadically dispersed, the testing of an area of 60 square feet, as described, "is entirely inadequate to be representative of the entire dike."[13/] Nor was there indicated any adequate basis for the conclusion that the beryllium oxide content of the beryl in the dike which was tested actually averaged 4.3%. On the contrary, the samplings were an entirely inadequate basis for such representation. But further, and equally important, there was no basis for the suggestion that beryl with 4.3% BeO can be sold or used commercially. On the contrary, Mr. Norman testified that beryl can be sold only if it contains 10% BeO; that both the 0.6% and the 8.1% content of the two samples tested are too low to support the commercial sale of beryl.[14/]

42. As indicated above, beryl is sold commercially and priced according to its BeO content. In its perfect or pure state beryl contains 14% BeO. It is seldom found in pure state, and beryl with 10 to 12% BeO is relatively high grade. Under a Federal government purchasing program formulated to encourage the domestic mining of beryl, the industry

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13/ The size of the dike was indicated as approximately 25 feet in width and 850 feet in length, and also as containing an estimated 50,000 tons of rock.

14/ The offering circular appears to suggest that the BeO content was to be increased by the milling process at the plant at Loveland, Colorado, as a basis for commercial sale. If so, the offering circular was utterly deficient and inept in its statement. (No testimony was given regarding such plan or its alleged feasibility. But assuming that a mill could use beryl containing an average of only 4.3% BeO, it would be necessary to process almost twice as much beryl, by getting rid of the rock and other minerals, to up-grade it to 10% BeO content, as it would use if it were processing 8% beryl.)

or commercial standards for minimum BeO content of 10 to 12% were relaxed and lowered to 8% for Government purchases. However, the program terminated on June 30, 1962, several weeks prior to the filing of the notification. 15/

43. The Division also asserts that there was no sufficient basis for the use of the term "ore" in the offering circular; that in using this term and in other respects respondent violated the disclosure requirements of Item 8A of Schedule I, Form 1-A.

44. Item 8A(b) of Schedule I provides that:

> "No claim shall be made as to the existence of a body of ore unless it has been sufficiently tested to be properly classified as 'proven' or 'probable ore' as defined below."

Item 8A(c) thereafter contains the following definition:

> "The term 'proven ore' means a body of ore so extensively sampled that the risk of failure in continuity of the ore in such body is reduced to a minimum. The term 'probable ore' means ore as to which the risk of failure in continuity is greater than for proven ore, but as to which there is sufficient warrant for assuming continuity of the ore."

45. The Examiner credits the testimony and conclusions of Mr. Norman that there was no justification for the representation in the offering circular concerning the existence of beryl ore, inasmuch as the

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15/ Although he was not requested to do so, the Examiner has taken official notice of the fact that it may not have been common knowledge that the Government's purchase program terminated in June 1962. The 1963 Ore Buyers' Guide, published by Mining World, carried a notation to the effect that beryl is purchased at Government buying depots. And the August 1962 issue of Mining World continued to publish, as current, the prices previously payable at these depots, apparently unaware of the termination of the program.

testing was inadequate basis on which to predicate an assumption of continuity of the beryl in any of the dikes. Cf. Gold Dust Mining & Milling Co., 3 S.E.C. 55 (1938).

46. The above deficiencies existed in the Loomis report as well as in the offering circular. Actually, the above-quoted statements from the offering circular were more enthusiastically and less guardedly expressed in the report.[16/] In addition, the Loomis report states that:

> "It is generally accepted that the beryl deposits are not continuous through-out the dikes. However, based on visual inspection and the work already completed, it would be safe to assume that 25% of the dike contains beryl ore. It is estimated that the dike in question contains approximately 50,000 tons of rock.
>
> "Using the 25% figure, this would result in 12,500 tons of mineable ore, and at $215 per ton (which is approximately what 4.3% BeO would bring) a possible yield out of this ore dike alone would be in the neighborhood of two and three-fourths (2-3/4) million dollars. The above figures, are of course, rough estimates but they do tend to point up the tremendous potential of the beryl mining industry."

47. Mr. Norman testified that the estimate that the dike contains 50,000 tons of beryl ore and the assumption that 25% of such ore consists of beryl, made as they were by visual observation from the surface and with inadequate testing and sampling, were unwarranted. His testimony is credited by the Examiner.

16/ For example, the discussion of beryl float indicated to Loomis "the possibilities of vast tonnage of beryl-rich ores."

48. Further, the valuation expressed in the above-quoted language assumed a price of $50 per short ton unit of beryllium oxide. A short ton unit is equivalent to 1% of 2,000 pounds or 20 pounds. By evaluating beryl with a 4.3% BeO content at $50 per short ton unit, the geologist arrived at the conclusion that the beryl was saleable at a price of $215 per ton. ($50.00 x 4.3 = $215) The Examiner credits the testimony of Mr. Norman that this figure was entirely unrealistic at the time of the filing in August 1962, even apart from the fact that 4.3% beryl was not saleable. The value of beryl with substantially higher BeO content, i.e., 10 to 12%, was much less than $50 per short ton unit at the time of filing of the notification.

49. Testimony was given by Mr. Marbry to the effect that the 1957 report of Mr. Loomis had been up-dated in 1961.[17/] However, no details regarding such up-dating were presented. The Examiner concludes that the dollar values and other figures in the Loomis report and used in the offering circular were outdated and inaccurate in the manner indicated above. The use of such figures in the offering circular filed in 1962 was unwarranted. (This is not to suggest that the figures were accurate as of the time the Loomis report was written in 1957. The indications throughout the testimony are to the contrary.)

17/ The Examiner rejects respondent's contention that inasmuch as Mr. Marbry so testified while a witness for the Division, the latter cannot impeach or contradict it. See Schoenberg v. Commissioner of Internal Revenue, 302 F. 2d 416 (C.A. 8, 1962), where the Court stated:

> "A court is not compelled to believe the testimony of a witness even if it is not contradicted by direct evidence. This is particularly true with regard to an interested witness."

Cf. also, United States v. Freeman, 302 F. 2d 347 (C.A. 2, 1962).

III. CONCLUSIONS OF LAW

From the above the Hearing Examiner concludes that:

1. Because of the deficiencies in the offering circular, consisting of untrue statements of material facts and omissions of other material facts relating particularly to:

> the overstatements of the primary and secondary reserves of the Crest-Gulf wells;
>
> the description of the semi-proven leased land in Colorado, the accumulations of oil thereon and the potential of the land for the production of oil;
>
> the description of the lease of unproven wildcat acreage in Utah, and the unproven leases in Wyoming;
>
> the description of the Marbry mining claims and their potential as a source of the profitable production of beryllium,

the offering was being made in violation of the requirements of the Act and Regulation A thereunder.

2. With respect to the mining claims, the offering circular was deficient not only for its untrue statements and its omission to state material facts with respect to the statements made therein, but also for its failure to state material facts necessary to correct the inaccurate and misleading statements in the geologist's report filed as part of the notification. *Cf*. *Big Wedge Gold Mining Company*, 1 S.E.C. 98 (1935); *Poulin Mining Company Limited*, 8 S.E.C. 116 (1940).

3. The offering failed to comply with the terms and conditions of Regulation A, and particularly with the requirements of Item 8A, Schedule I, Form 1-A of the Regulation, with respect to the mining properties. If made, the offering would have contravened the Regulation.

4. The offering would be made in violation of Section 17(a) of the Act, because of the false and misleading statements and the omissions of material facts as indicated above, and that such offering would operate as a fraud or deceit on purchasers of the stock.[18/]

IV. RECOMMENDATION

As indicated in footnote 1, page 2, _supra_, Rule 261 provides for the issuance of an order temporarily suspending a Regulation A exemption if the terms of the Regulation have not been complied with, or the offering circular contains untrue statements of a material fact or omits to state a material fact, or if the offering is being made in violation of Section 17(a) of the Act. Rule 261 also provides that the Commission, after opportunity for hearing, may enter an order permanently suspending the exemption for any reason upon which it could have entered a temporary

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18/ Section 17(a) of the Act makes unlawful the use of the mails or facilities of interstate commerce to offer or sell a security by means of a device, scheme, or artifice to defraud, by a false or misleading statement of a material fact, or by a transaction, practice, or course of business which operates as a fraud or deceit on the purchaser.

No question has been raised regarding the use of mails or facilities of interstate commerce although no proof was adduced of the use or specific intent to use these means in connection with the offer or sale of the stock. The Examiner concludes that the filing of the offering is itself some indication of the intent to use these means, and that in any event an inference of such intent is clearly warranted by the facts and circumstances. _Cf._ _National Labor Relations Board_ v. _United Aircraft Corporation, Pratt and Whitney Aircraft Division_, 324 F. 2d 128 (1963).

suspension order.[19/] An order of the Commission making permanent the suspension of the exemption clearly can be supported by the facts found and the conclusions reached herein.

In requesting authorization for withdrawal of the offering, respondent obviously recognizes that under the circumstances here present there is no absolute right of withdrawal, even though none of the securities have been sold and no literature pertaining to the offering has been distributed.[20/] The request, therefore, is directed to the discretion of the Commission. Although the Examiner does not believe the record establishes a deliberate attempt by respondent to misrepresent the nature or the potential of its properties or to conceal facts or considerations important to the evaluation of the securities, he finds such serious inaccuracies in the offering circular and such careless disregard of the requirements of the Act and of Regulation A that he is unable to recommend to the Commission that the request for authorization to withdraw the offering be granted.

19/ Rule 261(c) provides:

> "The Commission may at any time after notice of and opportunity for hearing, enter an order permanently suspending the exemption for any reason upon which it could have entered a temporary suspension order under paragraph (a) of this rule. Any such order shall remain in effect until vacated by the Commission."

20/ Rule 255(e) provides in part:

> "A notification or any exhibit or other document filed as part thereof may be withdrawn upon application unless the notification is subject to an order under Rule 261 at the time the application is filed or becomes subject to such order within 15 days. . . ."

The Examiner has attempted herein to indicate those mitigating factors which appear to support the request for withdrawal of the offering. He recognizes that although the record does not expressly reflect it, respondent may have relied in good faith on the two Loomis reports from which the more serious deficiencies in the offering circular stemmed. He also recognizes that the offering circular was prepared by an attorney and the geological reports by a consulting geologist and that to this extent respondent appears to have relied upon what it considered expert advice in its efforts to obtain a Regulation A exemption. Cf. Illowata Oil Co., 38 S.E.C. 720 (1958). But the Examiner is unable to find in the record the "clear showing of good faith and of other mitigating circumstances in connection with the deficiencies" which apparently motivated the Commission to grant the request for withdrawal of a Regulation A offering in Illowata Oil. The Commission's decisions in National Land Company of Arizona, et al., 39 S.E.C. 792 (1960) and San Miguel Uranium Mines, Inc., Securities Act Release No. 3538, (April 4, 1955), cited by respondent in support of the argument that withdrawal should be permitted, are less in point that are those in Mon-O-Co, supra, and Inspiration Lead Company, Inc., 39 S.E.C. 108 (1959), where the Commission denied similar requests. Cf. also, the recent decision in General Aeromation, Inc., Securities Act Release No. 4536 (September 19, 1962), where the Commission considered a request to amend a Regulation A filing, as to which the issuer asserted it had acted in good faith without intent to deceive or defraud. There

the Commission stated, at page 8:

> "While we have, upon a showing of good faith and other mitigating circumstances, permitted withdrawal or amendment of deficient filing after commencement of suspension proceedings in certain limited situations, we have emphasized that a careful and honest preparation is an absolute prerequisite to the exercise of our discretion in this area. We cannot countenance a practice of deliberate or even irresponsible submission of inadequate material by permitting the correction of deficiencies found by our staff in the examination of such material [citing Aetna Oil Dev. Co., Inc., Securities Act Release No. 4398 (July 20, 1961)]."

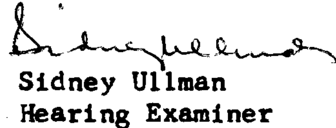
In view of the number and the serious nature of the deficiencies found, it does not appear that a sufficiently diligent or careful effort was made by respondent to present an accurate and adequate filing. Cf. General Aeromation, supra.[21/]

21/ Respondent has also urged in its brief, as did the issuer in General Aeromation, that it should have been afforded an opportunity to correct the deficiencies before the institution of these proceedings. The record in this case contains no evidence regarding the correspondence which took place between respondent and the Regional Office, but in any event the Commission has disposed of this argument as support for a request for withdrawal in Mutual Employees Trademart, Inc., 40 S.E.C. 128, 130 (1960), where it stated:

> "Nor do we find any substance in Trademart's complaint that it was not given a deficiency letter. Our informal procedure described in 17 CFR 202.3 states that while it is 'the usual practice' to bring deficiencies to the attention of the issuer and to afford a reasonable opportunity to discuss the matter and make the necessary corrections, such procedure 'is not generally employed where the deficiencies appear to stem from a deliberate attempt to conceal or mislead or where, for any other reason, the Commission deems formal proceedings necessary in the public interest.' "

Accordingly, the Hearing Examiner recommends that pursuant to Rule 261 of Regulation A the Commission enter an order permanently suspending the exemption.22/

Respectfully submitted,



Sidney Ullman
Hearing Examiner

Washington, D. C.
April 22, 1964

22/ 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.