IN THE MATTER OF

KENNEDY, CABOT & CO., INC.

DAVID PAUL KANE

LINDA D. TALLEN

File No. 3-326. Promulgated February 16, 1970

Securities Exchange Act of 1934—Section 15(b)

BROKER-DEALER PROCEEDINGS

Grounds for Suspension of Registration
Grounds for Suspension and Bar from Association with Broker-Dealer
Offer, Sale and Delivery of Unregistered Stock
Fraud in Offer and Sale of Securities
Bids and Purchases While Engaged in Distribution
Excessive Markups

Where registered broker-dealer and associated persons participated in unlawful distribution of unregistered stock, made fraudulent representations and predictions in connection with offer and sale of securities concerning, among other things, increases in price, investment quality, value and exchange listing of stock, and issuer's operations, assets, income and financial condition, bid for and purchased securities while engaged in distribution, and charged excessive markups, *held*, in public interest to suspend broker-dealer's registration and suspend and bar associated persons from association with any broker-dealer.

APPEARANCES:

Joseph C. Daley, D. J. Silman, Roberta S. Karmel, Judith G. Shepard, Robert M. Berson, William Nortman and *Ralph K. Kessler*, for the Division of Trading and Markets of the Commission.

Clark van der Velde, for Kennedy, Cabot & Co., Inc. and David Paul Kane.

George J. Nicholas, of Glickman, Nicholas & Burford, for Linda D. Tallen.

FINDINGS AND OPINION OF THE COMMISSION

These were private proceedings, instituted pursuant to Sec-

tion 15(b) of the Securities Exchange Act of 1934 ("Exchange Act"), in which after hearings before a hearing examiner he issued an initial decision concluding, among other things, that the registration as a broker and dealer of Kennedy, Cabot & Co., Inc. ("registrant") should be suspended for 120 days; that David Paul Kane, president of registrant, should be suspended from association with any broker or dealer for six months; and that Linda D. Tallen, a saleswoman and for most of 1961 secretary of registrant, should be suspended from such association for one year, with the proviso that following her suspension she may be associated with a broker-dealer only in a non-supervisory capacity under such supervision as we deem appropriate.[1]

Petitions for review of the initial decision were filed by respondents which did not take exception to the examiner's findings of fact and conclusions of law, and we ordered review with respect to certain procedural issues and the appropriateness of the sanctions imposed by the examiner. Briefs were filed by respondents and the Division of Trading and Markets ("Division") and we heard oral argument. On the basis of a review of the record and the initial decision, and for the reasons set forth herein and in that decision, we make the following findings.

Registrant was organized in May 1960 with Kane as its sole stockholder, and became registered with us the following month. Tallen became associated with registrant in December 1960.

OFFER AND SALE OF UNREGISTERED STOCK, AND BIDS AND PURCHASES DURING DISTRIBUTION

We agree with the finding of the hearing examiner that during 1961 respondents willfully violated the registration provisions of Sections 5(a) and 5(c) of the Securities Act of 1933 ("Securities Act") in the offer, sale and delivery of the stock of American States Oil Company ("ASO") when no registration statement had been filed or was in effect under the Securities Act as to those securities.

During the period under consideration, one J. Tom Grimmett was president and controlling person of ASO, which had been organized in Illinois in 1952 to own, develop and deal in oil, gas and mineral properties. From October 1959 to January 1960

[1] Two other respondents named in the instant proceedings were the subject of prior disciplinary action taken pursuant to their consents. One was barred from being associated with any broker-dealer and the other was suspended from such association for 10 months. (Securities Exchange Act Release Numbers 7781 and 8105, January 4, 1966 and June 23, 1967).

ASO issued 550,000 shares of its stock to The Mid-State Drilling Company ("Mid-State") for Mid-State's interest in certain Oklahoma oil and gas leases which Grimmett had assigned to it. During 1960 and 1961 Mid-State also purchased over 100,000 shares of ASO stock on the open market. Mid-State, like ASO, was controlled by Grimmett, and had as its president Grimmett's son-in-law, Larry Gulihur. The examiner found that between 1959 and 1962 Grimmett, through Mid-State and Gulihur, offered, sold and delivered over 600,000 unregistered shares of ASO stock, including over 500,000 of the shares issued to Mid-State described above.[2]

As the examiner further found, during 1961 registrant bought through Kane, Tallen and another employee about 19,000 shares of ASO stock, of which at least 7,200 emanated from the block of 550,000 shares issued to Mid-State, and around 5,500 shares from an account with another broker-dealer in the name of Gulihur who was acting as nominee for Mid-State and Grimmett. Between January and September 1961 registrant sold over 17,000 shares of which Tallen sold over 6,000. In March and May 1961 Tallen accepted 7,500 ASO shares in partial repayment of substantial loans previously made by her to Grimmett. Those shares emanated from the Mid-State block and her certificates were obtained directly from Mid-State. In August and October 1961 she sold to registrant 1,300 shares out of her account with registrant, including at least 600 shares reflected in a confirmation listing Kane as the salesman. In addition, in January and around March 1961 Tallen arranged for the sale of 4,000 shares of ASO stock to a customer directly from Mid-State. Kane arranged for the customer to sell 500 of those shares on February 27, 1961, and the customer received a confirmation from registrant reflecting such transaction.

Respondents by acquiring with a view to its distribution ASO stock held by Mid-State, which with ASO was under the common control of Grimmett,[3] participated in a distribution and became underwriters within the meaning of Section 2(11)

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[2] On the basis of a complaint filed by this Commission, Grimmett was enjoined in July 1956 by the United States District Court for the Southern District of New York from further violations of the registration provisions of the Securities Act in the sale of unregistered ASO stock. On November 21, 1956 we issued an order temporarily suspending an exemption from the registration requirements of the Securities Act under Regulation A with respect to an offering of ASO stock by Grimmett on the grounds that, among other things, ASO and Grimmett failed to disclose Grimmett's sale of a substantial number of unregistered ASO shares within one year prior to the filing of the notification and that he was subject to the above injunction.

[3] Under Section 2(11) "issuer" includes any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

of the Securities Act.[4] That they took only a small portion of the stock distributed does not alter the fact that they participated in the distribution. As statutory underwriters, respondents were subject to the prohibitions embodied in Section 5 of the Securities Act.

Respondents knew or should have known that they were participating in an unlawful distribution of ASO stock by Grimmett. Tallen knew that Grimmett was the president and largest single stockholder of ASO and controlled Mid-State, and that large blocks of ASO stock including shares received by her were emanating from Mid-State. Indeed, she accepted ASO stock in part payment of a debt owed her by Grimmett and received shares directly from Mid-State after Grimmett told her that since his own stock was "locked up" and under scrutiny by our staff he would have Mid-State give her the shares.[5] She also arranged for a customer to acquire ASO shares directly from Mid-State and for payment for shares purchased by a part-time salesman for registrant to be made by a check with the payee's name left blank, which was thereafter stamped with Mid-State's name and endorsed by it.[6] In addition, Tallen participated with Grimmett and a customer acquainted with Grimmett, in a transaction in which the customer borrowed and then loaned to Gulihur $100,000 to enable Gulihur to pay for 36,000 ASO shares, with the customer's loan being secured by 100,000 ASO shares transferred from Mid-State's name to Tallen's at Grimmett's direction.[7] The customer defaulted in payment of the loan, and some of the shares were subsequently sold by the pledgee.[8]

Kane, who was a trader for registrant and in control of its operations, knew of Grimmett's connection with ASO and the circumstances surrounding Tallen's acquisition of ASO stock from Mid-State, that Mid-State owned a considerable amount of ASO stock, and that registrant had obtained such stock from Mid-State. He handled the purchase by registrant of ASO stock from another broker-dealer which came from Mid-State, and the record contains a number of sight drafts drawn by Mid-

[4] *Cf. S.E.C.* v. *Chinese Consolidated Benevolent Association, Inc.*, 120 F.2d 738 (C.A. 2, 1941) *cert. denied* 314 U.S. 618; *S.E.C.* v. *Guild Films Company, Inc.*, 279 F.2d 485 (C.A. 2, 1960), *cert. denied sub nom Santa Monica Bank* v. *S.E.C.*, 364 U.S. 819; *Sutro Bros. & Co.*, 41 S.E.C. 470, 477–78 (1963).

[5] The record contains a March 1961 letter from Mid-State to Tallen in care of registrant enclosing a certificate for 5,000 shares and signed by Gulihur as president of Mid-State.

[6] The salesman testified that Tallen did not write up an order for his purchase, stating that she was getting his stock from the president of ASO, although he apparently received his stock certificate from registrant.

[7] Tallen was reimbursed by Mid-State for legal expenses incurred in connection with the transaction.

[8] *Cf. S.E.C.* v. *Guild Films Company, Inc.*, 279 F.2d 485 (C.A. 2, 1960), *cert. denied sub. nom. Santa Monica Banks* v. *S.E.C.*, 364 U.S. 819.

State on registrant in payment for purchases from that broker-dealer. Under all the circumstances Kane was at least alerted to make adequate inquiry and obtain reliable information with respect to the source of the stock registrant was selling. He did not do so, however, and did not even communicate with Grimmett with respect to the source of the stock notwithstanding the fact that he was acquainted with Grimmett through prior dealings and knew of Grimmett's connection with ASO and dealings with Tallen. Nor did he check to see whether a registration statement was filed under the Securities Act with respect to such stock.

As further found by the hearing examiner, respondents also willfully violated and willfully aided and abetted violations of Section 10(b) of the Exchange Act and Rule 10b–6 thereunder in that Kane and Tallen bid for and purchased ASO stock for registrant's account during the period that they participated in the distribution of such stock by Grimmett.[9]

FRAUD IN OFFER AND SALE OF STOCK

The record establishes, as found by the hearing examiner, that in connection with the offer and sale of ASO securities respondents willfully violated and willfully aided and abetted violations of the antifraud provisions of Section 17(a) of the Securities Act and Sections 10(b) and 15(c)(1) of the Exchange Act and Rules 10b–5 and 15c1–2 thereunder.

In connection with the sale by registrant of ASO stock between January and July 1961 at from 3½ to 6¼ per share, Tallen represented that such stock was "better than American Telephone & Telegraph," would be listed on the New York Stock Exchange very soon or when ASO started to drill a certain Wilmington off-shore oil field near Long Beach, California, was worth at least 50, would rise in price to 10 within six months, or up to 15 to 50 in three or six months, and Tallen expected it would rise to the upper 20's upon the acquisition of the right to drill around Long Beach, or to 25 or 30 within a very short time; that ASO was a producing company with good potential in the Wilmington area and was "financially sound"; and that millions of dollars were involved in the Wilmington oil fields and registrant had oil holdings worth $70 per share. In February 1961 she told a customer she thought the stock was a

[9] Rule 10b–6 provides that it is a manipulative or deceptive device for an underwriter in a distribution of securities, or issuer or other person on whose behalf such a distribution is being made, or a broker-dealer or other person participating in such distribution, to bid for or purchase such securities until he has completed his participation in the distribution.

"very good buy" because the company had just completed a well in the Long Beach tidelands area.

Kane told a customer in May 1961 who had purchased ASO stock from registrant through Tallen, that he had just spoken to Grimmett who had convinced him that ASO stock was good and that he (Kane) now believed in it. In that month another customer bought 50 shares from registrant at 5½ after Kane had recommended that he buy that number of shares, and the following month registrant sold ASO stock to another person at 4 following the buyer's telephone conversation with Tallen and Kane in the course of which Kane represented that ASO stock was a "good deal to buy" because the company was involved with oil leases in the Long Beach area, and that its price had a good chance to double in six months. In connection with a sale by Kane in November 1961 at 1¼ to a customer, who had previously bought ASO stock at 6¼, Kane stated that she should not worry about the decline in its price because another oil well had come in, and she should average down her costs by purchasing more stock. And in December 1961 Kane told a customer, who had purchased ASO stock from registrant, that there had been some difficulty with the oil leases which was expected to be cleared up soon, and that he still felt ASO would be a good deal.

Between March and June 1961 other salesmen of registrant effected sales of ASO stock to its customers at 3¾ to 6¼. In connection with such sales they represented that the stock was a "good deal" on which the customer could not lose, and would be listed on a securities exchange; that the price should rise to around 11 or 12 in possibly a year or longer, or would go to 10 to 20 within a year; and that ASO was a good stable company and was an important off-shore drilling company in Long Beach and expected to derive $10,000,000 of earnings through leases there.

The highly optimistic representations and predictions listed above concerning ASO and its stock were not warranted by the facts. ASO was not in any sense a stable or financially sound company. It was organized in Illinois in 1952, was dissolved by that State in 1957 but reinstated the following year, and in November 1961 was "ousted" by the State of Oklahoma for failure to comply with requirements relating to the payment of that State's fees.[10] For the fiscal years ending April 30, 1960, 1961 and 1962, respectively, it suffered losses of $15,588, $19,-

[10] In November 1964 ASO was again dissolved by the State of Illinois.

016 and $116,997, and had earned surplus deficits of $1,071,164, $1,090,180 and $1,207,000. No off-shore oil leases in the Wilmington field were ever acquired by ASO or Grimmett.[11] While ASO did ultimately acquire three other leases on California oil properties in July and August 1961 and obtained some oil production from two wells on those properties, all such leases were sold in May 1962 at a loss of $60,838. ASO lacked basic qualifications for listing its stock on the New York Stock Exchange and the record does not show that it had undertaken any steps to secure any exchange listing.

Kane and Tallen had no current financial information on ASO during the period when a large number of the sales were effected. Kane was advised in November 1960 that ASO had had inadequate capital and around the end of February 1961 that financial statements were not available, and such statements were not received by registrant until June 1961. Nevertheless, Kane took no effective steps to obtain reliable financial data, and his asserted reliance on Tallen for other information was misplaced in view of her inexperience in the securities business.[12] Tallen assertedly relied primarily on information from Grimmett despite his failure to perform on prior business dealings with her and Kane or repay loans she made and the fact that he had given his checks unsupported by sufficient funds. In any event, none of the information assertedly furnished by Grimmett or others warranted the predictions and extravagant statements she made, and she knew of ASO's losses. Moreover, as we have repeatedly held, it is inherently fraudulent to predict specific and substantial increases in the price of a speculative security, as Kane and Tallen did in this case.[13]

EXCESSIVE MARKUPS

In 34 principal transactions with customers in ASO stock effected by registrant between January and July 1961, registrant's markups ranged from 8.3 percent to 95.7 percent over its contemporaneous costs of the stock. Such markups were excessive and not reasonably related to prevailing market prices, and by charging them respondents willfully violated and willfully aided and abetted violations of the antifraud

[11] In December 1959 Grimmett entered into a contract to purchase all the stock of Dynamic Industries Company, which had in June 1959 lost a legal action to enforce a purported contract giving it the right to drill on certain off-shore lands near long Beach. In a legal action instituted in March 1960, however, Dynamic shareholders recovered the escrowed shares purchased by Grimmett because of non-performance of his obligations under the December 1959 contract.

[12] Tallen admitted she did not even know during 1961 how to read a financial statement.

[13] See, *e.g.*, *Crow, Brourman & Chatkin, Inc.*, 42 S.E.C. 938, 942 (1966).

provisions of Section 17(a) of the Securities Act and Sections 10(b) and 15(c)(1) of the Exchange Act and Rules 10b–5 and 15c1–2 thereunder.[14]

PROCEDURAL MATTERS

Registrant and Kane renew their objection to the hearing examiner's denial of their motion for his disqualification based on the fact that he had previously presided in a prior proceeding relating to another broker-dealer who purchased ASO shares from Grimmett in 1954 and 1955 which involved assertedly related issues. We reaffirm our prior order upholding his ruling on the grounds that even if there were common issues of law or fact in these and the prior proceedings, which we indicated was not the case, that circumstance would not disqualify the examiner from presiding in these proceedings.[15]

Tallen also objects to certain other rulings of the hearing examiner. He denied a request by her attorney for a postponement made at the commencement of the hearings on the ground that she was ill and unable to attend, noting that the motion was untimely, and directed the Division to make the transcript available for examination by Tallen's counsel at the Commission's branch office, and to notify counsel in advance of calling a witness who had direct dealings with Tallen. The examiner indicated a willingness to grant liberal recesses to enable counsel to confer with Tallen, and even to hold a portion of the hearings in her home if it was accessible. At the opening of the afternoon session Tallen's counsel advised that he had been discharged because Tallen did not want representation when testimony is given in her absence. At a later stage of the proceedings the same counsel again represented Tallen, and he requested that the Division recall four specific witnesses for cross-examination. The examiner denied that request, noting that any party was free to ask for the issuance of subpoenas, and stated that if counsel called the witnesses, he would "make rulings in cognizance of the actual situation." Counsel declined to call the four persons as Tallen's witnesses.

In our opinion the examiner did not abuse his discretion in denying postponement, and the accommodations he was willing to extend to Tallen and her counsel would if accepted have enabled counsel to cross-examine the witnesses effectively when they were testifying. Any examination by Tallen's coun-

[14] *Cf. Norman J. Adams*, 41 S.E.C. 993 (1964); *Powell & Mc-Gowan, Inc.*, 41 S.E.C. 933 (1964).

[15] *Transamerica Corporation*, 10 S.E.C. 454, 473–4 (1941). *Cf. Federal Trade Commission* v. *Cement Institute*, 333 U.S. 683, 703 (1948); *Barnes* v. *United States*, 241 F.2d 252, 254 (C.A. 9, 1956); *Lyons* v. *United States*, 325 F.2d 370, 375–6 (C.A. 9, 1963).

sel would naturally have related to the subject-matter covered on direct examination, so that in substance such examination would have been in the nature of and equivalent to cross-examination.[16] Indeed, Tallen's counsel recognized that he could in effect cross-examine the witnesses if called by him, and counsel for the Division pointed out that Tallen's counsel could elect to have them declared hostile. There is no indication that the examiner would have restricted any attempt by Tallen's counsel to impeach the testimony of those witnesses.[17] While it might have been preferable for the examiner to grant counsel's request for recall of the four witnesses, in the circumstances his denial did not prejudice Tallen.

PUBLIC INTEREST

On the question of what remedial action is appropriate in the public interest, respondents claim that the sanctions ordered by the hearing examiner are excessive. They stress that the alleged violations stemmed from the activities of Grimmett, who was an experienced manipulator of unregistered securities and, as found by the hearing examiner, engaged in an elaborate scheme to defraud, and that they were inexperienced in the securities business at the time.

Registrant and Kane state that Tallen was primarily responsible for registrant's activities in ASO stock, that Kane himself did not sell any ASO stock, and that Kane relied on the information concerning ASO given him by Tallen and others and on the existence of active trading in the stock by reputable firms. They state that they have not engaged in the general securities business for over seven years and do not intend to do so in the future, and that since February 1964 Kane's activities in the securities business have been limited to serving as president of a registered investment company, its investment adviser and registrant, which now acts solely as its principal underwriter. Tallen states that since July 1961 she has limited her activities to acting as a finder and selling a small amount

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[16] *Cf. Giant Food Inc.* v. *F.T.C.*, 322 F.2d 977 (C.A.D.C., 1963), *cert. dismissed* 376 U.S. 967 (1964). In that case, after the examiner had ruled cross-examination closed, the respondent refused to examine witnesses with respect to subsequently obtained documents even though the examiner stated that leading questions could be asked and counsel should not be concerned about being "bound" because the testimony would be appraised objectively. The Court rejected respondent's contention that it had not been accorded and adequate opportunity for cross-examination, pointing out that administrative agencies are afforded "some leeway" as to application of rules of evidence, as long as "accepted standards of fairness" are observed, and that the examiner was willing to afford all the benefits of cross-examination, "though hesitating to apply the name."

[17] Allowance of impeachment of a party's own witness is within the discretion of the trier of facts who heard him and saw him testify. See *Journeymen Plasterers' Protective and Benevolent Society of Chicago* v. *N.L.R.B.*, 341 F. 2d 539 (C.A. 7, 1965).

of mutual fund securities, and has undertaken to acquire the knowledge necessary to adequately inform investors concerning the value and potential of securities.

We agree with the hearing examiner that the misconduct engaged in by respondents was serious and requires the imposition of sanctions, but we consider that the sanctions he would impose are not adequate for the protection of investors and the public interest in light of such misconduct. As has been seen, respondents made false and misleading statements and predictions in connection with the sale of unregistered shares of a highly speculative security while participating in an unlawful distribution of such shares during which they improperly bid for and purchased shares, and charged customers excessive markups. We have given recognition to the fact that, with the exception of the excessive markups, the violations stemmed in large part from Grimmett's activities including false and misleading information emanating from him and ASO. However, respondents could not reasonably place reliance upon such statements in view of Tallen's and Kane's previous dealings with Grimmett who defaulted on his obligations and in the repayment of substantial loans made by Tallen. As to Kane's participation in the sales activities, we have found that he made misrepresentations in a sale which he effected himself as well as in connection with sales by other representatives of registrant.

We are of the opinion that the maintenance of required standards of honest dealing and compliance with necessary statutory protections requires that respondents be subjected to a more extensive exclusion from the securities business. With respect to Tallen, we agree with the Division that she played the key role in registrant's activities involving ASO stock and in her representations and predictions as well as in all other respects demonstrated a flagrant indifference to the basic duty of fair dealing required of securities salesmen and that she should be indefinitely barred from association with any broker or dealer.

With respect to registrant and Kane we are satisfied that under all the circumstances an indefinite bar is not necessary. While we consider a six-month suspension as recommended by the examiner inadequate in light of the misconduct, we conclude that the public interest will be adequately served by imposing upon those respondents a suspension of nine months, coupled with a grant of their request to permit sales of shares of the mutual fund of which Kane is president through a

named broker-dealer in which respondents have no financial interest, provided that respondents are to receive no commissions, directly or indirectly, on such sales.

An appropriate order will issue.[18]

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

[18] We have considered the initial decision of the hearing examiner and the exceptions thereto, and to whatever extent such exceptions involve issues which are relevant and material to the decision of the case, we have by our Findings and Opinion herein ruled upon them. We hereby sustain such exceptions to the extent, that they are in accord with the views set forth herein, and we overrule them to the extent they they are inconsistent with such views.