ADMINISTRATIVE PROCEEDING
FILE NO. 3-6562

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	:
JAMES E. CAVALLO	:
	:

INITIAL DECISION

Washington, D.C.
March 30, 1987

Max O. Regensteiner
Administrative Law Judge

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APPEARANCES: Anne C. Flannery, Sandra L. Dolan, Joseph G. Mari and John B. Myers, of the Commission's New York Regional Office, for the Division of Enforcement.

Michael B. Pollack, for James E. Cavallo.

BEFORE: Max O. Regensteiner, Administrative Law Judge.

In these proceedings pursuant to Sections 15(b) and 19(h) of the Securities Exchange Act of 1934 ("Exchange Act"), the issues for consideration are whether James E. Cavallo engaged in misconduct as alleged by the Division of Enforcement and, if so, what if any remedial action is appropriate in the public interest.

The Division alleged that during the period from about November 1980 to about March 1981, Cavallo, while employed as a salesman by a registered broker-dealer, willfully violated antifraud provisions of the securities laws by making false and misleading representations in the offer and sale of common stock of Reserve Oil and Minerals Corporation ("ROIL").

Following hearings, the parties filed proposed findings of fact and conclusions of law. The Division also filed a memorandum in support of its proposed findings and conclusions. The findings and conclusions herein are based on the preponderance of the evidence as determined from the record and upon observation of the witnesses.

ROIL

During the relevant period, ROIL was engaged in the acquisition, development and mining of uranium properties. Its principal asset was an undivided 50 percent interest in a uranium mine and mill complex known as the L-Bar project. Sohio Western Mining Company owned the other 50 percent interest and was the operator of the

complex. In 1979 ROIL called for arbitration under its operating agreement with Sohio to resolve a dispute regarding Sohio's management of the project. It sought damages of $50 million. Following hearings in August 1980 and February 1981, a decision was rendered in June 1981, in which ROIL's claims were largely rejected and it was awarded only about $1.1 million. Following the hearings and prior to the decision, Sohio made a telephonic settlement proposal involving its takeover of ROIL's interest in the L-Bar project or possibly of the entire company. James Melfi, ROIL's president, and his brother, also an officer, rejected the proposal on the spot as inadequate, without even submitting it to the board of directors. Aside from this, there were no acquisition or merger proposals during the period under consideration.

Due in substantial part to depressed uranium prices, ROIL's financial history in the years preceding the period here under consideration and during that period was bleak. With the exception of 1978, it suffered losses in every fiscal year from 1975 through 1980. In the years ended August 31, 1979 and 1980, its losses were $1.6 million and $3.4 million, respectively. ROIL reported these losses in filings with the Commission, annual reports to shareholders and press releases. A release dated November 14, 1980, reported the 1980 loss, including a loss of $2.2 million for the fourth quarter alone. At the end of fiscal year 1980, the company had a retained earnings deficit of

$6.2 million. In its next quarter, ROIL had revenues of only $47,000 and sustained a net loss of $2.7 million. For the first six months of fiscal year 1981, ROIL sustained a loss of $6.7 million, on total revenues of $165,000, as compared to a loss of $716,000 on revenues of $8.3 million during the first half of 1980. In its report to the Commission on Form 10-Q for the quarter ended February 28, 1981, ROIL reported that there was no significant revenue during the past six months, because the company did not ship any uranium concentrate from its properties and did not process uranium for others.

Cavallo's Representations to Customers

In December 1980 and the early months of 1981, Cavallo sold more than 6,000 shares of ROIL stock to about 17 customers (not including his own account and his father's and sister's accounts) at prices ranging from 20 1/2 to 33 1/2. He recommended the purchase of ROIL stock to a number of other persons. Many of those who bought the stock ultimately sustained large losses when the price of the stock declined substantially beginning in January 1981. Six customers testified in these proceedings. While the specific representations to which they testified varied to some extent, there was a common theme in what Cavallo told them, namely, that ROIL was about to be acquired by or to merge with

another company, identified in some instances as a major oil company, with the result that the price of ROIL stock would appreciate substantially. Figures were mentioned to the effect that the price would or could double or even rise more substantially in a short time. Cavallo told or gave the impression to some of these customers that he had an inside source of non-public information. And he failed to advise any of them of ROIL's adverse financial history and condition.

Customer R.G. testified that a friend told him that he had a tip that Cavallo knew someone who in turn knew an official of a large company (ROIL) and "there was going to be a takeover or something" and the company's stock "was supposed to move." (Tr. 151) In January 1981, at the friend's suggestion, R.G. called Cavallo to ascertain if the tip was accurate and, if so, to buy shares. Cavallo confirmed that ROIL was to be acquired. According to R.G., he asked Cavallo where he thought the ROIL stock would "go" in the next few months "if everything went the way it was supposed to," (Tr. 152) and Cavallo said he thought it would go to the range of about 65-75. 1/ At that

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1/ According to Cavallo's proposed findings, R.G.'s testimony was that Cavallo told him an acquisition was possible and that "if everything worked out positively" the price of the stock could rise significantly. In my view, the correct reading of R.G.'s testimony is as stated in the text.

time, the price was 31 1/2. As a result of the conversation, R.G. bought 400 shares.

A.G., who had been an insurance customer of Cavallo's, testified that prior to his first purchase of ROIL stock in December 1980, Cavallo told him that ROIL stock was going to make a "fairly quick move" (Tr. 261), because there was probably going to be a merger within three to five months. A.G. recalled that Cavallo mentioned Gulf as the other party in the prospective merger, and that Cavallo expected the price to go up to about 60. Cavallo was "very enthusiastic" about his information that the stock was "going to move." (Tr. 283) As to the source of his information, Cavallo mentioned that he knew Melfi, the president of ROIL, and had cocktails with him on various occasions. Cavallo also apparently referred to the arbitration and the possibility of ROIL receiving $50 million. A.G. bought 200 shares at 25 1/4 on December 24 and another 100 shares at 26 1/4 a few days later. With reference to the second purchase, A.G. testified that Cavallo said he thought it was a good buy and advised A.G. to keep buying because "the move is going to be made shortly and I should make more profits." (Tr. 265) On January 5, 1981, A.G. made a third purchase, 300 shares at 33 1/2, this one on margin. This reflected Cavallo's recommendation that A.G. could "profit better by having more stock." (Tr. 268)

N.S. testified that Cavallo, whom he had previously met when Cavallo was selling insurance, called him in

January 1981 and stated that he had a stock for him if he wanted to invest, a "good stock" with a "possible chance" of moving up. (Tr. 353) Cavallo also said that it was possible there could be a merger or takeover. N.S. thereupon bought 100 shares at 30 1/2. He bought another 100 shares in early February 1981 at 24 1/2. Preceding that purchase, he asked Cavallo about the drop in price. Cavallo in reply referred to cyclical movement. N.S. asked whether Cavallo thought he should "average out" his position, and Cavallo replied that that seemed like a good idea. Following the second purchase Cavallo also stated that there was an arbitration proceeding and that he got his information from Melfi, whom he later identified as ROIL's president. Cavallo stated that as a result of the arbitration proceeding, in which ROIL could receive from $30 million to $40 million, the stock possibly could go up to about 40. He also said that the "arbitration or merger" should be completed in April. (Tr. 357) On April 7, N.S. bought another 100 shares, at 20 1/2. Cavallo stated at that time that the arbitration was still continuing and would probably be resolved in June. In response to N.S.'s question whether Cavallo was relying on inside information, Cavallo answered in the negative.

Customer P.T. testified as follows: Cavallo, whom he considered a friend, told him he had "this inside deal that was a fantastic thing" involving an acquisition

by a major oil company, and that it was going to "like triple" in value in a matter of weeks. (Tr. 378) When P.T. stressed to Cavallo that he could not afford to lose any money, the latter told him that this was 100 percent certain and he could not lose. After watching the stock for a few weeks and seeing it go up in price, he bought 100 shares on December 22, 1980 at 24 1/4. Cavallo called him a short time later, pointed out that the price of the stock had appreciated further and suggested P.T. buy additional shares, using a margin account. P.T. bought an additional 100 shares at 33 on January 6, 1981. And, at P.T.'s suggestion, his son bought 50 shares.

According to M.G.'s testimony, she first heard about ROIL from P.T., a former employer, who told her that Cavallo had told him that the price would double in about two weeks. When she contacted Cavallo, he told her that "there was supposed to be" (Tr. 308-09) a merger of ROIL with Sohio and that ROIL or its shareholders would make a lot of money in a short time. He was "very excited" (Tr. 311) about the stock. She asked whether the price would double, to which he responded that he hoped so. He referred as the source of his information to a Mr. Melfi, who she assumed was associated with ROIL. On January 21, 1981, she bought 100 shares at 30 3/4.

J.S. testified as follows: Co-workers, including

P.T., talked about ROIL stock as a stock that "looked very, very good" (Tr. 327) and said that Cavallo handled it. When he called Cavallo in late December 1980, the latter said that ROIL looked like a very good buy, that a merger was being planned and was to be completed by February 20, and that the stock looked like it might double or even triple. After a second conversation, in which Cavallo said the price of ROIL stock had increased substantially and that it looked very good, J.S. bought 50 shares at 30 3/4 on December 31. In subsequent conversations in February and April, Cavallo said the merger was delayed but thought it was still going through.

Cavallo was called as a witness by the Division, but chose not to testify in his own behalf or to present any other evidence. As a result, and because of the nature of the questions put to him by the Division, only a fragmentary story emerges from the record as to his version of what he told customers or of the information on which he relied in making representations to them.

Cavallo denied that he ever told customers that ROIL was going to be acquired by or merged with another company or that he had a source of confidential inside information about ROIL. While also denying that he made flat predictions of specific increases in the price of ROIL stock, he admitted that he told various customers that

the price would rise to levels of $40, $60, or $65-$75, "under certain circumstances." (Tr. 516-17) He indicated in his testimony that the "circumstances" referred principally to the results of the arbitration proceeding. Cavallo also claimed that he did advise customers of ROIL's financial condition.

As to the information he relied upon, Cavallo stated that he was familiar with published information concerning ROIL, including its annual reports to shareholders and periodic reports filed with the Commission. He further testified that he first heard about ROIL from one Judith C., a friend who was a sales representative of another securities firm and who referred to ROIL as an acquisition candidate, mentioning figures as high as $60 per share. Cavallo stated that they never discussed the source of her information. He further testified that he also relied on information supplied by one David Y., who gave him favorable information about the progress of the arbitration on the basis of information that he claimed to have obtained from Melfi. Cavallo admitted that while he had some conversations with Melfi, neither Melfi nor anyone else associated with ROIL ever told him that ROIL would be taken over by or merged with another company. This is consistent with Melfi's testimony, who further testified that he never gave Cavallo any information of a non-public nature.

To the extent there is a conflict between the customers' testimony and Cavallo's testimony concerning the representations made by him, I credit the substance of the customers' versions, which are generally consistent with each other. While customer P.T. conceded that he had a bad memory, and there was some inconsistency and uncertainty in his testimony regarding the sources of his information about ROIL as between Cavallo and David Y., who was an associate of P.T., his testimony regarding Cavallo's representations as set forth above is clear, and I credit it in substance. Cavallo's claim that the customers testified "with rancor over having lost money" and were bent on getting even with him does not square with my observation of their testimony. As the Commission has pointed out, the fact that a customer may have lost money is no reason for rejecting his testimony. 2/

When a securities salesman recommends securities, he is under a duty to ensure that his recommendation and his particular representations have a reasonable basis. 3/ As far as the record shows, Cavallo's representations

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2/ Richard J. Buck & Co., 43 S.E.C. 998, 1008 (1968).

3/ See, e.g., Hanly v. S.E.C., 415 F.2d 589 (2d Cir. 1969); Lester Kuznetz, Securities Exchange Act Release No. 23525 (August 12, 1986), 36 S.E.C. Docket 466, petition for review pending.

concerning a probable or likely or even certain takeover or merger, with resultant increases in the price of ROIL stock, appear to have been predicated on mere rumor and did not have a reasonable basis in fact. There was no basis for the impression he conveyed that he was relying on information received from a company official. To the extent that statements concerning expected price increases were based on the rumored merger or takeover, they were without foundation. To the extent they may have been related to the pending arbitration proceeding, the outcome of that proceeding was speculative. Cavallo had no reasonable basis for believing that it would result in a large award to ROIL. Moreover, Cavallo had a duty to disclose ROIL's adverse financial condition to his customers. 4/ This he failed to do.

It is clear that Cavallo acted with scienter. He must have been aware that there was no reasonable basis for the representations and predictions that he made to customers.

Based on the foregoing findings, I conclude that Cavallo willfully violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

4/ See, e.g., Richard J. Buck & Co., 43 S.E.C. 998, 1005-6, aff'd sub nom. Hanly v. S.E.C., 415 F.2d 589 (2d Cir. 1969); Lester Kuznetz, supra.

Public Interest

In light of the findings of violations, the remaining issue concerns the remedial action that is appropriate in the public interest. The Division urges that those violations require an unqualified bar of Cavallo from association with a broker-dealer. Cavallo argues essentially that he committed no violations and that there is therefore no basis for the imposition of a sanction.

Cavallo's misconduct, involving wholly irresponsible misrepresentations to a number of customers, was of a very serious nature and reflects insensitivity to the obligation of fair dealing borne by persons in the securities business. A severe sanction is clearly called for. In contending for a total bar, the Division seeks to draw a parallel with certain other cases where a bar was imposed, including in particular Lester Kuznetz, Securities Exchange Act Release No. 23525 (April 12, 1986), 36 SEC Docket 466, which also involved the sale of ROIL stock. The misrepresentations that Kuznetz made to his customers were similar to those made by Cavallo. In his initial decision, the administrative law judge barred Kuznetz from association with any broker or dealer but provided that after one year he could apply to become so

associated in a non-proprietary, non-supervisory capacity. On review, the Commission agreed with the Division that the public interest required an unqualified bar. While that case and this one have important similarities, there are also material differences. The duration and magnitude of Kuznetz's selling effort far exceeded that of Cavallo. More importantly, Kuznetz's sales effort was characterized by high-pressure tactics. While the Division asserts that Cavallo also engaged in such sales tactics, the record does not bear out its argument. As the Commission has stated time and again, the remedial action that is appropriate in the public interest depends on the facts and circumstances of each particular case and cannot be precisely determined by comparison with the action taken in other cases. 5/

Under all the circumstances, I conclude that Cavallo should be barred from association with any broker or dealer, with the proviso that after 18 months, he may apply to become so associated in a non-supervisory and non-proprietary capacity, upon a satisfactory showing of adequate supervision.

5/ See Butz v. Glover Livestock Commission Co., Inc., 411 U.S. 182, 187 (1973); Hiller v. S.E.C., 429 F.2d 856, 858-859 (2d Cir. 1970).

IT IS SO ORDERED. 6/

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

Pursuant to that rule, this initial decision shall become the final decision of the Commission as to each party who has not filed a petition for review pursuant to Rule 17(b) within fifteen days after service of the initial decision upon him, unless the Commission, pursuant to Rule 17(c), determines on its own initiative to review that initial decision as to him. If a party timely files a petition for review, or the Commission takes action to review as to a party, the initial decision shall not become final with respect to that party.

Max O. Regensteiner
Administrative Law Judge

Washington, D.C.
March 30, 1987

6/ All proposed findings and conclusions and all contentions have been considered. They are accepted to the extent they are consistent with this decision.