ADMINISTRATIVE PROCEEDING
FILE NO. 3-5389

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	:
NEW SOUTH SECURITIES, INC., et al.	:
	:

INITIAL DECISION

Washington, D.C.
April 3, 1978

Max O. Regensteiner
Administrative Law Judge

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APPEARANCES: Wayne M. Whitaker, Cecil S. Mathis, Gregg E. Radetsky and Mary Lou Felsman, of the Commission's Fort Worth Regional Office, for the Division of Enforcement.

William D. Sims, Jr., C. Cleave Buchanan, Jr. and Kenneth R. Marvel, of Jenkens & Gilchrist, for Respondents.

BEFORE: Max O. Regensteiner, Administrative Law Judge

These proceedings pursuant to Sections 15(b) and 19(h) of the Securities Exchange Act of 1934 with respect to New South Securities, Inc. ("registrant"), a registered broker-dealer, and four individuals associated with it were instituted by the Commission on February 22, 1978. The Commission directed that consideration be given initially to the question whether, pursuant to Section 15(b)(5) of that Act, it is necessary or appropriate in the public interest or for the protection of investors to suspend registrant's registration pending final determination whether such registration should be revoked. A hearing on that question was held on March 16, 1978. Proposed findings and conclusions and supporting briefs were filed simultaneously by the Division of Enforcement and registrant pursuant to the expedited procedures provided in Rule 19 of the Rules of Practice for interim suspension proceedings. On the basis of the record and my observation of the witnesses' demeanor, I conclude that interim suspension of registrant's registration is not warranted.

Alleged Misconduct

As set forth in the order for proceedings, the Division alleges that during the period from September 1977 through January 1978 registrant, in willful violation of Section 5 of the Securities Act of 1933, offered and sold, through general solicitation, unregistered securities in the form of limited partnership interests in oil and gas ventures and fractional undivided working interests in oil and gas leases. It

further alleges that in the offer and sale of those securities, registrant failed to disclose that it was dependent on loans from one of the issuers to provide it with necessary working capital, and that this issuer in fact controlled the registrant. By failing to disclose those relationships, it is alleged, registrant willfully violated the general antifraud provisions of Section 17(a) of the Securities Act and Rule 10b-5 under Section 10(b) of the Exchange Act as well as specific antifraud Rule 15c1-5 under Section 15(c)(1) of the Exchange Act. The remaining allegations charge registrant with willful violations of net capital and related notification requirements (Rules 15c3-1 and 17a-11 under the Exchange Act) and of record-keeping and record-retention requirements (Rules 17a-3 and 17a-4 under that Act).

The Registrant

Registrant has been registered with the Commission since 1974. Originally, it was located in North Carolina. In the summer or fall of 1977, it was in the process of opening an office in Dallas for the purpose of dealing in oil and gas investments. Lowell A. Olsen, one of the respondents in this proceeding, joined the firm as vice-president in September 1977. He succeeded to the presidency and sole ownership in November 1977 when the then owner and president, desirous of leaving the brokerage field, simply turned over the business to Olsen. The

North Carolina office was then closed. Olsen had been in the securities business for some five years prior to becoming associated with registrant, specializing in tax sheltered investments.

During the period under consideration, registrant had three salesmen who are also respondents herein. Registrant has not engaged in business since February 1, 1978, when Olsen was advised that it had inadequate net capital, and it has undertaken not to resume operations pending issuance of this decision.

Findings as to Alleged Misconduct

1. Sale of Unregistered Securities

During the period from October 1977 through January 1978, registrant's sole activity was acting as best efforts underwriter of three oil and gas offerings. The first of these, commencing in about October 1977, was an offering of 490 pre-formation limited partnership interests in Energy Investments 1977-A, Ltd. ("Program A") at $1,000 per interest. The general partners for Program A were Energy Investments, Inc. ("EII") and the two principal officers of EII. Following completion of that offering in November 1977, registrant during December 1977 offered and sold 170 pre-formation limited partnership interests at $1,000 per interest in Energy Investments 1977-B, Ltd. ("Program B"). EII was the general partner for

Program B. In each case, the number of purchasers did not exceed 35.[1/] Finally, in January 1978 registrant commenced an offering, on behalf of Fine Petroleum Energy, Incorporated, of 390 fractional undivided working interests at $1,000 per interest. As of the time registrant suspended operations as noted above, it had not sold any of those interests.

No registration statement was filed with the Commission for any of the above offerings. Each was made in purported reliance on Rule 146 under the Securities Act. The Division takes the position that the claimed exemption was not available because registrant engaged in a "general solicitation" prohibited by the Rule.

Rule 146, adopted in 1974, was designed to provide greater certainty and more objective standards than existed previously for determining when offers or sales of securities by an issuer are deemed to be transactions "not involving any public offering" within the meaning of the Section 4(2) exemption from the Act's registration provisions.[2/] Among other things, the Rule limits the number of purchasers to 35 for one offering.[3/]

1/ The minimum investment was to be $14,000 for Program A and $5,000 for Program B. However, in the discretion of the general partners smaller investments could be permitted, provided the total number of purchasers did not exceed 35 per offering.

2/ See Securities Act Release No. 5487 (April 23, 1974), 4 SEC Docket 154.

3/ The above statement represents an over-simplification of the Rule as amended. Paragraph (g) provides that an "issuer shall have reasonable grounds to believe, and after making reasonable inquiry, shall believe," that there are no more than 35 purchasers.

It places no limit on the number of offerees. However, the manner of the offering and the nature of the offerees are severely circumscribed (paragraphs (c) and (d) of the Rule), and those offerees who do not have access, by virtue of their relationship to the issuer, to the kind of information that registration would disclose must be furnished with such information (paragraph (e)).

Here detailed and extensive private placement memoranda were furnished to offerees of the three offerings.[4/] The focus of the inquiry regarding the asserted non-compliance with the conditions of Rule 146 is thus on paragraphs (c) and (d).

Those paragraphs, in pertinent part, read as follows:

> "(c) Limitation of Manner of Offering. Neither the issuer nor any person acting on its behalf shall offer. . . or sell the securities by means of any form of general solicitation or general advertising, including but not limited to, the following:
> (1) Any advertisement, article, notice or other communication published in any newspaper, magazine or similar medium or broadcast over television or radio;
> (2) Any seminar or meeting, except that if paragraph (d)(1) of this section is satisfied as to each person invited to or attending such seminar or meeting, . . . then such seminar or meeting shall be deemed not to be a form of general solicitation or general advertising; and
> (3) Any letter, circular, notice or other written communication, except that if Paragraph (d)(1) of this section is satisfied as to each person to whom the communication is directed, such communication shall be deemed not to be a form of general solicitation or general advertising.

4/ The Division urges, as an additional basis for the non-availability of the claimed exemption, that registrant failed to disclose a control relationship between EII and registrant, and that therefore material information which would have been required to be disclosed in a registration statement was not disclosed. As I find below, there was such a control relationship. And it was not disclosed. However, there is no indication (CONT'D)

(d) Nature of Offerees. The issuer and any person acting on its behalf who offer . . . or sell the securities shall have reasonable grounds to believe and shall believe:

(1) Immediately prior to making any offer, either:

(i) That the offeree has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or

(ii) That the offeree is a person who is able to bear the economic risk of the investment; and

(2) Immediately prior to making any sale, after making reasonable inquiry, either:

(i) That the offeree has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or

(ii) That the offeree and his offeree representative(s) together have such knowledge and expertise in financial and business matters that they are capable of evaluating the merits and risks of the prospective investment and that the offeree is able to bear the economic risk of the investment."

Turning to the manner in which registrant effected the offerings -- and considering first Programs A and B -- the testimony of Olsen and George Covington, one of the registrant's salesmen, shows the following: Registrant and its personnel had a large number of "leads" derived from various sources. Many came from EII, including names of persons who had invested in prior EII ventures and others who had responded to a 1975 Dun and Bradstreet questionnaire addressed to persons believed to have substantial means and designed to find potential

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4/ (Continued)
in the order for proceedings nor in anything stated by Division counsel at the hearing that such nondisclosure, which is the basis for alleged violations of antifraud provisions, would be relied upon with respect to the alleged Section 5 violations. Hence, it would be unfair, particularly at this stage of the proceedings where reply briefs are not permitted, to make the finding requested by the Division.

investors in oil and gas ventures. In addition, Olsen and his sales staff had a large number of names in their personal files. From this pool of several thousand names, Olsen and Covington selected those believed to be "substantial people" and those who had indicated interest and/or prior investment in oil and gas ventures. Persons in the selected group, provided they lived in states in which registrant was licensed to do business, were then contacted over the telephone by one of registrant's representatives to determine if they were "qualified" offerees and interested in receiving a private placement memorandum. If the prospect's response indicated that he was both qualified and interested, a memorandum was sent to him. In addition, some 20 memoranda for each offering were sent to accounting firms and accountants which had indicated they would maintain a file on registrant's offerings. Registrant saw this as a potential source of business, presumably from the accountants' clientele. In total, some 300 memoranda were distributed for Program A and about 200 for Program B. During the Fine Petroleum offering, 21 offering memoranda were sent out, all to the "CPA list."

Each offering memorandum included an "acknowledgement of receipt" which was to be signed by the recipient and returned to the issuer. It included certain representations regarding financial status and sophistication. As to the former, they

were to the effect that he either had a net worth (excluding homes, furnishings and personal automobiles) of at least $200,000 or had a net worth (excluding those items) of at least $75,000 and anticipated having taxable income some portion of which would be subject to Federal tax at a rate of at least 50 percent. As to sophistication, the representation was that by virtue of his knowledge and experience in financial and business matters, the recipient was capable of evaluating the merits and risks of making the prospective investment. In seeking to determine whether a potential offeree was "qualified," registrant's sales personnel generally used this form as a guide.

The Division, focusing on the Program A and B offerings, contends that in view of the large number of persons who were contacted by telephone and the substantial number of offering memoranda that were distributed, these offerings were made by means of a "general solicitation" within the meaning of paragraph (c) of Rule 146. Registrant, on the other hand, urges that in view of the procedure it followed for screening and qualifying offerees, the manner of solicitation complied with the terms of the Rule, and that the number of offerees is irrelevant under the Rule.

The Division has not argued that there was any noncompliance with the terms of paragraph (d), relating to the nature of the offerees. Thus, it cannot take the position that,

under the terms of paragraph (c)(3), the distribution of the offering memoranda as such constituted a general solicitation. Nevertheless, the conclusion seems inescapable that the sales effort as a whole, at least as to Programs A and B, did run afoul of the rule's prohibition of such solicitations. Despite the initial screening that took place, the fact remains that in each of those offerings hundreds of phone calls were made to various parts of the country, and to persons who in large part were not known to registrant or the issuer. An offering which is begun in this manner is appropriately characterized as a general solicitation, even if it is considered that the offer was made only by the offering memoranda.

2. Financial Relationship Between Registrant and EII; Net Capital

During the period from October through December 1977, when registrant needed funds to pay its expenses, Olsen borrowed a total of about $47,000 from EII, which he immediately deposited in registrant's bank account. The loans were unsecured, carried 6-7 percent interest and were payable on demand. Olsen testified that there was an understanding between him and EII that no demand for payment would be made because "they had plenty of confidence in our ability to continue to market the product. . ." (Tr. 121). Registrant used the funds as working capital. When registrant received commissions from the sale of Program A interests, it repaid about $16,000

to Olsen who in turn repaid that amount to EII. 5/

The Division argues that under the circumstances, registrant, at the time it was offering the EII Programs, was under EII's control and was financially dependent on the EII loans, facts which should have been but were not disclosed. Admittedly, no such disclosure was made. Registrant contends, however, that there was neither control nor financial dependency. Its contention rests largely on the fact that the loans were made to Olsen personally, and on Olsen's asserted intent to have the funds he transferred to registrant treated as capital contributions. Registrant also relies on Olsen's testimony to the effect that EII had made no attempt to actually exercise any control over the manner in which registrant's business was operated.

The argument based on the manner in which funds reached registrant represents an over-simplification. The loans were designed not for Olsen's personal needs, but to provide registrant, the underwriter for EII's offerings, with working capital. Considering registrant's inadequate resources aside from the infusion of these funds, its financial dependency on EII seems clear. That dependency placed EII in a control

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5/ Registrant errs in stating in its proposed finding No. 48 that Olsen made these repayments out of his personal share of commissions. On the transcript page cited (p. 120), Olsen testified that they came from registrant's share.

position over registrant. A finding of control need not rest on evidence of control actually exercised. Possession of the "power to direct or cause the direction of the management and policies of a person" [6/] suffices. Here EII had such power, by virtue of registrant's financial dependency on it and its ability to put pressure on Olsen and through him on registrant for repayment of the loans.

The facts recited above concerning EII's loans also provide the context for the net capital violations. Registrant's quarterly "FOCUS" report for the quarter ended December 31, 1977, which was apparently filed with the National Association of Securities Dealers ("NASD") in January 1978, showed net capital of $15,911, well above registrant's required minimum net capital of $5,000. However, that computation was based on the exclusion from the liabilities side of liabilities totalling $47,629 (representing the funds obtained from EII) which were purportedly subordinated to the claims of general creditors. In fact, the required "satisfactory subordination agreements" did not exist and thus there was no basis for that exclusion. The Commission staff examiner's recomputation showed that registrant had a net capital deficit of $36,396 and a net capital deficiency of $41,396. On the same basis,

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6/ Rule 17 CFR 240.12b-2. Although that rule defines "control" in a different context, the definition applies by analogy in the instant context. See Loss, Securities Regulation (1961), Vol. II, p. 772, n. 8; Financial Counsellors, Inc., 42 S.E.C. 153, 156, aff'd 339 F.2d 196 (C.A. 2, 1964).

the corresponding deficit and deficiency as of January 31, 1978 were $24,310 and $29,310, respectively.[7/]

Olsen testified that it was his intention to contribute the loan proceeds he received from EII to registrant as capital, and not to lend them to registrant; that the accountant on whom he relied for registrant's financial record-keeping advised him that he could properly contribute capital and withdraw it as commissions came in; and that he was not aware that the accountant, who prepared the firm's financial statements (including net capital computations), in fact treated the item as a loan. However, Olsen's expectation of prompt repayment from commissions earned by the firm is inconsistent with treatment of the transactions as capital contributions. And in any event registrant cannot disassociate itself from the report it filed with the regulatory authorities.

The record also shows that with respect to the December 31, 1977 net capital deficiency, the telegraphic notice which under Rule 17a-11 must be given to the regulatory authorities was not given until January 31 or February 1, 1978.[8/]

7/ In February 1978, Olsen entered into a subordination agreement with registrant in the amount of $31,500 which was submitted to and found satisfactory by the NASD.

8/ But see Management Financial, Inc., Securities Exchange Act Release No. 12098 (February 11, 1976), 8 SEC Docket 1248, 1249: "We think that Rule 17a-11, fairly interpreted, requires that telegraphic notice be sent as soon as a capital deficiency is discovered." (Emphasis added). Query whether that interpretation, made in a different context, is applicable here.

3. Registrant's Records

While registrant maintained a file on each of the two EII Programs which included information regarding investors and the amounts they had invested, that information was not complete. Registrant kept no record for each customer's account, as required by Rule 17a-3. Olsen testified that, during the course of each of the two offerings, registrant maintained a list indicating those persons who had decided to invest and showing when their subscription checks were mailed to EII and when they were received. But the list was destroyed when each offering was completed and was not available for inspection by the compliance examiner when he began his inspection on January 31, 1978. Although, with rare exceptions, signed subscription agreements and checks were mailed directly to EII,[9/] the investors were nevertheless registrant's customers. And the information which registrant had could not serve as a substitute for full compliance with applicable requirements.[10/]

Registrant failed further to comply with Rule 17a-3 in that its records did not reflect the loans discussed above, and it had no records of net capital computations for October and November 1977.[11/]

9/ In the few instances they were sent to registrant, the latter immediately forwarded them to EII.

10/ See WCBA Investments, Inc., 43 S.E.C. 1136 (1969).

11/ However, it does not appear that registrant was required to keep on file the copies of subscription agreements entered into by investors, since the paragraph of Rule 17a-4 relied upon requires preservation only of agreements entered into by the broker-dealer. Registrant was not a party to the subscription agreements.

Conclusions

In Dunhill Securities Corporation, the most recent Commission decision in a suspension proceeding, the Commission stated:

> "The purpose of a suspension proceeding under the Exchange Act is to determine, where it is preliminarily shown that a registered broker-dealer has engaged in misconduct, whether the proper protection of investors and the securities markets requires that the statutory permission to engage in the securities business should be withdrawn pending final determination whether it should be revoked." 12/

In earlier decisions cited in a footnote to that statement of the governing principle, the Commission had said the following:

> "The Exchange Act clearly contemplates that a suspension order is properly issued when a preliminary showing is made that a registered broker or dealer has engaged in such misconduct, of a nature that would warrant revocation, that public investors would be jeopardized by registrant's continuing dealings with them during the more extended interval which development and determination of the issues relating to revocation would entail." Biltmore Securities Corp. 13/

> " The suspension provision in Section 15(b) of the Exchange Act indicates recognition by the Congress that where it is preliminarily shown that a registered broker-dealer has engaged in serious misconduct, proper protection of investors and the securities markets requires that the statutory permission to engage in interstate securities transactions with others which is conferred by his registration be withdrawn pending further hearings on the revocation issue. Under that provision, we are only directed to inquire into the question of whether the public interest or the protection of investors warrants suspension, and there is no requirement that suspension be based upon findings of willful violations or the other grounds specified with respect to revocation. The pattern of Section 15(b) thus shows that in

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12/ 44 S.E.C. 1, 6 (1969).

13/ 40 S.E.C. 273, 277 (1960).

> balancing the interests of the registrant on the one hand and of investors on the other, Congress viewed the interest of investors in being protected from such a broker or dealer as outweighing his interest in continuing to have full access to investors. Nor is it necessary, as urged by registrant, that the record show imminent danger to the public interest in connection with the particular securities involved. In our opinion we are required in the public interest or for the protection of investors to suspend registration where the record before us on the suspension issue contains a sufficient showing of misconduct to indicate the likelihood that after hearings on the revocation issue registrant will be found to have committed willful violations or any of the other grounds prescribed with respect to revocation in Section 15(b) will be established, and that revocation will be required in the public interest." A.G. Bellin Securities Corp. 14/

The suspension remedy is obviously of a drastic nature, since its likely impact is the final termination of a going business in advance of a determination of issues raised by the order for proceedings on the basis of a full record and an opportunity for full presentation of contentions based thereon. For that reason, its use has in the past been reserved for cases involving flagrant misconduct. The thrust of the decisions referred to above is that a suspension order must be predicated on a preliminary showing of misconduct, likely to ripen into findings of willful violations upon completion of the record, of such a serious nature that it would call for revocation of registration, and possibly in addition a showing that the broker-dealer's continuation in business

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14/ 39 S.E.C. 178, 185 (1959).

pending determination of the ultimate issues in the case would jeopardize public investors. On the other hand, the Commission has also stressed, as reflected in the excerpt quoted from the Bellin decision, that the protection of investors is the paramount consideration and takes precedence over considerations of hardship to the broker-dealer.

Under applicable standards, the misconduct here, though it cannot be condoned and is in part of a serious nature, is not in my opinion of the flagrant nature which would provide a sufficient basis for suspension. In this connection, consideration has been given to certain mitigating factors. For one thing, while the record lacks the specificity on the point which would be desirable, it appears that registrant acted in reliance on the advice of counsel in determining the manner in which it would proceed in offering the limited partnership interests. And it relied on a CPA who appeared to be familiar with applicable requirements for compliance with the net capital and financial record-keeping requirements. While such reliance cannot absolve registrant of misconduct in the above areas, it is entitled to consideration as a mitigating factor. As a result of the subordination referred to above, registrant's net capital deficiency has been cured. And it does not appear that customers' funds and securities were subjected to risk as a result of the prior deficiencies. I have also taken into consideration the fact that Olsen,

registrant's owner and president, has not been the subject of any prior disciplinary action. Finally, the continued pendency of these proceedings should serve to deter any repetition of the misconduct found herein.

The above observations regarding the misconduct found and the mitigating factors should not be viewed as foreshadowing any particular conclusion on the question of the remedial action which may ultimately be appropriate, after completion of the evidentiary record and a fuller briefing of the issues. The only determination now made is that on the record so far developed, it has not been shown that suspension of registrant's registration pending final determination of the remaining issues is necessary or appropriate in the public interest or for the protection of investors.[15/]

Accordingly, IT IS ORDERED that the registration as a broker-dealer of New South Securities, Inc. not be suspended pending determination of the remaining issues in these proceedings.

This order shall become effective in accordance with and subject to the provisions of Rule 17(f), as modified by Rule 19, of the Commission's Rules of Practice. Pursuant to

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15/ All proposed findings and conclusions and contentions submitted by the parties have been considered. They are accepted to the extent they are consistent with this decision.

those provisions, this initial decision shall become the final decision of the Commission unless a petition for review is filed by a party within three days after receipt of the initial decision. If such a petition is filed, the initial decision shall not become final.

Max O. Regensteiner
Administrative Law Judge

Washington, D.C.
April 3, 1978