

IN THE MATTER OF

RICHARD J. BUCK & CO., ET AL.\*

*File No. 3-417. Promulgated December 31, 1968*

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

**BROKER-DEALER PROCEEDINGS**

**Grounds for Remedial Action**

**Fraud in Offer and Sale of Securities**

**Confirmation of Unauthorized Transaction**

**Inadequate Supervision**

**Withdrawal from Registration**

Where branch managers and salesmen of registered broker-dealer, in offer and sale of speculative security, made fraudulent representations and predictions concerning issuer's earnings, products, patents and contracts, future market price of stock, and possible mergers and acquisitions, and one branch manager sent confirmation of sale to person who had not agreed to purchase, in willful violation of anti-fraud provisions of securities acts, and broker-dealer failed to exercise reasonable supervision to prevent such violations but thereafter ceased doing business and requested withdrawal of registration, *held*, appropriate in public interest, among other things, to bar branch managers and salesmen from association with any broker or dealer and to censure broker-dealer and permit withdrawal.

**Sale of Broker-Dealer's Assets**

Where registered broker-dealer respondent, charged with failure to exercise adequate supervision to prevent and detect violations of securities acts by personnel in two branch offices, sold all of its tangible assets to another registered broker-dealer prior to issuance of hearing examiner's initial decision and ceased doing business, *held*, suspension of those branch offices unwarranted under circumstances.

**Practice and Procedure**

Contentions by respondents that they were prejudiced by staff's conduct of investigation assertedly lulling them into belief that proceedings would not be instituted, by staff counsel's references at hearings to certain injunctive proceedings and to invocation of privilege against self-incrimination by person

\* Arthur Gladstone, Charles Arthur Fehr, Mortimer W. Henly, Frederick C. Stutzmann, Jr., and Steve Charles Paras.

not named as party or called as witness, and by admission in evidence of disciplinary action taken against one respondent by national securities exchange, rejected.

APPEARANCES:

*Joseph C. Daley, Roberta S. Karmel, Claire S. Meadow, and Bruce A. Rich*, of the New York Regional Office of the Commission, for the Division of Trading and Markets.

*Robert R. Thornton and Robert Thomajan*, of Nixon, Mudge, Rose, Guthrie, Alexander & Mitchell, for Richard J. Buck & Co.

*Andrew N. Grass, Jr. and Charles M. Taylor*, of Windels, Meritt & Ingraham, for Arthur Gladstone and Frederick C. Stutzmann, Jr.

*Harold I. Geringer*, of Lian & Geringer, for Charles Arthur Fehr.

*James C. Sargent, Robert S. Newman, and Michael Heitner*, of Lowenstein, Pitcher, Hotchkiss & Parr, for Mortimer W. Hanly.

*Thomas A. Harnett*, of Harnett, Reid & Brown, for Steve Charles Paras.

FINDINGS AND OPINION OF THE COMMISSION

Following extensive hearings in these private proceedings pursuant to Sections 15(b), 15A and 19(a) (3) of the Securities Exchange Act of 1934 ("Exchange Act"), the hearing examiner filed an initial decision in which he concluded that Richard J. Buck & Co. ("registrant"), a partnership registered as a broker-dealer, should be suspended from membership on the New York and American Stock Exchanges for 10 days, and in the National Association of Securities Dealers, Inc. ("NASD") for 45 days, and that its requested withdrawal from registration should then be permitted. He further concluded that certain sanctions should be imposed upon Arthur Gladstone and Charles Arthur Fehr, who were co-managers of registrant's Forest Hills, N.Y., branch office, Mortimer W. Hanly, who was manager of registrant's Hemnstead, N.Y., office, and Frederick C. Stutzmann, Jr. and Steve Charles Paras, who were salesmen in the Hempstead office. We granted petitions of respondents and our Division of Trading and Markets ("Division") for review of the initial decision as to certain issues, and, pursuant to Rule 17 CFR 201.17(C) of our Rules of Practice, ordered review of the initial decision with respect to all issues involved in the proceedings. Briefs were filed and we heard oral argument. Our findings are based upon an independent review of the record.

## VIOLATIONS IN OFFER AND SALE OF SECURITIES

Between September 1962 and August 1963, Gladstone, Fehr, Hanly, Stutzmann, and Paras willfully violated anti-fraud provisions of Section 17(a) of the Securities Act of 1933 and Section 19(b) of the Exchange Act and Rule 17 CFR 240.10b-5 thereunder in the offer and sale of stock of U.S. Sonics Corporation ("Sonics"), and between January and August 1963, while they were in registrant's employ, registrant failed reasonably to supervise them with a view to preventing and detecting such violations.

*Sonics*

Sonics, which was engaged in the production and sale of electronic devices, did not have a net profit in any year except 1958 when it was organized. It sustained a net loss of \$854,226 in 1961, and had an accumulated deficit of \$1,047,273 as of December 31, 1961. In 1962, 80 to 85 percent of Sonics' production was of hydrophones, which are underwater listening devices, for the United States Navy. During the same year, the president of Sonics concluded that the company had satisfactory technologies for mass-producing a type of ceramic filter which had been under development since 1960 and was intended to replace the conventional type used in radio circuits. However, because of the substantial funds that would be required for purchasing machinery to manufacture the filter and for perfecting production techniques, Sonics decided to grant production licenses to foreign and domestic companies on a royalty basis. In 1962 it licensed a Japanese and a West German firm, each of which made an initial payment of \$25,000, and began discussions with several prospective domestic licensees, including Texas Instruments, Incorporated. In that year, Sonics sustained a net loss of \$671,944, and its accumulated deficit increased to \$1,719,217.

Sonics' condition deteriorated rapidly during 1963. General Instrument Corporation, which expressed considerable interest in Sonics' filter during February and early March, decided that the filter was not patentable and involved cost problems and advised the company on March 20 that it did not wish a license.<sup>1</sup> It also declined to manufacture filters for Sonics, advising Sonics on May 3 that discussions respecting such manufacture were being terminated because it considered that the filter did not meet the stated specifications. Texas Instruments, which had appeared in-

---

<sup>1</sup> Sonics had filed a number of applications for a patent with respect to the ceramic filter. However, none had been issued in the United States as of March 1963, and it appears that the first one was issued in this country in March 1965. Sonics' president testified that he thought patents were issued to Sonics by three or four foreign governments in 1963.

terested in a licensing agreement during late 1962 and early 1963, terminated negotiations on July 29, 1963 after concluding that Sonics' filter would not be sufficiently competitive and that any production by it might result in the infringement of patents of others. An automobile radio manufacturer which placed an order for 1,000,000 filters at 31 cents each, subject to a testing of the filters, cancelled the order after the tests showed that the filters did not meet its specifications and was of low quality. The filter also was tested by at least three other large companies with negative results. Further, the agreement with the Japanese concern never obtained the required approval of the Japanese government, and no additional royalties were received from the West German company. Sonics licensed an Argentine company in June 1963, and its initial payment of \$50,000 and a small payment thereafter were the only royalties received. In addition, because of a reduction in Navy requirements, anticipated orders for the hydrophones were not forthcoming. And although new devices were being developed by Sonics, they were not generating substantial revenues. Sonics suffered a net loss of \$327,720 in the first half of 1963, which increased its accumulated deficit to \$2,046,937. Beginning in the spring of 1963, Sonics sought relief from its rising deficit and an increasingly precarious working capital position through a merger with or acquisition by another company. Discussions were held with General Instrument, Texas Instruments, and other large concerns. However, apparently due in large part to a continuing decline in the price of Sonics stock not even a tentative agreement was negotiated.<sup>2</sup> Despite loans by banks and one of Sonics' principal backers,<sup>3</sup> bankruptcy proceedings were instituted against Sonics on December 6, and it was adjudicated a bankrupt on December 27, 1963.

*False and Misleading Statements by Individual Respondents*

Before the individual respondents joined registrant in early 1963, they were or had been employed in various offices of another securities firm, of which one A. R. was sales manager. Gladstone and Paras had first heard of Sonics in September 1962 during a casual conversation with A. R. In substance, he told them that Sonics and another company, whose stock he had previously recommended and subsequently had had a dramatic rise in price, had

<sup>2</sup> Published bids ranged from between 5% and 8% during January-March 1962 to a low of 4½ in April 1963 following announcement of Sonics' 1962 loss and to 3 in May, June and July 1963. Thereafter the bids decreased to a low of 1 in August and never rose above 1% thereafter.

<sup>3</sup> On August 12, 1963, Sonics assigned its rights under the foreign licensing agreements and its patent applications to that person in consideration of certain advances.

a common director and equally good management, that Sonics produced sonar devices and had a ceramic filter designed to replace the conventional type which a Japanese firm would be licensed to produce, and that Sonics had large research and development expenses and, while it had shown profits from time to time on a monthly "or maybe a quarterly basis," it had never shown a year-end profit. Paras testified that he also learned that Sonics was "losing money right along." Shortly thereafter, and on the basis of this conversation, Gladstone represented to a customer, who purchased 300 shares at  $8\frac{3}{4}$ , that Sonics was "a winner" and had "fabulous potential," that the price of its stock should double or triple within two or three months, and that a Japanese licensing agreement would be "worth \$15 on a share." Paras told a customer, who purchased 100 shares at  $8\frac{1}{2}$ , that the price of the stock would double in 2 to 4 weeks. Paras also told the customer that Sonics had negotiated a contract with Texas Instruments and that when the contract was signed the "stock would go." Neither Gladstone nor Paras disclosed the adverse facts with respect to Sonics' financial condition.<sup>4</sup>

In January 1963 A. R. told Gladstone that Sonics might license a domestic company to produce its filter, and suggested that he contact one of Sonics' principals. Gladstone then spoke to Sonics' treasurer, who told him that Sonics had licensed or was about to grant a license to a European firm, would market a safety alarm device for swimming pools, and, although it did not expect any earnings for 1962, it anticipated an improvement in sales and earnings in the near future. During the same month, A. R. furnished Gladstone with a copy of what he claimed to be a "confidential" study of Sonics prepared by a competent financial analyst.<sup>5</sup> The report, which was written about October 1962, stated that Sonics had sales of \$375,000 from January to June 1962 and projected an increase to \$685,000 and a profit of \$100,000 during the second half of that year.<sup>6</sup> It also stated that management anticipated 200 percent annual increase in sales in 1963 and 1964, and predicted earnings of at least \$1.50 per share in 1963. At a meeting in early February 1963 attended by Gladstone, Fehr and A. R., Sonics' president confirmed most of the statements in the report and told those present of Sonics' losses.

<sup>4</sup> In 1962, Gladstone sold a total of 1,000 shares of Sonics stock to six customers, and Paras a total of 1,000 shares to two customers.

<sup>5</sup> According to Gladstone, A. R. had removed the first page to conceal the identity of the author, and the record does not disclose by whom the report had been prepared. Sonics' president testified that he had never seen it.

<sup>6</sup> Actual 1962 sales were \$459,694, and, as previously mentioned, Sonics sustained a net loss of \$871,944 in that year.

In addition, he produced correspondence respecting licensing negotiations with Texas Instruments and other firms that indicated they had some interest in Sonics' filter. In March 1963, A. R. advised Gladstone that license negotiations were being conducted with General Instrument, and Gladstone and Fehr subsequently learned that Sonics was making efforts to merge with or be acquired by another firm.

Beginning in February 1963, Gladstone, who was now employed by registrant as a branch office co-manager, variously represented to 11 customers, who purchased a total of 9,600 shares of Sonics stock at  $3\frac{7}{8}$  to  $7\frac{3}{4}$ , that the stock had "possibilities of skyrocketing," and would go "sky high" and "make Xerox look like a standstill." In addition, he predicted that the price of the stock would rise to about 12 (from a price at the time of  $6\frac{3}{8}$ ) in a week or two, would rise 15 or 18 points (from  $5\frac{3}{8}$ ) in the near future, and, when the stock was selling at  $7\frac{7}{8}$ , would probably double within six months to a year. He also told a customer that Sonics had earned \$1 per share during the preceding year and informed others that it would earn \$1 or more in the current year. Further, Gladstone stated that Sonics had made a "fantastic" technological breakthrough, that it had a device that would "revolutionize the space age industry," that other companies would "run after" its patents, and that it had valuable agreements licensing foreign firms to produce its products. He also represented that Sonics had signed a contract with General Instrument and had a verbal agreement with Texas Instruments which would be put in writing in the near future, and that American Motors was field testing one of Sonics' products and was "very anxious to have it." In addition, Gladstone stated that Sonics was "in the throes of a merger" with a big electronics company and that there was talk that it would be acquired by a subsidiary of General Motors or American Motors. Gladstone also claimed that he owned Sonics stock himself and would be able to retire on it. When the price of the stock declined between April and June 1963, Gladstone told customers that such decline was attributable to sales or the "dumping" of such stock by the wife of Sonics' president because of marital difficulties.<sup>7</sup> Gladstone failed to disclose Sonics' poor financial history, of which he admittedly was aware, to most of the customers to whom he recommended the stock.

In May 1963, Gladstone sent a confirmation of a sale of 500 shares of Sonics stock to a customer who had not placed an order

<sup>7</sup> The president's wife, who with her husband had organized Sonics and served as vice president, obtained a divorce in March or April 1963 and resigned at the end of May 1963.

for such stock. The confirmation was fraudulent in representing that a sale had been made.<sup>8</sup>

Fehr, in recommending the stock to a customer who purchased 200 shares at 8 in March 1963, failed to disclose Sonics' unfavorable financial condition. In addition, between March and May 1963, Fehr advised a customer, who was concerned about the decline in the price of the stock which he had purchased following representations by Gladstone, that he thought the stock was "good," having bought shares for himself or his family, and that he considered the decline only "temporary." It does not appear that Fehr made any disclosure of the adverse facts which were clearly material to an investment decision.

After the individual respondents had joined registrant in early 1963, Gladstone and Fehr conveyed information concerning Sonics, including the fact that Sonics had suffered losses and was in poor financial condition, to Hanly, Stutzmann and Paras, who knew that Gladstone and Fehr had been in touch with Sonics.<sup>9</sup> In addition, a copy of the report furnished by A. R. was examined by Stutzmann and Paras. Following the receipt of such information, Hanly, Paras and, later, Stutzmann made various representations to customers.

Hanly told a customer who purchased 300 shares at  $8\frac{3}{8}$  on March 1, 1963 that Sonics had "a new type of invention that would rock the world," that it would merge with another company in the near future, and that the price of its stock would rise to 12 or 15 in a short time. Hanly did not disclose Sonics' financial condition to this customer or to another customer who, pursuant to his recommendation, purchased 100 shares at  $8\frac{3}{8}$  on the same date.

Paras represented to three customers who purchased a total of 400 shares at  $7\frac{7}{8}$  to  $8\frac{5}{8}$  in March 1963 that the price would double in four to six months or rise 10 or 15 points, and that Texas Instruments might acquire Sonics. He also told the customers that he had purchased Sonics stock for himself and members of his family. None of the three customers was informed of Sonics' financial condition.

Five customers, who purchased a total of 3,000 shares of Sonics stock at prices ranging from  $1\frac{3}{4}$  to  $5\frac{1}{2}$  between May and August 1963, testified concerning representations made to them by Stutzmann. He stated that Sonics might be a "hot prospect," predicted

<sup>8</sup> See *R. A. Holman & Co., Inc. v. S.E.C.*, 366 F.2d 446, 451 (C.A. 2, 1966), *aff'd R. A. Holman & Co., Inc.*, 42 S.E.C. 866, 876 (1965); *Shelly Roberts & Company of California*, 38 S.E.C. 744, 751 (1953).

<sup>9</sup> The record shows that Hanly and Stutzmann were told that Sonics had sustained a loss of \$600,000 in 1962.

that the price of its stock should rise to 15 (from  $4\frac{1}{2}$ ) within a year and, when the stock was selling at  $5\frac{1}{8}$ , should double within six months, and compared such stock with securities of a company that had increased rapidly in price in a short time. Stutzmann also advised a customer that Sonics' earnings had not been good but would become "very bright" as a result of royalty payments by its Japanese and West German licensees and that Sonics would transact business with Texas Instruments. In addition, he told a customer that he was going to purchase Sonics stock "himself" and represented to another that he had made such a purchase at about 9. Stutzmann did not disclose Sonics' financial condition to any of the five customer-witnesses.

The individual respondents' factual or optimistic representations were materially false or misleading. Affirmatively false were Gladstone's representations that Sonics had earned \$1 per share in 1962, had signed a contract with General Instrument and had a verbal agreement with Texas Instruments which would be reduced to writing in the near future, and that American Motors was field-testing one of Sonics' products; Paras' representation that Sonics had negotiated a contract with Texas Instruments; and the representations of Gladstone, Paras and Stutzmann that they had purchased stock for themselves or their families.<sup>10</sup>

Essentially, however, the fraud in this case consisted of the optimistic representations or the recommendations previously recited without disclosure of known or reasonably ascertainable adverse information which rendered them materially misleading.<sup>11</sup> Thus, in connection with the optimistic or favorable representations or recommendations, the respondents who made them were under a duty to disclose the known or then reasonably ascertainable facts with respect to Sonics' deteriorating financial condition and financial inability to manufacture the filter, which necessi-

<sup>10</sup> Paras' assertion that he merely meant he was buying the stock for customers is inconsistent with his reference to himself and members of his family.

<sup>11</sup> See *Mac Robbins & Co., Inc.*, 41 S.E.C. 116, 120, 126 (July 11, 1962), *aff'd sub nom. Berko v. S.E.C.*, 316 F.2d 137 (C.A. 2, 1963); *R. A. Holman & Co., Inc.*, 42 S.E.C. 866, 874 (1965), *aff'd* 366 F.2d 446 (C.A. 2, 1966); *Van Alstyne, Noel & Company*, 33 S.E.C. 311, 321 (1952), which, in rejecting a contention that registrant, which made optimistic representations respecting the issuer's prospective financial condition, was under no duty to disclose the adverse information contained in the issuer's financial statements of which it had knowledge, because those statements assertedly were confidential, stated:

"Even if it be assumed that registrant owed a duty to the [the issuer] to treat the financial information as confidential, in our opinion when registrant disseminated favorable and optimistic information with respect to [the issuer's] condition and prospects, it made itself subject to an overriding duty of disclosure to its customers. Registrant should have appreciated that giving to a customer favorable or optimistic information and withholding unfavorable information which it considered confidential would be misleading and unfair to the customer. Having chosen to continue to effect transactions in [the] stock, registrant should have refrained from making any statements which would be rendered misleading by the failure to disclose such financial information."



tated reliance on others to manufacture it pursuant to license or agreement; the lack of information as to the commercial feasibility of the filter and as to the progress of Sonics' negotiations with the electronic companies for the sale or licensing of its filter; and the negative or unfavorable results of such negotiations. Such disclosure was necessary to enable the customer to assess the weight to be given to the optimism of the salesman and make an informed judgment on whether to purchase or retain the stock. Absent such disclosure, the customer was entitled to assume not only that the salesman had a reasonable basis for his representations and recommendations, but also that he had no knowledge of any adverse factors which might effect the customer's investment decision. It is clear that a salesman must not merely avoid affirmative misstatements when he recommends the stock to a customer; he must also disclose material adverse facts of which he is or should be aware. Moreover, we have repeatedly held that predictions of specific and substantial increases in the price of a speculative and unseasoned security are inherently fraudulent and cannot be justified.<sup>12</sup> Similarly, predictions of a sharp increase in earnings with respect to such a security without full disclosure of both the facts on which they are based and the attendant uncertainties are inherently misleading.<sup>13</sup> Nor does it appear that the sales of some stock by the wife of Sonics' president was the only factor which could have affected the market price.<sup>14</sup>

Respondents urge that the testimony of customers with respect to the misrepresentations should not be credited. They claim that they had no motive to defraud since they sought only to secure a noteworthy speculative opportunity for their customers and their sales of Sonics stock were very small in relation to their total transactions and produced little compensation. In addition, Gladstone complains that the hearing examiner found he had made misrepresentations to a customer-witness to whom he had not sold Sonics stock, and Paras asserts that each of the customers who testified with respect to his representations had sustained a loss and might be biased against him. It is also argued that registrant was not a "boiler room," and that there was no obligation to

---

<sup>12</sup> See, e.g., *Armstrong, Jones and Company*, 43 S.E.C. 888, 896 (1968); *R. Baruch and Company*, 43 S.E.C. 13, 18 (1966).

<sup>13</sup> *Richard Bruce & Co.*, 43 S.E.C. 777, 779 (1968); *James De Mammos*, 43 S.E.C. 333, 336 (1967), *aff'd*, C.A.2, Docket No. 31469 (October 13, 1967).

<sup>14</sup> Between March 7, 1963, when she sold 200 shares at 7%, the highest price received by her, and a sale in June of 600 shares at 4%, the wife of Sonics' president sold a total of 4,000 shares out of about 525,000 shares outstanding and compared to a floating supply of approximately 150,000 shares. And her June sale was the only sale she effected between May 2 and August 19, 1963. In the first half of 1963 she sold a total of 5,800 shares and in the latter part of August 1963 she sold 1,200 shares.

disclose Sonics' financial condition or to refrain from predicting the future market price of its stock because many of the customer-witnesses were sophisticated or had previous relationships with individual respondents, and Sonics was being financed by investors of substantial means. Further, respondents assert that Sonics' products were successfully exploited by its successor, which was formed after the bankruptcy proceedings, and that this attests to the quality of those products. In addition, Fehr states that his purchase of Sonics stock for himself and his wife reflects his optimism with respect to the company and that they too lost money on the investment.

The hearing examiner, who heard the witnesses and observed their demeanor, credited the customers' testimony, and we find no adequate basis in the record for disagreeing with his conclusions in that respect. In this connection, we note that the testimony or admissions of three of the respondents provide some support for their customers' testimony. Gladstone testified that, on the basis of projected earnings, he told customers that the price of Sonics stock could rise to 12 or 13 and that he might have predicted an increase to 18. Stutzmann states that he does not deny projecting earnings of \$1 per share or a possible price rise to 12 to 15. Paras admits that he "outlined the overall potential" of the stock to his customers and testified he may have stated that if the stock earned \$1 - \$1.50 per share, the price could possibly rise to between 10 and 15.

We have taken into account the relatively small gains of the individual respondents but do not consider it an adequate reason for discrediting the testimony of the customers. Nor do we think the examiner erred in finding misrepresentations by Gladstone to the customer-witness who did not purchase his Sonics stock through him. The record shows that Gladstone discussed Sonics with the customer about two months after the latter's purchase, which was effected through the customer's employer who had an account with registrant, and made the misrepresentations at that time.

It is irrelevant that customers were sophisticated<sup>15</sup> or had prior business or social relationships with respondents.<sup>16</sup> Nor can affirmative misrepresentations or a failure to disclose adverse financial information be justified whether or not a "boiler room" situa-

<sup>15</sup> See *A. T. Brod & Company*, 43 S.E.C. 289, 292 (1967); *Hamilton Waters & Co., Inc.*, 42 S.E.C. 784, 790 (1965).

<sup>16</sup> See *Alfred Miller*, 43 S.E.C. 233, 238 (1966), *aff'd*, C.A. 2, Docket No. 31270 (January 4, 1968); *James De Mamos*, 43 S.E.C. 333, 335 (1967), *aff'd*, C.A. 2, Docket No. P1469 (October 13, 1967).

tion exists.<sup>17</sup> And the fact that a customer may have lost money is no reason for rejecting his testimony.<sup>18</sup> In addition, it is clear that whether a representation or prediction is fraudulent depends on the facts and circumstances at the time it is made and not upon subsequent assertedly successful developments.<sup>19</sup> Fehr's position is not aided by his purchases of Sonics stock;<sup>20</sup> a salesman's willingness to speculate with his own funds despite his knowledge of adverse financial information cannot justify recommending the purchase or retention of such stock by customers without disclosure of that information so that the customers can make their own informed decision.

Gladstone and Fehr also assert that their investigation of Sonics provided a reasonable basis for their representations and recommendations,<sup>21</sup> and Gladstone and Paras assert that the customers had confidence in respondents and were not interested in the various factors considered by them in recommending the stock. Gladstone, Fehr and Stutzmann state that the stock was analyzed and recommended on the basis primarily of the future potential of the company. Hanly, Stutzmann and Paras also assert that they relied on information supplied by Gladstone and Fehr.

The investigation by Gladstone and Fehr furnished no support or adequate basis for the representations we have found, and in a number of instances the representations went beyond the information made available to them and imparted to the other individual respondents. In view of Sonics' history of continuous operating losses and the fact that its filter was commercially untried, respondents should not have based representations on the self-serving and extravagant claims received directly or indirectly from Son-

---

<sup>17</sup> See *Charles P. Lawrence*, 43 S.E.C. 607 (1967), *aff'd* 398 F.2d 276 (C.A. 1, 1968); *Van Alstyne, Noel & Company*, 33 S.E.C. 311, 316 (1952).

Paras is not aided by *Berko v. S.E.C.*, 316 F.2d 137 (C.A. 2, 1963), *aff'd Mac Robbins & Co., Inc.*, 41 S.E.C. 116 (1962), which he cites. That case dealt with the duty of a salesman engaged in a boiler-room sales campaign to investigate optimistic information concerning that issuer furnished to him by his employer. Here, Paras was aware of Sonics' poor financial condition but did not disclose it to customers, made price predictions that were inherently fraudulent, and made representations unsupported by the information he had received.

<sup>18</sup> *R. Baruch and Company*, 43 S.E.C. 13, 19 (1966).

<sup>19</sup> *Cf. Heft, Kahn & Infante*, 41 S.E.C. 379, 382 (1963); *David T. Fleischman*, 43 S.E.C. 518, 522 (1967).

<sup>20</sup> *Cf. A. T. Brod & Company, supra*, at p. —; *Shearson, Hammill & Co., Inc.*, 42 S.E.C. 811, 834 (1965).

<sup>21</sup> No request was made by any of the individual respondents to registrant's research department to check on Sonics although, according to registrant's senior partner, it was eminently qualified to do so. Fehr testified that that department reported primarily on listed and high-grade securities, and he did not believe that a company like Sonics was within its sphere of knowledge or experience. Gladstone testified he felt he did not know its personnel well enough to call them, did not know their fields of expertise, and thought they were too busy. Stutzmann's stated reason was that he relied on Gladstone and the report furnished by A. R. Paras considered that the department would not have had the time to and could not obtain as much information as he had.

ics' management.<sup>22</sup> In addition, respondents should have been on notice in 1963, when most of the representations and predictions were made to customers, that the report furnished by A. R. was not a reliable document in view of the absence of financial statements in the report and its uncertain authorship, highly optimistic tone, and demonstrably false estimates of sales and earnings for 1962. And nothing in the statements by Sonics' management or in the report provided any basis for a representation that a licensing contract with a domestic company had been or was certain to be signed, or that a merger agreement was imminent. Moreover, a customer's reliance upon a salesman whom he trusts cannot excuse false or misleading representations.<sup>23</sup>

#### INADEQUATE SUPERVISION

We agree with the Division's contention that, while registrant had established supervisory procedures, it failed to discharge reasonably its duties and obligations under those procedures with a view to the prevention and detection of the violations we have found, and had reasonable cause to believe that such procedures were not being complied with. Although particularly close scrutiny of the two recently opened branch offices, which were managed and staffed by new personnel, was essential,<sup>24</sup> registrant ignored red flags that should have prompted a thorough investigation of the transactions in Sonics stock in those offices. In 1963, about 90 percent of registrant's business was in securities listed on the New York and American Stock Exchanges, and, according to registrant's senior partner, everyone in the firm was aware that it did not favor transactions in low-priced, over-the-counter securities. Moreover, registrant's branch offices were not permitted to purchase securities on a principal basis except to fill existing orders, and it acted as agent in over 99 percent of its transactions. Yet registrant's partner who was responsible for advising the firm's compliance director of any unusual circumstances revealed by his daily examination of blotters, showing all transactions by each branch office, was not concerned by the substantial number of over-the-counter transactions in the Sonics stock, many on a principal basis.<sup>25</sup>

<sup>22</sup> See *J. P. Howell & Co., Inc.*, 43 S.E.C. 325, 329 (1967), *aff'd sub nom. Vanasco v. S.E.C.*, 395 F.2d 349 (C.A. 2, 1968); *A. T. Brod & Co.*, 43 S.E.C. 289, 292 (1967).

<sup>23</sup> On the record before us, we are unable to find, as charged in the order for proceedings, that the individual respondents acted in concert in the conduct of the fraudulent activities discussed above.

<sup>24</sup> See *Kamen & Company*, 43 S.E.C. 97, 103 (1966); *Sutro Bros. & Co.*, 41 S.E.C. 443, 464 (1963).

<sup>25</sup> Between February 14 and 28, 1963, 10,500 shares of Sonics stock were sold to registrant's customers on a principal basis.

In May 1963, registrant was advised by the NASD of a complaint received from a customer of one of the salesmen in the Forest Hills office indicating that the salesman had represented to him that Sonics stock would reach 12 or 13 in a few days due to a merger of the company with General Instrument. Registrant's compliance director asked Gladstone for a letter of explanation by him or the salesman or both. Thereafter, the compliance director sent a letter signed by Gladstone to the NASD which advised that the customer had received the same information on Sonics from both Gladstone and the salesman, denied that the customer had been told of a merger or a rise in price "in a few days," and stated that Gladstone had told the customer that he was recommending the stock "on its future," and that Sonics had potential earnings of over a dollar a share which would bring the price of the stock to 12 or 13. Gladstone's letter characterized the customer as a "speculator" who was "always looking" for a "'sure thing.'"

It does not appear that any meaningful questions were raised or investigation conducted by the compliance director until after additional complaints were presented by an attorney on behalf of several customers in late September 1963 with respect to allegedly false representations by Gladstone and Fehr, resulting in "very substantial losses" to the customers. As we stated in *Reynolds & Co.*, "in large organizations it is especially imperative that the system of internal control" not only be "adequate" but also effective and that "those in authority exercise the utmost vigilance whenever even a remote indication of irregularity reaches their attention."<sup>26</sup>

#### OTHER MATTERS

Gladstone and Stutzmann contend that they were denied due process. They assert that the Division's conduct of its investigation lulled them into the belief that proceedings would not be instituted and that they therefore did not record customers' recollections or preserve documentary evidence in their favor. In addition, they claim they were prejudiced at the hearings by Division counsel. They cite counsel's statement, in a colloquy with an attorney for one of the respondents, that A. R. had invoked the privilege against self-incrimination following a staff inquiry concerning certain of his activities unrelated to Sonics stock. They also

<sup>26</sup> 39 S.E.C. 902, 916 (1960). See also *Shearson, Hammill & Co.*, 42 S.E.C. 811, 843 (1965); *Sutro Bros & Co.*, 41 S.E.C. 443, 463 (1963).

In 1963, registrant had eleven branch offices, including those in Forest Hills and Hempstead, and 171 employees including 93 registered representatives.

point out that counsel showed Gladstone a Commission litigation release, prepared after the period covered by the order for proceedings, concerning injunction proceedings against one of Sonics' backers, and asked Gladstone whether he knew that a company whose securities he purchased pursuant to a customer's order had been enjoined from selling unregistered shares even though the injunction was entered sometime after the purchase. Stutzmann objects to the introduction in evidence of the action of the New York Stock Exchange in censuring him for executing transactions for customers on a discretionary basis without appropriate written authorization. He notes that the censure was based on that Exchange's *ex parte* review of his testimony in arbitration proceedings between registrant and a customer to which he was not a party and that despite such censure he was thereafter admitted to membership on the American Stock Exchange.

There is no substance to these contentions. Gladstone and Stutzmann did not have a reasonable basis for assuming that the instant proceedings would not be instituted. In any event, they have not cited any specific inadequacies in the record resulting from any such assumption. Further, there is no indication that the hearing examiner, who is legally trained and judicially oriented,<sup>27</sup> was influenced by counsel's references to A. R.'s claim of privilege against self-incrimination and the two injunctive proceedings, and we have not considered these matters in making our findings.<sup>28</sup>

The hearing examiner properly admitted evidence of Stutzmann's censure by the New York Stock Exchange. We may consider any such prior disciplinary action against a respondent in determining the nature and extent of any sanction to be imposed in the public interest.<sup>29</sup> Stutzmann was advised by an attorney with respect to the arbitration proceedings and censure action and chose not to exercise his right of appeal from that action after registrant's counsel told him that such a course would entail additional cost and the risk of an increased sanction. And the fact that Stutzmann's application for membership on the American Stock

---

<sup>27</sup> See *Marketlines, Inc.*, 43 S.E.C. 267, 275 (1967), *aff'd*, 384 F.2d 264 (C.A. 2, 1967), *cert. denied* 390 U.S. 947; *Clinton Engines Corporation*, 41 S.E.C. 408, 411 (1963).

<sup>28</sup> We also note that it is within the discretion of the hearing examiner to permit the use of any document to refresh the recollection of a witness, which was the purpose of the references to the injunctions. See McCormick, *Evidence*, ch. 2, §9 (1954); II Wigmore, *Evidence* (3rd ed., 1940), § 758; *U.S. v. Ricardi*, 174 F.2d 883 (C.A. 3, 1949); *U.S. v. Ward Baking Co.*, 224 F. Supp. 66, 73 (E.D. Pa., 1963).

<sup>29</sup> See *Gibbs & Company*, 40 S.E.C. 963, 965 (1962); *Reynolds & Co.*, 39 S.E.C. 902, 918, n. 31 (1960).

Exchange was approved despite the censure does not affect the admissibility of the evidence.<sup>30</sup>

#### PUBLIC INTEREST

In view of registrant's failure to exercise adequate supervision and the individual respondents' willful violations we must determine whether it is necessary or appropriate in the public interest or for the protection of investors to impose sanctions upon them.

On September 1, 1966, after the completion of the hearings but before the filing of the initial decision, registrant sold all of its tangible assets and the leasehold improvements in its offices and assigned all of its leases to X Co., a broker-dealer firm, requested withdrawal of its registration, and ceased doing business.<sup>31</sup> The hearing examiner viewed the sale as a device for minimizing the impact of anticipated Commission action and as a basis for imposing a sanction more severe than censure which he considered might otherwise adequately serve the public interest. The Division asserts that the branch offices where the violations occurred were continued as substantially the same entities under X Co.'s ownership and urges that, although it would be unfair to impose sanctions upon X Co. itself, those offices should be suspended as the "locus of infection." X Co., which has filed briefs, stresses that it is not alleged to have participated in any misconduct and is not a party to these proceedings, and argues that we lack authority to take any such remedial action.

We cannot agree with the staff's position that the two branch offices should be suspended, entirely apart from the existence of our power to take such action. A broker-dealer is not prevented from selling the tangible assets of its business to an independent purchaser by the institution of disciplinary proceedings or even by the suspension or revocation of its registration.<sup>32</sup> While a different situation would be presented if the sale were merely a device

---

<sup>30</sup> It additionally appears that approval by the American Stock Exchange of Stutzmann's membership application was suspended pending the outcome of our staff's investigation of his transactions in Sonics stock.

Stutzmann has also complained that one of his customers was asked by the Division whether Stutzmann had disclosed the censure to him, although the censure was not entered until after his last conversation with the customer. However, although the censure was entered after the conversation, Stutzmann had previously been notified of it by the New York Stock Exchange, and he does not claim that such notification was subsequent to the conversation.

<sup>31</sup> X Co. offered employment to registrant's partners and employees, many of whom accepted such offer. Registrant's senior partner became one of 77 vice presidents but is no longer associated with X Co. Fehr and Hanly became managers of the Forest Hills and Hempstead branch offices, respectively, and Paras became manager of another branch office. Gladstone and Stutzmann were no longer branch office. Gladstone and Stutzmann were no longer employed by registrant at that time. Although, X Co. employed 101 registered representatives of registrant, 53 of whom are no longer in its employ.

<sup>32</sup> See *Marketlines, Inc.*, Order Denying Stay (File No. 3-227, April 11, 1968).

to ensure registrant's continuance in business,<sup>33</sup> nothing in the record indicates that X Co.'s acquisition of registrant was not *bona fide*, and the Division states that it is not alleging that X Co. is the successor or *alter ego* of registrant. The impact of a suspension of the branch offices would fall on X Co. and its employees in those offices, including those previously employed by registrant, who have not been charged with any violations or failed to exercise adequate supervision, and appropriate remedial action with respect to the wrongdoers still employed in those offices can be achieved without such suspension.

In considering the sanction to be imposed on registrant we have taken into account as mitigating factors the improvements in registrant's supervisory procedures made after the violations,<sup>34</sup> and that registrant's prior record was good. Under all the circumstances, we conclude that it is appropriate in the public interest to censure registrant and permit its withdrawal from registration.

The individual respondents variously urge, as mitigative factors, that with the exception of the censure of Stutzmann, they have clean records, and that standards governing the securities industry in 1962 and 1963 rather than at the present time should be considered in determining the extent of any sanctions required in the public interest, that any violations committed do not warrant imposition of a sanction, and that the lapse of time since the violations should be taken into account. We consider the fraudulent conduct of the individual respondents to be extremely serious as well as unlawful under the standards embodied in the Securities Acts since their adoption,<sup>35</sup> and that the mitigative factors presented are insufficient to overcome it. Moreover, Gladstone, Fehr, Hanly, Stutzmann and Paras have been in the securities business since 1957, 1954, 1947, 1959 and 1955, respectively, and must have been aware of the fraudulent nature of their conduct. We agree with the hearing examiner's determination that Gladstone should be barred from association with any broker or dealer. Further, we find that the sanctions which the examiner imposed on the other individual respondents were inadequate in the public interest and

---

<sup>33</sup> Cf. *Batten & Co., Inc.*, 40 S.E.C. 997 (1963); *Regal Knitwear Co., v. N.L.R.B.*, 324 U.S. 9, 14 (1945); *Southport Petroleum Co. v. N.L.R.B.*, 315 U.S. 100, 106 (1942); *N.L.R.B. v. Herman Bros. Pet Supply, Inc.*, 325 F.2d 68, 69 (C.A. 6, 1963).

<sup>34</sup> For example, registrant prohibited solicitation of purchases of securities, priced at less than \$5 per share, without the approval of a partner and an investigation by its research department; adopted a policy of consulting that department with respect to any security sold in large quantities; circulated memoranda dealing with important legal topics; and installed automatic data processing systems.

<sup>35</sup> Cf. *Alexander Reid & Co., Inc.*, 40 S.E.C. 985, 991 (1962), 41 S.E.C. 372 (1963).



conclude that they also should be barred from such association.<sup>36</sup> However, in view of the limited nature of Fehr's violations, we will permit his return to the securities business after 60 days in a non-supervisory capacity and upon an appropriate showing that he will be adequately supervised.<sup>37</sup>

An appropriate order will issue.

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

---

<sup>36</sup> The examiner concluded that Stutzmann and Paras should be barred with the proviso that they may return to the securities business after five months upon a showing of adequate supervision, and that Fehr and Hanly should be suspended from association for five and four months, respectively.

<sup>37</sup> The exceptions to the initial decision of the hearing examiner are overruled or sustained to the extent that they are inconsistent or in accord with our decision.