IN THE MATTER OF

ABBETT, SOMMER & CO., INC.

CHARLES W. SOMMER III

ABBETT, SOMMER & COMPANY MORTGAGE CORPORATION

File Nos. 3-1510. Promulgated November 10, 1969

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

BROKER-DEALER PROCEEDINGS

Fraudulent Representations in Offer and Sale of Securities

Offer and Sale of Unregistered Securities

Noncompliance with Records Requirements

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

Offering of Mortgage Notes Involving Investment Contracts

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

APPEARANCES:

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

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

FINDINGS AND OPINION OF THE COMMISSION

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

VIOLATIONS IN OFFER AND SALE OF MORTGAGE NOTES

We find, as did the examiner, that between December 1960 and April 1965 respondents, in connection with the offer and sale of certain mortgage notes, willfully violated, or willfully aided and abetted violations of, the antifraud provisions of Section 17(a) of the Securities Act of 1933 and Sections 10(b) and 15(c)(1) of the Exchange Act and Rules 10b–5 and 15c1–2 thereunder and the registration provisions of Sections 5(a) and 5(c) of the Securities Act. The notes in question, generally executed by home owners for home improvements and secured by first mortgages on the properties, were purchased by respondents from Century Trust Company ("Century") or sold as agent for Century. That company was engaged in the business of buying such notes at a discount from building contractors and others and reselling them "with recourse" against it in the

event of default by the note maker.[1] Respondents sold over 600 of these notes to about 150 customers for more than $1.3 million.[2] The sales were effected by registrant prior to July 1963, and thereafter by Mortgage Corp., which was organized for that purpose by Sommer and, as found by the examiner, "lacked a palpable identity distinct from" registrant since it had the same officers and employees and used registrant's stationery.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Aside from the fact that the doctrine of estoppel cannot be

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

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

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

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

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

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

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

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

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

VIOLATIONS IN OFFER AND SALE OF MORTGAGE NOTES

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

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

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

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

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

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

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

OTHER MATTERS

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

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

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

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

PUBLIC INTEREST

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

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

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

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

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

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

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

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

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

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