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UNITED STATES OF AMERICA

before the

SECURITIES AND EXCHANGE COMMISSION

In the Matters of
CAPITAL GAINS INSTITUTE, INC. Post Office Box 53 Beverly Hills, California
File No. 801-1917
and
PATRICK CLEMENTS, d/b/a PATRICK CLEMENTS & ASSOCIATES 8440 Sunset Boulevard Los Angeles 69, California
File No. 8-7030

RECOMMENDED DECISION

Warren E. Blair,
Hearing Examiner

New York, New York
June 19, 1964

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Before the
SECURITIES AND EXCHANGE COMMISSION

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BEFORE: Warren E. Blair, Hearing Examiner

APPEARANCES: Dennis G. Ryan, Esq., Los Angeles Branch Office of the Commission for the Division of Trading and Markets.

George J. Nicholas, Esq., of Glickman and Nicholas, Los Angeles, California for Capital Gains Institute, Inc. and Karl N. Kaiser

Patrick Clements, pro se

Nature of Proceedings

These are public consolidated proceedings instituted pursuant to Sections 15(b) and 15A of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(d) of the Investment Advisers Act of 1940 ("Advisers Act") to determine whether the allegations of the Division of Trading and Markets ("Division") against Patrick Clements, doing business as Patrick Clements & Associates ("Clements & Associates"), a registered broker-dealer, and against Capital Gains Institute, Inc. ("Capital Gains"), a registered investment adviser, are true, and, if so, whether remedial action is appropriate pursuant to the provisions of the respective statutes. Also at issue are the questions of whether within the meaning of Section 15A(b)(4) of the Exchange Act, George Russell Barber ("Barber"), James Risser ("Risser"), and Louis R. Kurtin ("Kurtin") or any of them, should be found to be a cause of any order

of revocation, expulsion or suspension entered against Clements & Associates,[1/] and whether a notice of withdrawal of registration filed by Clements & Associates on January 20, 1964 should be permitted to become effective.

In the Clements & Associates matter, the Division, in substance, charges that Clements & Associates, Risser, Barber, Kurtin, Louis B. Cherry ("Cherry"), Glen Meyers, now known as Karl N. Kaiser ("Kaiser") and Capital Gains wilfully violated and aided and abetted wilful violations of the anti-fraud provisions of the Securities Act of 1933 ("Securities Act") and of the Exchange Act in the offer and sale of the stock of California Growth Capital, Inc., ("California Growth");

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1/ Louis Arthur Ray ("Ray"), also named as a possible cause in the Order for Public Proceedings against Clements & Associates dated February 17, 1964, was dismissed as a party to the proceedings by an Order entered by the Commission on April 6, 1964.

and that Clements & Associates also violated Rule 17 CFR 240.15c3-1 ("Net Capital Rule"), the bookkeeping provisions of Rule 17CFR 240.17a-3 under the Exchange Act, and, by such conduct, again violated the anti-fraud provisions of the Securities Act and Exchange Act.

In substance, the Division alleges in the Capital Gains matter that Capital Gains, Kaiser, Barber, Kurtin, Cherry, Risser and Clements & Associates wilfully violated and aided and abetted wilful violations of the anti-fraud provisions of the Securities Act, the Exchange Act and the Advisers Act in connection with the circulation and distribution of market letters and other literature relating to California Growth stock and in the offer and sale of that stock to clients of Capital Gains and other investors. In addition, the Division charges that Capital Gains, aided and abetted by Kaiser, further wilfully violated the anti-fraud provisions of the Advisers Act by various acts and omissions which also resulted in wilful violations of Section 204 of the

Advisers Act and of the bookkeeping requirements of Rule 17 CFR 275.204 thereunder; of Section 207 of the Advisers Act which prohibits the making of untrue statements in an application for registration by an investment adviser; and of Section 208(c) of the Advisers Act which specifies the conditions under which a registered investment adviser may represent that he is an "investment counsel" or so describe his business.

In response to the Division's charges, Clements & Associates, Capital Gains and Kaiser filed answers denying the allegations contained in the Orders for Proceedings. A notice of appearance in the Capital Gains matter was filed by Risser and a letter of his dated March 26, 1964 addressed to the Commission has been deemed to be his answer therein.

After appropriate notice to the parties and to the persons named as possible causes, a consolidated hearing over a period of three days was held before this Hearing Examiner. At the opening session of the hearing,

Capital Gains and Kaiser appeared and participated through counsel. Patrick Clements ("Clements") appeared without counsel on behalf of Clements & Associates and, after being advised by the Hearing Examiner of his rights to counsel, actively participated in the hearing on his own behalf. Early in the second day of the hearing, counsel for Capital Gains and Kaiser withdrew from the hearing after announcing that such absence on his part was not to be construed as a waiver of any rights of his clients relating to the hearing or to post-hearing procedures. No other person named in the Orders for Proceedings participated in the hearing.2/

As part of the post-hearing procedures, successive filings of proposed findings, conclusions and supporting briefs were specified. Timely filing thereof was made

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2/ Motions filed by Barber on June 4, 1964 seeking to reopen the hearing and to dismiss the proceedings as to him were denied by the Hearing Examiner.

by the Division and a reply thereto (which is regarded herein as a counter statement of proposed findings and conclusions and brief) was filed by Clements & Associates. Counter proposals and a brief in support thereof were also filed on behalf of Kaiser and Capital Gains.

The following findings, conclusions and recommendations of the Hearing Examiner are made on the basis of the record in this proceeding, including the testimony of the witnesses, the exhibits introduced at the hearing, and the proposed findings and conclusions submitted.

Capital Gains Institute, Inc.

1. Capital Gains has been registered as an investment adviser pursuant to Section 203(d) of the Advisers Act since March 17, 1959. Kaiser, whose name was legally changed on March 26, 1963 from Glendon Meyers, also known as Glen Meyers, is president of Capital Gains as well as a director of it.

2. According to its Form ADV application for registration, Capital Gains intended to publish and offer a book written by Kaiser which would enable the reader to predict mechanically future reactions and

trends in the securities markets. As an adjunct, Capital Gains planned to offer a monthly service that in effect did the work for those subscribers who did not have the time to make analyses based upon the book's principles. In a Form ADV supplement dated May 29, 1961, Capital Gains reported that it issued Trends & Signals, a monthly publication, and furnished no other investment advice.

Patrick Clements & Associates

3. Clements, a sole proprietor doing business as Patrick Clements & Associates, became registered as a broker-dealer pursuant to Section 15(b) of the Exchange Act on December 9, 1958. Clements & Associates is a member of the National Association of Securities Dealers, Inc. ("NASD"), a national securities association.

4. Sometime in the middle of 1962 Clements had discussions with Kaiser, Kurtin, Barber, and Risser regarding the formation of a corporation to be named Patrick Clements & Associates, Inc., to take over the

assets and liabilities of Clements & Associates. These discussions led to the drafting of an agreement for that purpose and also resulted in loans aggregating $8,400 being made to Clements & Associates by Kurtin, Barber and Risser, with repayment to be made by issuance of stock to them in Patrick Clements & Associates, Inc.3/

5. In October, 1962 Clements went to Hong Kong on business, leaving with Barber a general power of attorney to act for him in his absence. Barber, together with Risser and Kurtin, carried on the business of Clements & Associates until Clements returned at the end of December, 1962. The relationship between Clements & Associates and Barber, Risser and Kurtin apparently terminated shortly after Clement's return, when their plans to activate a corporate securities business were

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3/ The agreement was never executed by the proposed parties thereto, and eventually releases were obtained by Clements with respect to the loans, although it does not appear that the loans were repaid.

abandoned. In August, 1963 Ray became office manager of Clements & Associates, and left that position in December, 1963 to form his own firm under the name of Sierra Securities, Inc. 4/

Offer and Sale of California Growth Capital, Inc. Stock

6. Kurtin was the source of the information Clements received about California Growth, a small business investment company located in California. After showing Clements a copy of the first annual report of California Growth for the fiscal year ended March 31, 1962 he told Clements that he had a group that was interested in getting control of California Growth and liquidating its cash assets, which would result in shareholders receiving about $10 per share. Clements knew that the existing market price for California Growth

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4/ The application of Sierra Securities, Inc. for registration as a broker-dealer pursuant to Section 15(b) of the Exchange Act was denied. Securities Exchange Act Release No. 7257(February 28, 1964).

stock was $6 per share and claims to have indicated at that time an interest in the proposition only to the extent that he would find out whether persons in Hong Kong would care to invest. When Clements reached Hong Kong, he found a number of people who wanted stock, and he ordered it from Kurtin. Clements later canceled that order when he and Kurtin couldn't agree on delivery of the stock.

7. As noted before, when Clements went to Hong Kong in October, 1962 he placed his general power of attorney in the hands of Barber and left him, with Risser and Kurtin, in charge of Clements & Associates. About November 1, 1962 they moved the offices of Clements & Associates into the same suite occupied by a securities firm operated by Cherry under the name of Kennedy, Levy & Co., as a preliminary step to a merger of the two firms. However, when Clements received word of the proposed merger, he advised Barber that he was opposed to any association with Cherry, with the result

that the merger was never consummated.

8. The first step taken to offer California Growth stock to the public appears to have been by means of a telegram that Capital Gains sent on October 14, 1962 to about 200 of its subscribers. The telegram informed the recipients that "insiders" were accumulating stock for control of a "cash-rich special situation"; that minimum participation was $7,000; that projected gains were 60% to 120% within about 8 months, with negligible risk; and that further information could be obtained by telephoning "Mr. James Risser, Executive, Patrick Clements Associates."

9. The telegram was followed next day by the mailing to Capital Gains subscribers of a form letter of similar content on the letterhead of Capital Gains over the printed signature of Kaiser.

10. About a week later, Capital Gains sent a mimeographed "Memo From The Desk of Karl N. Kaiser" dated October 20, 1962 to subscribers, together with an

attachment containing favorable biographical information about Kurtin. The memo represented that large blocks of stock in the "cash-rich" company had already been acquired, and that Kurtin would provide specific information about the special situation at a meeting for investors to be held at Cherry's offices during the week of October 22, 1962.

11. The meeting, which was a fiasco insofar as attracting prospective investors, was held on October 29, 1962. Present at the outset, in addition to Kaiser and Barber, were an investigator of the California Division of Corporations and his secretary, posing under assumed names as interested members of the public, and Kaiser's brother, Raymond Meyers, who had taken on the role of a "shill." Barber started the meeting with a brief statement to the effect that the group planned to obtain 51% of the stock of California Growth and to install Kurtin as chairman of the board of directors. Kurtin having by then arrived, amplified Barber's talk,

pointing out that the assets of California Growth exceeded its liabilities and that book value was more than $11 as compared to a market price of about $6. He further stated that he and his group then owned 40% of the company's stock; that interested investors could buy the stock quietly through Kennedy, Levy & Co. or Clements & Associates at $7 per share, which price included a small bonus for the brokers; and that as soon as his group obtained control, the controlling interest could be sold immediately to another group that would be willing to pay $11 per share. Kurtin summed up the proposition in an almost classic bit of high-pressure salesmanship by saying "Well, it's eleven for seven. That's it, eleven for seven. Make a big piece of change." Barber emphasized this quick profit possibility by repeating Kurtin's closing statements. Shortly after the meeting, Kaiser mailed California Growth's first annual report to the investigator.

12. At another meeting at Cherry's office held

about the same time as the one just referred to, Kurtin, in Kaiser's presence, spoke to three prospective investors stressing the $11 per share book value of California Growth stock, and comparing that value to the stock's "depressed" market price. In addition, Kurtin said that $7,000 was the limit that a person would be permitted to invest because disclosure would have to be made if anyone held more than 10% of the stock. With respect to the future of California Growth, Kurtin's stated intention was a liquidation of the company with the resulting cash to be distributed to the stockholders. Kurtin characterized an investment in his proposition as "buying discounted dollars" and warned that if investors did not purchase through him, the price would be driven up.

13. Capital Gains continued the selling program for California Growth stock by devoting considerable space in the November, 1962 issue of its investment advisory publication, Trends & Signals, to an investment opportunity

designated "Special Situation #1." This issue, mailed to subscribers, purported to explain how acquisition of control in a company can lead to substantial capital gains, and went on to represent that the special situation referred to held out a likely potential profit to investors of 60% or 120% if the investor desired to purchase the stock on a basis of 50% margin. In passing, the Trends & Signals item mentioned as another problem in acquiring control of a company, that the "Securities and Exchange Commission requires that any stockholder cannot hold over 10% of the outstanding stock of a company unless the fact is disclosed to the public."

14. Kurtin, using representations similar to those made at the meetings, also personally solicited a Capital Gains subscriber at the latter's place of business, with the result that on October 25, 1962 the subscriber purchased 1,000 shares of California Growth stock from Kennedy, Levy & Co. at a price of $6.75 per share. However, the 1,000 shares purchased by this

subscriber were not obtained by Kennedy, Levy & Co. on the open market but were, in fact, shares owned by Kurtin which Kennedy, Levy & Co. was selling as his agent.

15. It also appears that on the same day that Kurtin sold these 1,000 shares, he purchased 100 shares of California Growth stock at 5-1/4 per share from a San Francisco broker and on the following day purchased another 1,500 shares at 5-1/8 per share.

16. During a three week period from October 3, 1962 through October 25, 1962 Kurtin bought 4,000 shares of California Growth stock from his broker in San Francisco at prices ranging from 5-1/8 to 5-1/2 per share. During the same period, he sold at least 1,000 shares of his California Growth stock for 6-3/4 per share through Kennedy, Levy & Co., and between September 12, 1962 and October 31, 1962 sold another 12,800 shares through Clements & Associates at prices ranging from 6-3/8 to 6-3/4 per share, although all of

the latter sales, except for 1,100 shares, were later canceled.

17. The Hearing Examiner finds that the evidence is conclusive that Kurtin devised an unconscionable scheme for the purpose of defrauding the public in the offer and sale of California Growth stock, and that he enlisted the willing aid and support of Capital Gains, Kaiser, Barber, Cherry, and Risser in that scheme. The Hearing Examiner concludes that Clements & Associates also participated in Kurtin's scheme and was of material assistance in carrying it forward, but further finds that Clements as an individual, although grossly negligent regarding his responsibilities as a broker-dealer, was not aware during the operation of the scheme of the means which the other individuals and Capital Gains intended to and did employ to accomplish their purpose.

18. It is hardly necessary to recount the numerous misrepresentations and omissions of material

facts that went into the scheme. However, the most flagrant were those which expressly and impliedly held out to prospective investors the lure of very sizable profits to be gained by joining with Kurtin in acquiring control of California Growth at a time when Kurtin and his cohorts were, in fact, intending to profit and actually profiting by selling Kurtin's California Growth stock at prices of a dollar or more per share above the market.

19. The references to a limitation on an investment in California Growth because of disclosure requirements of the Securities and Exchange Commission, and misrepresentations concerning the need to effect purchases through Kennedy, Levy & Co. or Clements & Associates and the justification for the premium price investors had to pay, added to the conspiratorial air, and were undoubtedly intended to excite the fancies of gullible investors as well as to cause credence to be given to the scheme.

20. Although the Hearing Examiner accepts as true Clements' testimony that he did not authorize the use of the name of Clements & Associates by Capital Gains, the evidence is clear that he permitted Kurtin, Barber and Risser to use his offices and business name in his absence and that he knew that sales of California Growth stock were to be attempted. Moreover, Clements could not escape his responsibilities as a registered broker-dealer by absenting himself from the United States nor could he delegate those responsibilities to Barber by a power of attorney. The Commission has on several occasions in recent years made it clear that the principal of a registered broker-dealer has a duty to keep himself informed about the activities in his office and to insure compliance with applicable regulations.[5/] Accordingly, even if Clements were to be

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5/ General Investing Corporation, Securities Exchange Act Release No. 7316, p. 6(May 15, 1964): Aldrich, Scott & Co., Inc., 40 S.E.C. 775, 778(1961); Reynolds & Co., 39 S.E.C. 902, 916(1960).

found not to have been actually aware of the plans of Kurtin and the others, he would still have failed to properly supervise the activities of persons employed by and controlling Clements & Associates. That failure to supervise constitutes a participation in the misconduct of registrant for which Clements becomes responsible.6/

21. In view of the foregoing, the Hearing Examiner finds, as alleged by the Division, that during the period from approximately September 1, 1962 to approximately December 31, 1962 Capital Gains, Kaiser, Clements & Associates, Barber, Kurtin, Cherry7/ and Risser wilfully violated and aided and abetted wilful

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6/ Reynolds & Co., id, 39 S.E.C. at p. 917.

7/ While some question could be raised as to whether Cherry is associated with either Capital Gains or Clements & Associates in the sense required to vest jurisdiction over him in these proceedings, the Hearing Examiner finds that the evidence is sufficient to show that he did so associate himself with these registrants.

violations of 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 offer and sale of California Growth stock; and of Sections 206(1) and (2) of the Advisers Act, by employing devices, schemes and artifices to defraud, and by engaging in transactions, practices and courses of business which operated as a fraud upon clients of Capital Gains.

Other Violations by Capital Gains and Kaiser

A. Bookkeeping Rules

22. The uncontradicted evidence with respect to the general conduct of the business of Capital Gains is that it had never maintained general and auxillary ledgers (or other comparable records) reflecting asset, liability, reserve, capital, income and expense accounts, except insofar as copies of tax returns filed with the Internal Revenue Service related to the assets and liabilities of the firm; and did not make and keep trial balances, financial statements or internal audit working

papers relating to its business.

23. It further appears that Capital Gains ceased doing business on April 1, 1963 when, as Kaiser testified in an earlier proceeding before the Commission,[8/] advisory publications by Capital Gains were discontinued. However, the Commission's File No. 801-1917-1 containing the public documents relating to the registration of Capital Gains does not include the notification, as required by Rule 204-2(f), of the address at which such books and records as Capital Gains may have had were to be maintained for the period required by the Commission's rules.

B. Failure to Amend Form ADV

24. No amendment has ever been filed by Capital Gains to its Form ADV application for registration to disclose that the name of its president had been legally

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8/ Kennedy, Levy & Co., File No. 8-10587.

changed on March 26, 1963 from Glen Meyers to Karl N. Kaiser. Such amendment was required to be filed promptly by Rule 204-1(b) under the Advisers Act to correct information which had become inaccurate in the application by reason of that name change.

25. In addition, Capital Gains was required by Rule 204-1(b) to file promptly amendments to disclose the discontinuance of its publication, Trend & Signals. A more serious omission by Capital Gains with respect to filing an amendment was its failure to report that its advisory service was not limited to the issuance of Trends & Signals but included the offering to the public of several investment advisory reports and manuals under the titles Capital Gains in Gold, High Rebound Convertible Bonds, Rebound Ratings for 1960, High Rebound Warrants, and Capital Gains, and of a second periodic market letter entitled Low Priced Situations.

C. False and Misleading Statement in Form ADV-Sup

26. The failure of Capital Gains to disclose the numerous advisory publications being offered by it to

the public and the negative responses it placed in the Form ADV supplement dated May 29, 1961 concerning the existence of any such advisory service made the supplement false and misleading with respect to those material facts.

D. Representation as being an Investment Counselor

27. On the facing page of Trends & Signals and of the manuals published by Capital Gains, and in its advertisements in national financial publications, as well as on the face of envelopes used by it, Capital Gains printed the words "Investment Counselors", thereby holding out to the public that it was an investment counsel. In view of the fact that the investment advice of Capital Gains was furnished solely by means of publications, periodic and otherwise, with no investment supervisory services being rendered, there is no question but that Capital Gains unlawfully represented itself to be an investment counsel.

E. Other Fraudulent Conduct

28. When Kaiser terminated the business of

Capital Gains on April 1, 1963, he did not trouble himself with advising his subscribers that they would receive no further service. Capital Gains did not answer inquiries from subscribers resulting from their failure to receive Trends & Signals but did retain at least one renewal payment mailed to it in May, 1963. Such conduct, unexplained by Kaiser, when taken in context with the other activities of Capital, leads to the conclusion that the cessation of publication and retention of subscription payments were part of the fraudulent practices engaged in by Capital Gains.

29. It further appears that Kaiser was not above attempting to make illegal profits through "scalping." Capital Gains strongly recommended purchase of the Class B common stock of Autofab, Ltd., a Canadian company,[9/] in its February and March, 1963 issues of Trends & Signals and Low Priced Situations. No disclosure

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9/ On April 19, 1963 the Commission announced the addition of Autofab, Ltd. to its Canadian Restricted List (Securities Act Release No. 4599).

was made by Capital Gains that Kaiser had purchased 10,000 shares of that stock between January 18, 1963 and February 12, 1963 with the apparent intention of disposing of it as soon as the recommendation had been assimilated and acted upon by Capital Gains' subscribers. Kaiser sold 7,900 shares of his 10,000 shares during the period March 27, 1963 to April 23, 1963, taking a loss on his trading.10/

30. Failure to disclose the material facts concerning Kaiser's pecuniary interest in the stock his company was recommending operated as a fraud or deceit upon the subscriber receiving those recommendations. For, as the United States Supreme Court observed in

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10/ Whether Kaiser made a profit or incurred a loss would not be material to the determination of whether a fraud has been committed. S.E.C. v. Capital Gains Research Bureau, 375 U.S. 180, 201, 84 S. Ct. 275, 287.

S.E.C. v. Capital Gains Research Bureau, supra:

> .... The high standards of business morality exacted by our laws regulating the securities industry do not permit an investment adviser to trade on the market effect of his own recommendations without fully and fairly revealing his personal interests in these recommendations to his clients.

F. Responsibility of Kaiser

31. The record establishes that Kaiser is the dominant and controlling force behind Capital Gains, and that as its president, a director, and owner of a majority of its stock, he directed and managed the affairs of the company. It is also clear that Kaiser had an obligation and responsibility in his position of control to make certain that Capital Gains complied with the regulations relating to investment advisers, and, of course, not to cause Capital Gains to act improperly and fraudulently.

G. Wilful Violations

32. On the basis of the foregoing, the Hearing Examiner concludes that Capital Gains, aided and abetted by Kaiser, wilfully violated, as alleged by the Division in Paragraphs B and C of Section II of the Order for

Proceedings against Capital Gains, Sections 204, 206(1) and (2), 207 and 208(c) of the Advisers Act and Rules 204-1(b) and 204-2(a) and (f) thereunder.

Other Violations by Clements & Associates

A. Net Capital Rule[11/]

33. In September, 1963 and again in December, 1963 inspections of the books and records of Clements & Associates were made and trial balances as of September 23, 1963 and November 29, 1963, respectively, were extracted from those books and records by an investigator on the staff of the Los Angeles Branch Office. According to the computations of that investigator, Clements & Associates required $4,268 as of September 23, 1963 and $5,221 as of November 29, 1963 to be in compliance with the Net Capital Rule. It

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11/ Rule 240.15c3-1.

further appears that Clements & Associates made use of the mails to effect over-the-counter securities transactions on and during the period covered by the dates of these trial balances.

34. In connection with the computations of the net capital of Clements & Associates, Clements challenged the investigator's deduction of certain securities in inventory and of a bank balance from the total assets shown on the books of Clements & Associates. The securities in question were 471 shares of stock of F. W. Woolworth Ltd. which Clements had given as collateral or earnest during the course of negotiations for the purchase of a franchise unrelated to the securities business. In September, 1963 Clements made demand upon the holder of the Woolworth stock for its return, but the demand was refused. It was not until December 31, 1963 following several months of negotiations by Clements and his attorney, that Clements was able to regain possession of the Woolworth

certificates. The bank balance that was disregarded was an account which was shown on the books of Clements & Associates, as well as by the bank, to be in the name of Patrick Clements & Associates, Inc. The bank account appears to have been opened by Ray, who was then office manager for Clements & Associates, as a part of an understanding with Clements that Ray was to participate in Patrick Clements & Associates, Inc., when it became activated. Clements' signature was not one of the two authorized signatures to be honored in drawing against the bank account in question and there is no credible evidence that Clements could or did exercise dominion over that account.

35. The Hearing Examiner concludes that the Woolworth stock was not readily convertible into cash by Clements & Associates; that the bank account in the name of Patrick Clements & Associates, Inc., was not an asset of Clements & Associates; and that Clements & Associates was not in compliance with the Net Capital

Rule on September 23, 1963 and November 29, 1963. The Examiner further concludes that Clements & Associates wilfully violated, as alleged by the Division, Section 15(c)(3) of the Exchange Act and Rule 15c3-1 thereunder.

B. Bookkeeping Rule[12/]

36. On June 4, 1963, Clements placed an order for 5,000 shares of Sarcee Petroleums, Ltd. stock with a securities firm located in San Marino, California. The following day, Clements asked that the trade be canceled because the person for whom he had purchased the stock refused to accept it. It appears that the trade could not be broken and that instead, without notification to Clements, the 5,000 shares were sold at a loss on June 5, 1963. The purchase and later sale of the Sarcee Petroleum Ltd. stock were not recorded in the general ledger of Clements & Associates. Clements contended that the Sarcee Petroleum transactions

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12/ Rule 240.17a-3.

were personal to him and that therefore it was not necessary to record them as transactions of Clements & Associates. Apart from the fact that Clements, engaged as he was in the securities business as a sole proprietor, cannot be permitted to designate certain securities transactions as personal and others as being those of Clements & Associates,[13/] the evidence shows that Clements was purchasing the Sarcee Petroleum stock for a customer and not for personal investment. Since the books and records of Clements & Associates did not during the period from August 30, 1963 to December 31, 1963 reflect the Sarcee Petroleum transactions, such books and records were incomplete and continuously inaccurate in that respect for that period.

34. The evidence is also conclusive that Clements & Associates did not adequately or properly reflect

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13/ Chester R. Koza & Co., 39 S.E.C. 950, 952(1960); Lawrence R. Leeby, 32 S.E.C. 307(1951)

capital contributions of $2,300 by Ray to Clements & Associates between September and November, 1963 and improperly included as of November 29, 1963 the bank account in the name of Patrick Clements & Associates, Inc. as an asset of Clements & Associates.

35. The Hearing Examiner does not agree with the Division that the fee owing to the attorney who had been engaged by Clements to incorporate Patrick Clements & Associates, Inc. or the disclaimed liabilities that Clements caused the accountant for Clements & Associates to eliminate by an adjusting entry should have been reflected in the books. With respect to the attorney's fees, the weight of the evidence does not establish that the attorney was engaged for a purpose related to Clements & Associates, but rather tends to indicate that he was representing Clements and other individuals in an undertaking divorced from the operations of Clements & Associates. Insofar as the disclaimed liabilities are concerned,

the Division failed to carry the burden of showing that those liabilities belonged on the books of Clements & Associates. Clements has steadfastly and repeatedly denied that any liability existed for the debts in question, and the Division introduced no evidence to overcome those denials beyond the fact, which is not deemed sufficient, that the debts had at one time been recognized on the books of Clements & Associates.

36. The Hearing Examiner concludes, in view of the noted inaccuracy and incompleteness of the books and records of Clements & Associates, that Clements & Associates wilfully violated Section 17(a) of the Exchange Act and Rule 17a-3 thereunder as alleged by the Division.

C. Other Fraudulent Conduct

37. The Division also alleged in effect, that by reason of Clements & Associates engaging in business while in violation of the Net Capital Rule and of the Commission's bookkeeping rule, Clements & Associates

committed a fraud upon its customers. Although the Division did not pursue this issue in its Proposed Findings, Conclusions and Brief beyond proposing findings that a violation of the anti-fraud provisions of the Securities Act and of the Exchange Act had been committed in conjunction with the violation of the Net Capital Rule, and again when the bookkeeping rule had been violated, the question is one of importance in delineating the extent of the protection afforded to the public by these rules.

38. Insofar as the Hearing Examiner can determine, the Commission has never had before it the precise question involved in the present allegations, although there have been instances where a broker-dealer's conduct has been considered fraudulent when a net capital violation was linked with a failure by the broker-dealer to meet its obligations,[14/] or when net

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14/ Aronson & Co. 39 S.E.C. 839(1960); Financial Equity Corporation, Securities Exchange Act Release No. 7326, p. 3(May 27, 1964).

capital or bookkeeping violations have formed a part of a fraudulent scheme that included other conduct readily recognizable as fraudulent.15/ The present issue, while novel in the sense that the question has not been passed upon by the Commission, is not complex. It appears to resolve itself into one of determination of whether a false representation is made or an omission of a material fact occurs when a broker-dealer effects a transaction while in violation of one or both of these two rules. The purposes for which the rules were enacted have a highly material bearing upon this consideration.

39. The Net Capital Rule was promulgated by the Commission to implement the provisions of Section 15(c)(3) of the Exchange Act which prohibit transactions by a broker-dealer "in contravention of such rules as

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15/ Edward H. Stern & Co., Inc., Securities Exchange Act Release No. 7277(March 25, 1964)

the Commission may prescribe..... for the protection of investors to provide safeguards with respect to the financial responsibility of brokers and dealers." The importance of the rule and its purpose were articulated by the Commission in unequivocal terms in Luckhurst & Company, Inc., 40 S.E.C. 541, in response to the registrant's contention that its net capital violations should not be seriously regarded. The Commission there stated, at p. 541:

> The net capital rule was designed to make as certain as possible that broker-dealers subject to the /Securities Exchange/ Act would be solvent and to afford investors some margin of protection against the financial stresses and strains of the securities business. We can hardly bring ourselves to regard violations of this salutary rule as an innocuous failure to comply with an inconsequential administrative prescription.

In Blaise D'Antoni & Associates, Inc. v. Securities and Exchange Commission, 289 F2d 276, 277(C.A. 5, 1961) the Court took the same serious view of the rule that the Commission had taken, observing:

> The net capital rule is one of the most important weapons in the Commission's arsenal to protect investors. By limiting the ratio of a broker's indebtedness to his capital, the rule operates to assure confidence and safety to the investing public.... D'Antoni, Inc., improperly - and wilfully - subjected its customers to undue financial risks by conducting its business in violation of this rule. /Emphasis supplied/

40. It is apparent from the language of Section 15(c)(3) of the Exchange Act and that of the Commission and of the Court that the Net Capital Rule is considered as a protective device designed to reduce the risks of the public in dealing with a broker-dealer. It follows then that when a broker-dealer not in compliance with the rule effects a transaction, its customer does not have the protection to which he is entitled and is subjected to a risk of loss which he would not ordinarily have faced.

41. Over the years, the Commission has stressed in a variety of cases that the relationship of a

broker-dealer towards its customers is not that of an ordinary merchant to his customers,[16/] and, with concurrence by the Courts, has embraced within the "shingle" theory a number of implied representations - all relating to dealing fairly with the public - that are made by a broker-dealer whenever a transaction is effected.[17/] It further appears that the implied representations that have been found to exist relate to matters about which the ordinary investor would not inquire because of a normal assumption that the broker-dealer, regulated and registered as it is, would deal fairly and in keeping with the customs and practices of the securities industry.

42. It is the opinion of the Hearing Examiner

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16/ W. H. Keller, Stockbroker, 38 S. E. C. 900, 905(1959); William J. Stelmack Corporation, 11 S.E.C. 601, 623(1942).
See also Charles Hughes & Co., Inc. v. S.E.C., 139 F2d 434, 437, cert denied, 321 U.S. 786

17/ Loss, Securities Regulation, 2d Ed.(1961) pp. 1488-1489, 1508.

that now, even though perhaps not so in earlier years, investors are generally aware of the fact that the Commission has provided financial safeguards for them in their dealings with broker-dealers, and also that investors naturally assume that any broker-dealer open for business has the financial stability required by the Commission. The Hearing Examiner concludes therefore that an implied representation of compliance with the Net Capital Rule is made by a broker-dealer when it holds itself out as being ready, able and willing to effect securities transactions; that in effecting securities transactions while in violation of the Net Capital Rule, a broker-dealer makes a false representation to its customers; and that the financial status of a broker-dealer is a material fact to be taken into consideration by an investor in assessing the risks involved in turning over money or securities

to that broker-dealer.[18/] Accordingly, it is concluded that Clements & Associates wilfully violated Section 17(a) of the Securities Act and Sections 10(b) and 15(c)(1) and Rules 10b-5 and 15c1-2 thereunder by engaging in business as a broker-dealer while, at various times during the period from August 31, 1963 to December 31, 1963 not being in compliance with the Net Capital Rule.

43. The bookkeeping rule, although in no sense regarded as less important in the administration and enforcement of the securities laws, appears to have been promulgated more to create an enforcement tool than a safeguard as such.[19/] Moreover, it is doubtful

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18/ All other things being equal, it is inconceivable that, given a choice, the average prudent investor would not select a broker-dealer whose financial condition meets the standards adopted by the Commission for the protection of the public over another broker-dealer doing business in contravention of the Net Capital Rule.

19/ Midas Management Corporation, 40 S.E.C. 707, 709(1961);
Kelly Rubenstein, Inc., 38 S.E.C. 582, 584(1958).

that the risks to an investor are materially increased solely by reason of a failure of the broker-dealer with whom he effects a transaction to have the books and records required by the Commission's rule. Accordingly, the Hearing Examiner concludes that a violation of the bookkeeping rule in and of itself would not necessarily result in a fraud being perpetrated upon investors and further that, under the circumstances of this case, Clements & Associates did not violate the anti-fraud provisions of the Securities Act or of the Exchange Act by engaging in business while in violation of the bookkeeping rule.

Public Interest

44. The record discloses no mitigating circumstances for the abuse of the trust and confidence reposed in Capital Gains by its investment advisory clients nor for the irresponsible manner in which Clements & Associates conducted business in the absence, as well as during the presence, of Clements. The

seriousness and the multiplicity of the violations committed by Capital Gains and by Clements & Associates are such as to cause the Hearing Examiner to conclude that the public interest requires revocation of the registration of Capital Gains as an investment adviser and the revocation of the registration of Clements & Associates as a broker-dealer.

Recommendations

45. The Hearing Examiner recommends on the basis of the foregoing that the Commission enter an order finding that it is in the public interest to revoke the registration of Capital Gains as an investment adviser.

46. It is further recommended that the Commission enter an order that denies the request for withdrawal of the registration of Clements & Associates as a broker-dealer, revokes such registration, and expels Clements & Associates from membership in the NASD.

47. It is also recommended that Barber, Risser and Kurtin each be found to be a cause within the meaning

of Section 15A(b)(4) of the Exchange Act of any order of revocation, suspension or expulsion entered herein against Clements & Associates.[20/]

Respectfully submitted,

Warren E. Blair

Warren E. Blair
Hearing Examiner

New York, New York
June 19, 1964

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20/ To the extent that the proposed findings and conclusions submitted by the parties are in accord with the views set forth herein, they are sustained, and to the extent that they are inconsistent therewith, they are expressly overruled. However, that portion of the Division's proposed findings and conclusions under the caption Offer of Proof has not been considered because it relates to exceptions to rulings made by the Hearing Examiner during the course of the hearings herein.