UNITED STATES OF AMERICA

Before the

SECURITIES AND EXCHANGE COMMISSION

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In the Matter of
LINDER, BILOTTI & CO., INC. 50 Broadway New York, New York
File No. 8-9570

RECOMMENDED DECISION

Washington, D. C.
July 29, 1964

Irving Schiller
Hearing Examiner

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In the Matter of LINDER, BILOTTI & CO., INC. 50 Broadway New York, New York File No. 8-9570	RECOMMENDED DECISION

BEFORE: Irving Schiller, Hearing Examiner

APPEARANCES: William Lerner, John P. Cione, Roberta S. Karmel and Arthur F. Mathews, Esqs. For the Division of Trading and Markets of the Securities and Exchange Commission.

Davis J. Stolzar, Esq. of Kaufman, Stolzar and Kaufman for Linder, Bilotti & Co., Inc., Armand Bilotti and Hyman S. Linder.

The issues now before the Hearing Examiner in these proceedings under Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") is whether it is necessary or appropriate in the public interest or for the protection of investors to suspend the registration as a broker and dealer of Linder, Bilotti & Co., Inc. ("registrant") pending final determination of whether such registration should be revoked.[1/] These proceedings were instituted to determine whether to revoke or, pending final determination, to suspend registrant's registration; what, if any, remedial action is appropriate in the public interest pursuant to Section 15(b) and 15A of the Exchange Act and whether, under Section 15A(b)(4) of the Exchange Act Armand Bilotti ("Bilotti") and Hyman S. Linder ("Linder"), or either of them, should be found to be a cause of any order of revocation or of suspension, which may be issued.

The order for proceedings alleges, among other things, that from approximately July 31, 1962 to September 30, 1963 registrant,

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1/ Section 15(b) of the Exchange Act provides with respect to suspension of registration as a broker or dealer:

> "Pending final determination whether any such registration shall be revoked, the Commission shall by order suspend such registration if, after appropriate notice and opportunity for hearing, such suspension shall appear to the Commission to be necessary or appropriate in the public interest or for the protection of investors."

With respect to revocation, Section 15(b), as applicable to this case, provides that the Commission shall revoke the registration of any broker or dealer if it finds that it is in the public interest and such broker or dealer or a controlling or controlled person of such broker or dealer has willfully violated any provision of the Securities Act of 1933 or the Exchange Act or any rule thereunder.

Linder and Bilotti effected transactions in securities in willful violation of the net capital requirements of Section 15(c)(3) of the Exchange Act and Rule 17 CFR 240.15c3-1 thereunder;[2/] that from about July 31, 1962 to September 30, 1963 registrant, Linder and Bilotti willfully violated the anti-fraud provisions of the Exchange Act and of the Securities Act of 1933 ("Securities Act") in the offer for sale and sale of interest-bearing corporation notes of the registrant and shares of the Class A common stock of the Elite Theatrical Productions, Ltd. ("Elite")[3/] and that from approximately May 24, 1963 to September 26, 1963, registrant, Linder and Bilotti, singularly and in concert, willfully violated Sections 5(a) and (c) of the Securi-

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2/ Section 15(c)(3) of the Exchange Act and Rule 15c3-1 thereunder prohibit any broker or dealer from using the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (with certain stated exceptions) otherwise than on a national securities exchange, when his aggregate indebtedness to all other persons exceeds 2,000 per centum of his net capital. The terms "aggregate indebtedness" and "net capital" as used in the rule are defined therein.

3/ The anti-fraud provisions alleged to have been violated are Section 17(a) of the Securities Act and Sections 10(b) and 15(c)(1) of the Exchange Act and Rules 17 CFR 240.10b-5 and 15c1-2 thereunder. The effect of these provisions, as applicable here, is to make unlawful the use of the mails or interstate facilities in connection with the offer or sale of any security by means of a device to defraud, an untrue or misleading statement of a material fact, or any act, practice or course of business which operates or would operate as a fraud or deceit upon a customer, or by the use of any other manipulative or fraudulent device.

ties Act in the offer to sell and sale and delivery after sale of the Class A common stock of Elite when no registration statement had been filed or was in effect as to the said securities under the Securities Act.[4/]

After appropriate notice, hearings were held before the undersigned hearing examiner. Proposed findings of fact and conclusions of law and briefs in support thereof were submitted by counsel for the Division of Trading and Markets and by counsel for registrant and Linder and Bilotti (hereinafter sometimes referred to as respondents).

The following findings and conclusions are based on the record, the documents and exhibits therein and the hearing examiner's observation of the various witnesses.

1. Registrant, a New York corporation, has been registered with the Commission as a broker and dealer since June 10, 1961.[5/] Registrant has been and is a member of the National Association of Securities Dealers, Inc. ("NASD"). From June 10, 1961 to the date of

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4/ Sections 5(a) and 5(c) of the Securities Act make it unlawful to use the mails or the facilities of interstate commerce to sell or deliver a security unless a registration statement is in effect as to such security, or to offer a security unless a registration statement has been filed with respect to such security.

5/ Registrant originally registered under the name of Stirling, Linder and Prigal, Inc. and by amendment on Form BD filed December 3, 1962 changed its name to Stirling, Linder, Prigal and Bilotti, Inc. and by further amendment filed February 5, 1963 changed its name to Linder, Bilotti & Co., Inc.

these proceedings Linder has been vice president, director and owner of 10% or more of the common stock of the registrant and since February 21, 1963 has also acted as secretary of registrant. From approximately August 21, 1962 to February 21, 1963 Bilotti was vice president and beneficial owner of 10% or more of the common stock of registrant and on or prior to December 14, 1962 Bilotti became a director of registrant. From approximately February 21, 1963 to date Bilotti has been president, treasurer, director and beneficial owner of 10% or more of the common stock of the registrant.

Offer and Sale of Elite Stock - Violations of Anti-fraud Provisions

2. Elite was organized by Linder and Bilotti under the laws of the State of Delaware on May 24, 1963 for the purpose of operating, exploiting, managing and producing ventures of all types in the theatrical and entertainment fields. Elite has an authorized capitalization of 750,000 shares of Class A common stock and 5,000 shares of Class B common stock, both of which have a par value of 1¢ per share. Linder and Bilotti each received 1,000 shares of Class B common stock when Elite was incorporated for $200 in cash paid by each of them. In August of 1963 each of the said individuals purchased an additional 500 shares of the said stock for $50.00 each. In the same month Elite issued 500 shares to two individuals of a public relations and management consulting firm as additional compensation to a monthly retainer of $500 and 1,000 shares of said stock to a director of the company for 1¢ per share. Since the organization of

Elite, Linder has been president, treasurer and director and Bilotti has been vice president, secretary and a director. From its inception Elite has shared offices with registrant. Linder and Bilotti each received $5,000 for services rendered to Elite from its inception to September 1, 1963. On September 26, 1963 Elite filed a registration statement with the Commission for a proposed public offering of 400,000 shares of Class A common stock of the par value of 1¢ per share at a proposed offering price of $5.00 per share. Registrant was named as a proposed underwriter. The registration statement has not become effective.

3. The order for proceedings alleges, in pertinent part, that registrant and Linder and Bilotti offered for sale and sold the Class A common stock of Elite in violation of the anti-fraud provisions of the Securities Act and the Exchange Act. The record shows and registrant admits that during the period June through August of 1963 it sold a total of 45,500 shares of Class A common stock of Elite at $2.00 per share to ten individuals and that the mails were used in the offer to sell and sale of the said stock.

4. During the course of the hearing ten witnesses testified they purchased the common stock of Elite relying on representations made to them by Linder and Bilotti. Seven other witnesses testified as to conversations they had with either Linder or Bilotti or both during which Elite was suggested to them for their consideration as an investment, but they declined to purchase the said stock. To

properly evaluate all of the representations made by Linder and Bilotti to both purchasers of the stock and the other persons who testified, consideration will first be given to whether, at least, the seven witnesses who testified as to their conversations relating to Elite, should be considered as offerees under securities acts.

5. Registrant, Linder and Bilotti concede that three of the seven witnesses were offerees[6/] but contend no "offer" of Elite was made to the remaining four. All four of such witnesses testified that Bilotti spoke to them about a company in the theatrical or entertainment field or in the distribution of motion pictures. Three of them testified they were told the company was Elite. Though the fourth had some difficulty in definitely remembering the name Elite she testified that Linder and Bilotti both came to her place of business in the spring or early summer 1963, talked to her about stocks and wanted her to invest $10,000 in a motion picture company which they had recently organized. The record establishes that Elite was the only company organized by Linder and Bilotti in the spring or summer of 1963. The witness also testified that she was told the stock they were talking about would shortly come out in the public market and her investment would thus increase. Elite was the only company whose stock Linder

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6/ Though respondents in this brief state that these three persons may have been offerees the record shows that Bilotti furnished the staff with a statement on the letterhead of Elite entitled "Offerees" which included not only the ten purchasers of Elite stock but also listed the three persons in question as individuals to whom Elite stock had been offered.

and Bilotti intended to put on the market at this time. All four witnesses were told that the stock which was the subject matter of the conversations would shortly go "on the market" at a higher price or that their investment would appreciate when Elite went on the market. Two of the four witnesses testified they were told they could buy the stock at $2 a share and the third recalled the stock was under $5. The statements made to the four individuals concerning Elite were substantially similar to the statements made by Linder or Bilotti to the three persons whom they concede were offerees.

6. The term "offer to sell," "offer for sale" or "offer" is defined in the Securities Act to include every attempt or offer to dispose of. . .a security or interest in a security, for value. Linder and Bilotti admitted they talked to the four witnesses regarding Elite, but contend they never "offered" the Elite stock to such persons. The testimony of the four witnesses in question is clear and unmistakable that Linder and Bilotti in the terms of said Act either offered or attempted to dispose of Elite for value. Neither in their testimony nor their briefs do Linder and Bilotti furnish any rational explanation to support their claim that no offer was made to the four persons. The hearing examiner finds that Linder and Bilotti offered Elite stock to at least four persons in addition to the three individuals they admit were offerees.

7. Bilotti further testified that he "mentioned" Elite to another of his customers, once in person during a visit to the

customer's farm in Pennsylvania, and may have "discussed" Elite two or three times thereafter during telephone conversations in which he tried to interest him in the company. Though Bilotti also denied that he made an "offer" of Elite stock to this customer he admitted he considered him possibly as being "a purchaser of Elite when we went public." On the basis of the record the hearing examiner finds that Bilotti also offered Elite stock to this customer.

8. Shortly after Elite was formed Linder and Bilotti determined to raise capital for the company to permit it to commence operations. With this in mind Bilotti admittedly screened registrant's customers whose accounts he serviced, selected those who in the past had placed their trust and confidence in him as their broker and completely relied on his judgment in recommending investments and offered them stock in Elite. Fifteen of the witnesses who testified as to the Elite stock offered to them were clients of Bilotti, two were clients of Linder. Of the ten purchasers, nine were clients of Bilotti and the other a client of Linder.

9. Bilotti represented to each of his clients who testified that Elite was in the theatrical and entertainment business, was either in the process of making or would purchase films, including foreign films, and would finance and/or produce plays either on or off Broadway. Bilotti also represented to eleven of his customers that the price of Elite stock would increase shortly, telling them that the stock should go up to $5 when the public offering goes through the

SEC, or that the company had a great future and the stock should double in value or go to $5, or the Elite should go to $4, or that a public offering would soon be made at a price in excess of the $2, at which it was being offered to the customer, or the stock would shortly be on the market at a higher price, or the company would file a "brochure" in Washington to sell the stock at $5, or that Elite would do well and make up for some of the customers' previous losses or that the stock would be offered in September at $10. To one potential customer who earlier declined to purchase Elite but who inquired in August whether the $2 offering was still good Bilotti stated that if she wanted the stock she would then have to pay $5 for it. Linder represented to the one customer to whom he sold Elite stock that within 90 days a public offering would be applied for at $5 per share at which time the investor could sell his stock. In addition to the price increase representations, Bilotti told at least five of his customer witnesses that Elite was a very good or good or safe investment, that it had good possibilities of earning very good money, that there would be big capital gains and that Elite had a great future and in time may go on the Board. Linder represented to his client that Elite was a very good investment.

10. The record discloses that there was no reasonable basis for the representations made to the purchasers or potential purchasers. Elite had been recently organized by Linder and Bilotti, neither of whom had any prior experience in any phase of the theatrical business.

During the period June through September, when the offers and sales were made, the record shows that Linder and Bilotti in addition to operating registrant's brokerage business were making some efforts primarily of a promotional nature on behalf of Elite. There is some evidence that they talked with two or three producers and several actors, read scripts, employed one or two persons for a short period of time to try to obtain properties for the company and used one or two of registrant's clerical employees on a part-time basis. The record also shows that in July, Elite invested $3,300 in an off-Broadway repertory company doing Gilbert & Sullivan operettas which suspended operations on September 2, 1963 and in August entered into an agreement to become co-producer of a color film dealing with African Congo painters, which agreement was later rescinded and the investment recovered. Early in September, Elite agreed to invest a maximum of $10,000 in a play which opened on Broadway and closed after one performance. Elite never had any income and Linder testified the company sustained losses.

11. Wholly apart from the representations made, the record also shows that neither Linder nor Bilotti disclosed to any of the investors or potential investors the hazards inherent and the risks involved in an investment in a theatrical enterprise. Thus, no disclosure was made that Elite would be engaged in a highly competitive business, or that some area of business activities which the company intends to engage is already overcrowded or that many plays

produced for the legitimate stage are complete or partial financial failures, or that with respect to theatrical ventures there was a greater possibility of loss than of gain, or that in light of the speculative type of venture no assurance could be given as to income or as to return of investment, or that any of the company's operations will prove profitable.[7/] Though nine of the ten purchasers testified they were told that Elite would shortly make a public offering none of them was told that his equity would be diluted to the extent that such offering was successful.[8/]

12. Respondents urge that the record is virtually barren of any showing of any area wherein respondents departed from the material facts set forth in the subscription agreements each of the purchasers of Elite stock were requested to and signed at the time they purchased their Elite stock. The record fails to support such contention. Bilotti testified that no representations were made to the ten purchasers other than by way of explanation of the said subscription agreements. The hearing examiner rejects Bilotti's testimony in this respect and credits the testimony of the ten investor witnesses, all

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7/ Such disclosures were made in the registration statement filed with the Commission by Elite on September 26, 1963 (File No. 2-21732) which, as previously noted, has not yet become effective.

8/ The record shows that one purchaser who owned approximately 33% of the Class A common stock of Elite at the time the registration statement was filed would have owned slightly in excess of 3% if the offering had been successful and four other purchasers who owned between approximately 11 and 15% would have owned slightly in excess of 1% as a result of such offering.

of whom testified that Bilotti or Linder talked to them about Elite prior to the date they signed the agreements in an effort to interest them in making an investment in the company and that the representations were made to them orally either prior to or at the time they signed the agreements. The testimony of six of the purchasers regarding the representations as to the future price increase of the Elite stock and the testimony of four purchasers that they were told Elite was a good or safe investment was so strikingly similar to the representations made to the potential investors in attempts to induce them to purchase Elite stock that it leaves no doubt in the hearing examiner's mind, and he so finds, that Linder and Bilotti made representations, other than merely an explanation of the contents of the agreements, to the purchasers of the Elite stock.

13. On the basis of the record, registrant, Linder and Bilotti had no basis for the predictions of a substantial price rise. The representations that an investment in Elite stock was good or safe were without any reasonable basis and were unwarranted. The Commission has consistently held and it has been judicially established that unfounded predictions as to future levels, unsupported by any reasonable basis of fact are a "hallmark of fraud." Mac Robbins & Co., Inc., Exchange Act Release No. 6846, July 11, 1962, P 15, affirmed, sub nom Berko v. Securities and Exchange Commission, 316 F.2d 137 (C.A. 2, 1963), See also Alexander Reid & Co., Inc., 40 S.E.C. 986 (February 8, 1962). A Federal court, in language

particularly appropriate to the instant case, recently stated:

> "The financing of a corporate enterprise by the sale of stock to the public is a fertile field for the practice of deception. The purchaser receives a piece of paper for his investment and must rely in large degree, as to the worth of it, upon representations made with respect to the nature and value of the interest he has acquired in the corporate business.
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> "The standards of conduct prescribed for this type of business cannot be whittled away by the excuse that false statements made were inadvertently made without intent to deceive, or by reliance upon the literal truth of a statement which, in the light of other facts not disclosed is nothing more than a half-truth. Nor may refuge be sought in the argument that representations made to induce sale of stock dealt merely with forecasts of future events relating to projected earnings and the value of the securities, except to the extent that there is a rational basis from existing facts upon which such forecast can be made, and a fair disclosure of the material facts. The element of speculation is inherent in stock investments, but the investor is entitled to have the opportunity to evaluate the risk of loss, as against the hope of a lucrative return, from true statements of the financial status of the corporate enterprise in which he is acquiring an interest." 9/

14. The record shows Elite never had any earnings nor was there any measurable expectation of any profits in the future. Though the company sustained losses from its inception no effort was made to disclose such fact to the purchasers or offerees. Wholly apart from the losses, the predictions of a substantial price rise to named figures coupled with the representations, stated in some instances and implied in others, that when Elite made a public offering

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9/ S.E.C. v F. S. John & Co., 207 Fed. Supp. 566 (1962)

of its stock, purchasers and offerees would be free to sell at a price at least double their investment cannot under these circumstances be justified. Particularly is this true when the predictions relate to a promotional and highly speculative security of an unseasoned company. The hearing examiner finds that in the offer and sale of Elite Class A common stock registrant, Linder and Bilotti made false and misleading statements and omitted to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading in willful violation of the above-mentioned anti-fraud provisions of the securities acts.

Violation of Section 5 of the Securities Act

15. The Commission's order alleges additionally that the sale of the common stock of Elite also was in violation of the registration requirements of the Securities Act. The record shows that the offers to sell and sales of Elite stock occurred during the period June through about the middle of September 1963. Respondents admit that no registration statement was filed by Elite during such period and concede the use of the mails in connection with the offers to sell, sales and delivery after sale of the Elite stock. Respondents contend that the offer to sell the said stock during the period June through August 1963 was a non-public one exempt from the registration requirements of the Securities Act by reason of

Section 4(1) thereof. Respondents assert that the number of offerees was limited to under twenty (not conceding, of course, that all of the persons who testified as to their conversations concerning Elite should be deemed offerees), that all the purchasers agreed, in writing, to take for investment and not with a view to distribution and that a legend to this effect and with respect to resale appeared on all certificates.

16. In determining whether a private offering exemption is available, it is well settled that the general policy of the Securities Act requiring registration must be strictly construed against, and the burden of proof rests on the person claiming such exemption.[10/] On the basis of the record respondents have failed to sustain the burden of proof. In urging that the number of offerees was limited to any small number, respondents fail to comprehend the statutory purpose of the Securities Act to protect investors by promoting full disclosure of information necessary to informed investment decisions. A private offering exemption is not established by merely showing that the offering was made to a small group.[11/] The Supreme Court in S.E.C. v. Ralston Purina Co., 346 U.S. 119, 124, 125 (1953) held that "the applicability of Section 4(1) should turn

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10/ S.E.C. v. Ralston Purina Co., 346 U.S. 119 (1953); S.E.C. v. Culpepper, 270 F.2d 241 (C. A. 2 1959); Gilligan Will & Co., v. S.E.C. 267, F.2d 461 (C. A. 2 1959), cert denied 361 U.S. 896.

11/ S.E.C. v. Ralston Purina Co., supra; D. F. Bernheimer & Co., Inc., Exchange Act Release No.7000 (January 23, 1963).

on whether the particular class of persons affected need the protection of the Act." The Commission stated publicly (Release No. 4552, November 6, 1962) that the number of persons to whom the offering is extended is relevant only to the question whether they have the requisite association with and knowledge of the issues which make the exemption available and that consideration must be given not only to the identity of the actual purchasers but also to the offerees. The Commission specifically pointed out in its release that "The exemption does not become available simply because offerees are voluntarily furnished information about the issuer." (Underscoring ours.)

17. Applying the criteria ennunciated by the Courts and the Commission to the facts in the instant case it is evident that respondents have failed to establish that an exemption is available. None of the purchasers or offerees of the Elite stock had any association with or any knowledge of Elite prior to the time they were furnished information by Bilotti or Linder. The sole common bond between purchasers and offerees was that they were all customers of registrant and all placed faith and confidence in Linder and Bilotti. They were unrelated and unacquainted with each other and certainly had no means of securing any information concerning Elite by their own efforts. From the hearing examiner's observation of the persons who testified as to their purchases or offers made to them and considering that nearly all of them obviously lacked sophistication in securities matters it is the hearing examiner's opinion that the need for the protection afforded by registration was clearly present.

18. Moreover, the record does not show that the purchasers took their stock with a view to investment. Each of the purchasers of Elite stock signed a subscription agreement which stated the purchaser agreed he was "purchasing these shares for investment and not with a view to distribution" and that the stock certificates, when delivered to the purchasers, bore a legend somewhat similarly phrased. Notwithstanding the agreement in writing, nine of the ten purchasers testified unequivocally they were told that Elite would shortly make a public offering of its stock or that it would go to the SEC for clearance or "approval" at which time such purchasers would be free to sell their stock. Similar statements were made to two of the offerees. Eight of the purchasers and five of the offerees testified they were not told at the time of their purchases that there were any restrictions with respect to the resale of their stock nor does the record show they considered themselves under any such restrictions. In fact two of the purchasers testified they requested Bilotti to sell their shares. One such purchaser was told she would be "the first one when it does come out..." and the other was told she could sell her stock if she wanted to as soon as the company went public and that a "brochure" was shortly to be sent to Washington. Though Bilotti testified that at the time the subscription agreements were signed he, Linder or their attorney answered questions posed by the subscribers the record is clear that no effort was made by the respondents at such time or in fact at any time to

furnish a meaningful explanation of the phrase "take for investment and not with a view to disbribution." Thus, one purchaser testified she had no understanding of the phrase, another testified she understood she could not sell otherwise than on the open market, another testified he understood "taking for investment" meant "it is considered an investment until you can make something," and "view to distribution" meant purchasing a security which paid dividends and still another purchaser testified the phrase meant that she was purchasing Elite "like I invest in any other stock." The fact that the stock certificates bore a stamped legend to the effect that such shares were acquired for investment does not in and of itself establish the availability of an exemption,[12/] particularly since the record shows the certificates were delivered weeks after the purchases were made and paid for. Under all of the circumstances the hearing examiner finds that the purchasers of Elite stock did not take such stock for investment and not with a view to distribution and concludes that the private offering exemption was not available with respect to the sales of the said stock.

19. Moreover, in determining whether the offering of Elite stock as above described was public or private, the hearing examiner has also considered several factors to ascertain whether such offering should be regarded as a part of a larger offering for which a registration statement was filed by Elite on September 26, 1963.

12/ Cameron Industries, Inc., 39 S.E.C. 540, 546 (1959)

Bilotti and Linder admit that within a month or a month and a half after Elite was formed (May 24, 1963) they realized that the company's capital was insufficient and decided that a public offering of stock would have to be made in the near future. Each of the subscription agreements signed by the purchasers states that part of the proceeds of sale may be used "to pay for the costs of further financing." Linder further testified that by the time each of the subscription agreements were signed by the purchasers he believed there would be a public financing. As previously indicated such beliefs were also communicated by Bilotti to at least two of the offerees. It is evident from the testimony of the witnesses and the signed subscription agreements and the hearing examiner finds that the original offering made during the period June through the early part of September 1963 was part of a single plan of financing evidenced by the filing of the registration statement with the Commission on September 26, 1963. Second, the registration statement filed by Elite relates to the same class of security (Class A common stock) as that offered and sold by respondents during the period June through September 1963. Third, it is evident from the record that at least during August and certainly the early part of September 1963 Linder, Bilotti, their attorneys and accountants were engaged in the preparation of a registration statement on behalf of Elite and during the same period Linder and Bilotti were engaged in the offer and sale of the said company's stock. Elite's books show

that five of the purchasers paid for their stock from September 4 through September 17 and one such purchaser completed her payments on October 2, 1963 after the Elite registration was filed with the Commission. It is thus evident that the unregistered offers and sales were made at or about the time Elite was preparing a registration statement which it filed as above noted. Fourth, the same consideration was received for the unregistered shares and was to be received in the proposed public offering under the registration statement. And lastly, the general purpose of the unregistered offering was similar to the purpose for which the registration statement was filed, namely, to furnish Elite with necessary operating capital to permit the company to engage in the theatrical business. 13/ In light of the foregoing it is the hearing examiner's opinion that sales and offers to sell Elite stock during the three-month period immediately preceding the filing of Elite's registration statement and the offering proposed under the registration statement must be considered as one integrated public offering.

20. Registrant also urges that it has not violated the Securities Act since the sales of Elite's common stock were made by Linder and Bilotti acting in their capacities as officers of Elite

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13/ See Securities Act Release No. 4552 (November 1962); Cameron Industries Inc., 39 S.E.C. 540 (1959); Advanced Research Associates, Inc., Securities Act Release No.4630 (August 6, 1963).

and not as officers of registrant. The argument is not only specious but is not supported by the record and is rejected. Practically every witness who testified either as to the sales or offers stated that when they were dealing with Linder or Bilotti they considered them as their brokers even though they were aware of the fact that Linder and Bilotti were either officers of Elite or otherwise connected with the company. It is clear that the purchasers in relying on the representations made to them considered such representations were made by Linder and Bilotti as their brokers.

Offer and Sale of Subordinated Loans

21. The order for proceedings alleges that respondents willfully violated the anti-fraud provisions of the securities acts in the offer and sale of interest-bearing corporation notes of registrant. There is no dispute that three elderly women, two of whom were widows and the third a married woman who was employed as an attendant by the City of New York Welfare Department at approximately $4,000 per annum, loaned registrant a total of $55,000 and that each of the said loans were subordinated to all indebtedness or claims of creditors of registrant. Nor is there any dispute that in September 1963 when the first subordinated loan became due registrant obtained a two-year renewal of the said loan also on a subordinated basis. All three of the lenders were customers of registrant at the time the loans were made and their accounts were serviced by Bilotti. Each of the three lenders received a note signed by registrant at the

time the subordinated agreements were executed.

22. In August 1962 registrant was in financial difficulties and according to Bilotti's testimony desperately needed additional capital to remain in the brokerage business. In fact, as at July 31, 1962 registrant was in violation of the Commission's net capital rule.[14/] Bilotti approached one of his customers and after making some veiled reference to registrant's need for money to comply with state requirements represented that it would afford her a good investment opportunity, that she would receive a good return on her investment and that she would do better with registrant than investing in the market. Registrant's attorney testified that at the time the lender signed the subordination agreement she was told the money was needed for additional working capital to permit the firm to do a larger business. There was also some talk about needing additional capital to qualify to do business in other States. When asked if the financial condition of registrant was discussed the attorney testified "there was no numbers discussed." At no time was she furnished with any financial statement nor was the lender given any information concerning registrant's true financial condition. Though the record shows that some mention was made of the Commission's net capital rule the record is clear that no affirmative statement

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14/ Infra Pages 32-35.

was made of registrant's inability to comply with the net capital requirements of the Commission in the prior month nor was the lender informed that registrant had a net operating deficit. The record is equally clear that the lender placed full faith and confidence in Bilotti at the time she made the loan, and relied on his judgment that the investment would be beneficial to her.

23. One month later, November 1962, the lender was again requested by Bilotti to loan an additional $20,000 to registrant. On the second occasion Bilotti represented to the lender that registrant needed additional capital because of net capital problems and indicated that the primary purpose of the loan was to have a larger capital to permit it to expand its operations and do a greater volume of business. As in the first instance no financial statements were furnished, no information given as to the true financial condition of registrant nor was the lender told anything about registrant's net operating deficit.

24. In August 1963 registrant was aware that in the next month it would be unable to repay the first subordinate loan which was to become due. On September 15, 1963 Linder, Bilotti and their counsel informed the lender that registrant could not pay more than $5,000 of the amount due and requested her to renew the loan at the same interest rate. On this occasion the lender was shown what purported to be a financial statement of registrant as at June 30, 1963, which she was requested to sign. The lender was unable to

understand the statement, signed it without reading it relying on the assurances of Bilotti and the attorney that it was a necessary formality to consummate the transaction. Other than being shown the so-called financial statement and being told registrant was unable to pay the note then due no information was furnished concerning the true financial condition of registrant nor was any explanation offered concerning the statement she signed. From July 1962 to September 1963 when the loan was renewed registrant lost money in its operations. As at September 30, 1962 it had a net deficit from operations of approximately $27,700. Though the record does not reflect the net deficit from operations in September 1963 such deficit at December 1963 was in excess of $60,000.

25. The loans made by two other customers of Bilotti followed a pattern similar to the renewal. In August 1963 Bilotti suggested to another of his customers that she loan him $5,000 in return for $50 a month interest. The customer told Bilotti she would try to raise the money which she did by using all of her savings and borrowing $3,500 from a joint account she had with her daughter. On September 12, 1963 when she read the agreement and told Linder, Bilotti and their attorney that it "looked kind of risky" she was told it was "no riskier than any other business investment." The lender was also shown the so-called balance sheet of June 30, 1963 and testified she did not understand a single entry thereon but recalled seeing something pertaining to furniture. She signed the statement at

Bilotti's request and testified that she relied completely on Bilotti and "took Mr. Bilotti's word for everything." She believed Bilotti suggested the investment "to help her out." No information was given to her as to the true financial condition of registrant nor was she told of registrant's mounting net operating deficit. She was not informed that a prior subordinated loan of $20,000 was due and payable in three days and that registrant would be unable to repay such loan.

26. The third lender was informed that registrant needed additional capital "to conform with SEC regulation" although she had no idea what the phrase meant or what the regulations provide nor was any further explanation given to her. Her reasons for lending registrant money were that Linder and Bilotti were her friends, that she relied on Bilotti a great deal as her broker, had perfect trust in him, wanted to do him a favor and was interested in receiving the 12% interest on the loan. This lender was also asked to read and sign the so-called balance sheet referred to above which she did. No explanation concerning the said statement was offered despite the fact that she was unable to read the balance sheet and understand that registrant was losing money nor was any other information given to her as to the true financial condition of registrant. Thus, she was not informed that within the next month registrant would have to pay $20,000 due on an earlier subordinated loan and nothing was said about registrant's past failure to comply with the Commission's net

capital rule. The lender was not informed that registrant was losing money in its operations and had a mounting operating deficit.

27. Linder and Bilotti made false and fraudulent representations to the lenders regarding the nature of an investment in registrant, by representing that such investment was safe, that it was a good investment, that such investment was better than anything on the market, that the investment was no riskier than any other business investment, that such investment gave great hopes for the future, that the loans were being sought primarily to permit registrant to expand its operations and increase its volume of business in addition to conducting business in other states. Respondents omitted to state material facts necessary in order to make the statement made, in the light of the circumstances under which they were made not misleading. Thus, they omitted to state that an investment in registrant in light of registrant's past experience was highly speculative and inherently risky, that registrant sustained large operating losses, had accumulated a substantial operating deficit and that registrant had been in violation of the Commission's net capital rule, the requirements of which were not explained. With respect to the sale of the notes in August and September 1963 respondents additionally failed to inform the lenders that within the following thirty days in one case and three days in the other, registrant would be unable to repay $20,000 due on a previous subordinated loan.

28. The making of false statements and the failure or

omission to state material facts have consistently been held to violate the anti-fraud provisions of the securities acts both by the Commission and the courts.[15/] Frequently the Commission has emphasized that inherent in the relationship of every broker-dealer with his customers is the implied vital representation that the customer will be dealt with fairly and honestly.[16/] An examination of the activities of Linder and Bilotti in connection with the subordinated loan transaction demonstrates a marked failure to fulfill the fiduciary duty they owed to their customers. The record discloses that Bilotti recommended to each of his customers whom he asked to lend registrant money that they liquidate in whole or in part their portfolio securities to obtain the funds necessary for such purposes. These customers testified they trusted Bilotti and placed great faith and reliance in his recommendation. In fact one of the customers gave him complete discretion in the selection of the securities to be sold for her account. To induce these customers to lend registrant money Bilotti promised them a 12% return.[17/] Moreover, respondents

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15/ Charles E. Bailey & Company, 35 S.E.C., 33 (1953); Mac Robbins & Co., Inc., Exchange Act Release 6846, July 11, 1962, P.12, affirmed Sub Nom Berk v. S.E.C., 316 F.2d 137 (C.A.2, 1963); Norris & Hershberg v. S.E.C., 177 F.2d 228 (D.C. Cir. 1949).

16/ J. Logan & Co., Exchange Act Release No. 6848 (July 9, 1962), D. F. Bernheimer & Co., Inc., Exchange Act Release No. 7000 (January 23, 1963).

17/ The record shows that as at the date of the hearings interest had been paid regularly.

knew at the time of the execution of each of the subordination agreements that it was losing money, clearly a material fact not disclosed. Nor does it appear that respondents informed the lenders in August and September 1963 that it had been in violation of the Commission's net capital rule in May 1963. Fair dealing would have required full and meticulous disclosure of all pertinent information.[18/]

29. Registrant's breach of faith with its customers and the utilization of a course of conduct which operates as a fraud and deceit upon purchasers is best demonstrated by the loan transactions in August and September 1963 as well as the renewal of the first subordinated loan also in September. Knowing the urgent need for capital to continue in business and realizing that even unsophisticated investors might inquire about or should possibly be given some financial information Linder and Bilotti set the stage for deception. They first instructed their accountant to prepare a balance sheet as at June 30, 1963 omitting therefrom payables and accruals not appearing on its books. They then exhibited such statement to the three lenders and requested them to sign, suggesting it was a mere formality. Obviously the real purpose was to throw the cloak of knowledge of registrant's financial condition around the lenders where no such knowledge was possible. It is evident from their testimony that none of the lenders had any experience analyzing balance sheets and it is equally clear

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18/ Powell & McGowan, Inc., Exchange Act Release No. 7302 (April 24, 1964).

that no explanation of the statement was given or even offered to any of them.[19/] The accountant testified he was never told the purpose of the statement or the use to be made of it. The words "For management purposes only" were typed at the top of the statement and a legend appeared at the bottom as to the omissions. The accountant further testified that not only was the balance sheet unaudited and incomplete but in his opinion insufficient and improper for use in the sale of registrant's notes. He further testified that a layman after looking at such balance sheet alone would be unable to determine the financial condition of registrant.

30. Respondents urge that the lenders were at least generally aware of registrant's financial problems, that when the unaudited financial statement was shown to them there was "ample indication of the problems of registrant," that the reason for omitting items from the statement was because "it was not prepared for the information of the lenders and was supplied only as an indication of the finances of registrant without getting into the fine detail or exact numbers required by audited statements." The argument is frivolous and rejected by the hearing examiner. If, in fact, the statement was not

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19/ The record discloses that one of the lenders had no more than a grammer school education, the second completed high school and the third attended a convent in Italy and none of them professed to understand a balance sheet.

prepared for the lenders and was incomplete and insufficient it is preposterous to believe that showing it to potential investors would furnish them even an indication of "the finances of registrant" or would be meaningful to any one other than a sophisticated financial analyst. Moreover, the suggestion that a balance sheet used in connection with the offer and sale of securities could be anything less than an adequate and fair statement disclosing the true financial condition of an issuer is repugnant to the entire philosophy of the securities acts and would make a mockery of the disclosure requirements of such acts. Though it is true that in some instances unaudited statements may be used in connection with the sale of securities it is equally true that such statements may not be misleading or fail to reflect the true financial condition of the company.

31. Registrant argues the interest rate alone, 1% per month, should have been a sufficient indication of registrant's problems without anything further. The Hearing Examiner does not accept this argument. The lenders were unsophisticated and there is no evidence that any of the investors related the high interest rate to registrant's problems nor is there any evidence that they may have realized that the high interest rate necessarily reflects a high risk.[20/]

20/ See S.E.C. v. Los Angeles Trust Deed & Mortgage Exchange, 285 F.2d 162 (9th Cir 1960).

32. Respondents further urge that the transactions were exempt from the registration requirements of the 1933 Act by reason of Sections 4(1) and 3(a)(11) thereof. No violation of the registration requirements of the Securities Act are alleged with respect to the subordinated loan notes nor has any such finding been made by the hearing examiner. Moreover, Section 17(c) of the Securities Act specifically provides that Section 3 exemptions shall not apply to Section 17.

33. The hearing examiner finds that in the sale of registrant's notes respondents failed to deal fairly and honestly with the three customers in question and respondents engaged in a course of conduct which operated as a fraud or deceit and utilized a device, scheme or artifice to defraud in violation of the anti-fraud provisions of the securities acts. 21/

Net Capital Violations

34. The Commission's order alleges that from July 31, 1962 to September 30, 1963 registrant failed to comply with the Commission's net capital requirements. The record shows that registrant had a net capital deficiency computed in accordance with the provisions of Rule 15c3-1 as of the following dates, in the amounts indicated:

21/ Respondents concede that from approximately July 31, 1962 to September 30, 1963 the means or instruments of transportation or communication in interstate commerce and the mails were used in the offer to sell, and sale of registrant's interest-bearing notes.

Date	Amount of Deficiency
July 31, 1962	$1,369.21
November 9, 1962	3,522.46
May 31, 1963	3,919.91

Respondents do not dispute the foregoing figures but urge that the use of the "pink sheet" quotations in determining the value to be ascribed to securities owned by registrant is open to question. The record shows that the staff investigator who computed the deficiencies used the high bid quotations in the "pink sheets" for registrant's long position in securities and lowest offer quotations in the said sheet on securities short.[22/] It has been consistently held by the Commission and the Courts that in the absence of countervailing evidence the quotations in the "pink sheets" are a persuasive indication of the prevailing market price of over-the-counter securities.[23/] No such countervailing evidence was offered by respondents nor do they suggest that any other prices should have been used. The method used for computing the market price of registrant's securities appears to have given registrant the benefit of the highest available market prices and in the absence of proof that

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22/ The investigator testified the only exception he made in the use of the National Daily Quotation Pink Sheets was to disregard registrant's quotations and those by out-of-town dealers.

23/ Charles E. Hughes & Co. v. S.E.C., 139 F.2d 434, 438 (2nd Cir.1943).

such prices are unfair the use of the pink sheet prices appears to be proper for purposes of computing net capital under the above-mentioned rule. Respondents further urge that even assuming there were net capital deficiencies, the violations were unintentional and that on receiving notice from the staff of the Commission of such deficiencies on November 9, 1962 and May 31, 1963 registrant immediately took steps to cure them by either borrowing money on subordinated loans or having registrant's officers repaying loans and advances previously made to them by registrant. However, the subsequent curing of net capital deficiencies upon notice does not preclude a finding that a violation existed as at the date a computation under the Commission's rules was made. Registrant also urges that registrant immediately stopped doing business when notified concerning alleged deficiencies in its net capital position. Though there was testimony in the record that registrant ceased doing business upon notification of net capital deficiencies there is no dispute that registrant's offices remained open for business and the documentary evidence does not support such testimony or registrant's contentions. Registrant's blotters reflect that on each of the three dates that registrant was in violation of the net capital rule it effected purchases and sales of securities with customers and other broker-dealers. Other documentary evidence shows registrant issued checks on each of the days in question, some of which were payable to other broker-dealers, that numerous local and long-distance

telephone calls were made by registrant on such dates and that confirmations were mailed to customers. The hearing examiner finds that on the above-mentioned dates registrant used the mails and other interstate facilities to effect transactions in securities otherwise than on a national securities exchange when its aggregate indebtedness exceeded 2,000 per centum of its net capital in violation of Section 15(c)(3) of the Exchange Act and Rule 17 CFR 240.15c3-1 thereunder. 24/

24/ The Commission staff urges that registrant was in violation of the net capital rule on numerous occasions during the period July 31, 1962 through September 1963 by reason of the fact that on four occasions registrants submitted trial balances omitting unrecorded bills payable. Since on two of such occasions the hearing examiner found that registrant had a net capital deficiency any such unrecorded bills payable would have only increased the amount of the deficiency. Though there was some testimony that there may have been other occasions that bills payable were unrecorded no proof was furnished as to the amounts, if any, of such bills on the two remaining occasions and the hearing examiner makes no finding of violation with respect to such two dates nor can the hearing examiner make findings of violation on any other of the alleged numerous occasions in the absence of proof of the existence and amount of unrecorded bills payable.

A more serious question is raised as to whether registrant was in violation throughout the period August 1962 through September 1963. The hearing examiner has found that the interest-bearing notes were sold by registrant in violation of the anti-fraud provisions of the securities acts. Rule 17 CFR 240.15c3-1 provides that in computing net capital a broker may exclude liabilities which are subordinated to claims of general creditors pursuant to a satisfactory subordination agreement as defined. The term "satisfactory subordination agreement" is defined as a written agreement between a broker or dealer and a lender, which agreement is binding and enforceable in accordance with its terms upon the lender..... Having found that the subordinated loan notes and agreements were secured by fraud such agreements would be voidable by the lenders and not binding or enforceable upon them. Such a determination would result in registrant's being in violation of the net capital rule throughout the above-mentioned period.

Unfair Prices in Securities Transactions

35. The order for proceedings alleges that in the offer and sale of registrant's interest-bearing notes and the common stock of Elite respondents willfully violated the anti-fraud provisions of the securities acts in that they engaged in unreasonable and excessive mark-ups to generate profits in disregard of the financial welfare or investment aims of customers. The record contains an analysis of the accounts of two of the persons who purchased the above-mentioned notes and the Elite stock and the account of a third who purchased Elite stock. In the case of one of the customers, who purchased both the notes and the stock, the analysis disclosed that from approximately July to November 1962 registrant effected twenty-three transactions as principal and sold over-the-counter securities to such customer at prices representing mark-ups ranging from 7.5% to 200%. In ten of such transactions the mark-up ranged between 7.5% and 50% over same day costs and in five such transactions ranged between 11% and 200% over costs of acquiring the security either the day before or the day after it sold such security to the customer and in five such transactions acquired the securities within two or three days before or after selling such security to the customer at mark-ups ranging between 11% and 57%. In 1963, registrant effected twenty-one principal transactions in such customer account, of which eight represented mark-ups ranging from 11% to 100% over same day costs and eleven represented mark-ups ranging between 5% and 100% in securities which the registrant purchased either the day before or the day after it sold

such securities to the customer. In another transaction an additional sale was effected within three days of a purchase by registrant at a mark-up of 18%.[25/]

36. In the case of the second customer, who purchased both the notes and the stock, the record discloses that from May through December of 1962 registrant effected fourteen principal transactions, of which eleven such transactions represented mark-ups ranging between 15% and 50% over same day costs. From January to August of 1963, registrant effected thirty-two principal transactions in the said customer's account, of which twenty-two represented mark-ups ranging between 5% and 100% over same day costs and six transactions represented mark-ups between 21% and 40% over costs of acquiring the said securities

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25/ In its analysis the staff maintained that additional principal transactions should be considered as excessive mark-ups by registrant on the theory that such mark-ups were in excess of the prevailing market price at the time such securities were sold to the customer. Such transactions relate to sales by registrant to customers and the acquisition of the same class of securities by the registrant within a period of between 7 and 17 days before or after such securities were sold to the customer. The record fails to establish any basis for concluding that an acquisition by the registrant more than three days before or after the sale to a customer should be considered as a prevailing market price in order to determine whether a mark-up is excessive. In fact, the analysis in the record includes an excessive mark-up based upon an acquisition by the registrant 14 days before the sale to the customer. The hearing examiner is of the view that within the umbra of the Commission's decisions relating to excessive mark-ups a purchase two weeks prior to a sale to a customer should not be considered as evidence of the prevailing market price absent proof that such purchase represents a reliable indication of the prevailing market price. Accordingly, the hearing examiner has disregarded all purchases made by registrant within a period of more than three days before or after the sale to the customer since such purchases were not closely related in time to the sales to provide a reliable indication of the prevailing market price, absent proof to the contrary.

either the day before or the day after the sale to the customer. The record further shows that in the account of the third customer, who purchased only the Elite stock, registrant, during the period April through June 1963, effected nine principal transactions in the said customer's account, of which six represented mark-ups ranging between 11% and 28% over same day costs and two represented mark-ups of 14% and 200%, respectively, over securities purchased by registrant either the day before or the day after the sale to the customer. In another transaction, a sale was effected to the customer within two days of a purchase by registrant at a mark-up of 15.7%.

37. In addition, the record further discloses that registrant purchased securities from the above-mentioned three customers at prices which represented mark-downs ranging from 5.5% to 100% in relation to the price at which registrant resold the securities on the same day and in at least three transactions represented mark-downs ranging between 11% and 20% in relation to the price at which registrant resold the security the day after such purchases.

38. The Commission has held that it is a violation of the anti-fraud provisions of the securities acts to effect securities transactions with customers at prices which are not reasonably related to the prevailing market as determined by registrant's same day or substantially contemporaneous purchase or sale prices.[26/] Respondents do

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26/ Naftalin & Co., Inc., Exchange Act Release No. 7220 (January 10, 1964); Powell and McGowan, Inc., supra.

not question the accuracy of the above-mentioned mark-ups and mark-downs but urge that the analysis fails to take into account registrant's positions at the time of trades, their costs, their risks, customers' instructions, customers' desires, customers' interests, and the numerous other details with respect to mark-ups and activities. Such matters, if they have any bearing on determining whether the spreads charged to customers in the mark-up and mark-down transactions were reasonable and fair, are matters with respect to which respondents have the burden of presenting evidence justifying the pertinency of such matters.[27/] The Commission has held that the above-mentioned rule applies whether or not a dealer has a position in the security, unless it can be shown that the dealer's contemporaneous cost is not representative of the market price prevailing at the time of his sales.[28/] The Commission has also held the fact that during part of the period under consideration the registrant had a short position, with its attendant risk, did not justify mark-ups in excess of what would otherwise be reasonable.[29/] Registrant has not shown that its purchase price in the mark-up transactions and the sale price in the mark-down transactions were not representative of the prevailing market at the time of the

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27/ Thill Securities Corporation, Exchange Act Release 7342 (June 11, 1964).

28/ Cf. Naftalin & Co., Inc., supra.

29/ Advance Research Associates, Inc., Exchange Act Release No. 7117 (August 16, 1963).

transaction with the customers or presented any reasons why such prices should not be used as a basis for determining the fairness of registrant's prices to its customers. Moreover, respondents have failed to show any special services to justify the mark-ups charged.[30/]

39. The Commission's order, however, alleges that respondents engaged in unreasonable and excessive mark-ups as a part of a scheme to defraud in the offer and sale of interest-bearing notes and the common stock of Elite. The hearing examiner is of the view that although the record establishes that respondents engaged in unreasonable and excessive mark-ups it fails sufficiently to connect such activities to the offer and sale of registrant's notes or the common stock of Elite so as to establish that the activities were part of the scheme to defraud in the offer or sale of the aforesaid securities. In this connection, it should be noted that many of the transactions, which the record discloses were effected by respondents at unreasonable and unfair mark-ups, occurred in 1962, substantially prior to the time Elite was organized and prior to the time of registrant's sale of the first interest-bearing note. The staff apparently suggests that since many of the securities sold to these customers at excessive mark-up were later sold by them to invest in Elite or registrant's notes, the sales to the customers at unfair

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30/ Cf. Graham & Co., 38 S.E.C. 314, 317 (May 1958).

mark-ups necessarily was a part of the scheme or device to defraud the customers when they offered or sold Elite Stock or registrant's notes. The record does not support such position. In view of all of the circumstances the hearing examiner finds that the record fails to establish that respondents engaged in unreasonable and excessive mark-ups as a part of a scheme to defraud in connection with the offer and sale of registrant's interest-bearing notes and the common stock of Elite.

Excessive Trades

40. As noted above, the order for proceedings alleges that as part of the violation of the anti-fraud provisions of the securities acts, respondents in the offer and sale of registrant's notes and the common stock of Elite induced excessive trading to generate profits in disregard of the financial welfare or investment aims of the customers. The record shows that in the accounts of the three customers mentioned in the preceding section regarding excessive mark-ups registrant also engaged in excessive trading from approximately May of 1962 through September 1963. In one such account registrant, in at least four instances, bought and sold the same security more than once. In another account registrant, in at least thirteen instances, bought and sold the same security more than once and in the third account, in at least ten instances, the same security was bought and sold more than once in the customer's account. The record further shows that in the first of the foregoing customer accounts during the period April through June 1963 of a total of

sixteen transactions, registrant in ten instances sold securities for the account of such customer within a period of two months after purchasing the said security. In the account of the second customer, during the period July through November 1962, of a total of sixty-one transactions, registrant in thirty-two instances sold securities within four months after such securities were purchased for the said customer and in twelve such instances securities were held less than a month in the said account. In the third customer's account, from May 1962 to September 1963, registrant in at least eleven instances, bought and sold the same security more than once in the said account and during the same period of time out of eighty transactions registrant resold securities purchased in the said account within the previous six months.

41. Respondents do not challenge the above analysis, other than urging that the staff member who prepared it lacked experience. No explanation is furnished for the extensive trading activities in each of the foregoing accounts. Each of the said customers testified she placed great faith and reliance upon Bilotti and accepted his advice and recommendations. Contrary to Bilotti's claim the record shows that he was unaware of the investment aims and desires of the said customers and respondents offered no proof to establish that the numerous transaction in the customers' accounts were in the best interests of such customers. In fact, in each of the foregoing accounts the customers had realized trading losses which exceeded trading profits. In two of such accounts the customers started their accounts with registrant with substantial portfolios consisting,

primarily, of listed securities and as a result of registrant's activities one of such accounts was reduced to a subordinated loan and note referred to above and 5,000 shares of Elite common stock and the other reduced to two subordinate loans and promissory notes of registrant, 2500 shares of Elite common stock, five shares of registrant's stock and 475 shares of Allied Entertainment Corporation for which there does not appear to be any prevailing market value. It is evident from the foregoing and the hearing examiner finds, that registrant, in at least three of its customer's accounts, engaged in excessive trading to the detriment of the customers and that such activities were motivated solely by a desire to produce the greatest possible income to itself and to ignore the fiduciary duties owed to its customers.

42. However, insofar as the Commission's order for proceedings is concerned the record fails to establish that the excessive trading was a part of a device or scheme or artifice to defraud in connection with the offer and sale of registrant's notes or the common stock of Elite. Registrant's activities, which resulted in excessive trading, commenced in 1962, considerably prior to the organization of Elite (May 1963) and prior to the execution of the first subordinated loan. The staff has failed to demonstrate the manner in which the excessive trades and the sale of the notes and Elite stock to the customers were related as part of a scheme to defraud. While the record shows that immediately prior to the purchase by each of the customers of their Elite stock, registrant sold a portion of such customers'

portfolio for the purpose of obtaining funds to pay for the Elite stock. The record does not establish that all of the transactions which the hearing examiner found resulted in excessive trading were sufficiently connected to the offer and sale of registrant's notes and the Elite stock so as to establish the existence of a scheme to defraud in the offer and sale of the aforesaid securities. Rather, the record shows that excessive trading occurred in each of the accounts independently of the scheme to defraud. Accordingly, the hearing examiner finds that the excessive trading, which is established in the record, was not proved to be a part of a device, scheme or artifice to defraud in connection with the offer and sale of registrant's notes and the common stock of Elite.

Public Interest

43. Under Section 15(b) of the Exchange Act it is clearly contemplated that a suspension order should be issued where a preliminary showing is made that a registered broker-dealer has engaged in serious misconduct of a nature that would warrant revocation. Respondents urge that registrant has not engaged in such misconduct (if any at all), of a nature that would warrant revocation. They importune that the conduct of respondents, evidenced by their prompt action to comply with the Commission's net capital requirements when advised of violations thereof, and the detrimental disclosures contained in the subscription agreements in connection with the sale of Elite stock "are indicative of respondents' desire and intention

to comply with all applicable laws as well as the moral and ethical standards of their business and their relationships with their customers and the public." The argument is without merit, not supported by the record and is rejected.

44. On the basis of the record before the hearing examiner on the suspension issue the hearing examiner concludes that the record contains overwhelming evidence of serious misconduct, complete disregard of the financial welfare of customers and the utter abdication of the fiduciary duties which a broker-dealer owes to his customers. The record amply discloses and the hearing examiner found that registrant violated the Commission's net capital requirements, and in an effort to cure such deficiencies sold its interest-bearing notes by means of false and misleading representations and omissions to state material facts. Respondents also engaged in a similar course of conduct in connection with the offer to sell and sale of the common stock of Elite and in addition violated the registration requirements of the Securities Act with respect to the offer and sale of the said stock. Registrant, in addition, charged its customers excessive mark-ups and mark-downs and engaged in excessive trading in the accounts of at least three of its customers to the detriment of such customers and for its own profit.

45. Notwithstanding that the hearing examiner concluded that the said unreasonable mark-ups and excessive trading were not established within the framework of the allegations in the Commission's

order for proceeding regarding the offer and sale of registrant's interest-bearing notes and the common stock of Elite, nevertheless such conduct must necessarily be considered in determining whether it is in the public interest or for the protection of investors to invoke such a sanction as suspension pending revocation. The record discloses that registrant has in fact engaged in such activities. The Commission has consistently held that where brokers and dealers effect securities transactions with customers at prices which are not reasonably related to the current market and which are unfair willfully violate the anti-fraud provisions of the Securities Act. The record establishes and the hearing examiner finds that registrant effected transactions with customers at unreasonable and excessive mark-ups and mark-downs in violation of the anti-fraud provisions of the securities acts and that such activities, in addition, were inconsistent with just and equitable principles of trade in contravention of Sections 1 and 4 of Article III of the Rules of Fair Practice of the NASD, of which registrant was a member.[31/]

46. The record also establishes that registrant did in fact engage in excessive trading and that such trading was inimical to the best interest of the customers. In addition, the record establishes that the unreasonable mark-ups and excessive trading were not the only way which registrant took advantage of investors. The

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31/ See NASD Manual PP G-1-G-6.

record includes a schedule of only a partial sampling of customers' ledgers for the years 1962 and 1963, which shows that the same securities were bought from and sold to different customers at or about the same time and in many instances on the same day. Absent any proof by registrant that "switching" of securities back and forth between customers was in the interest of customers, the conclusion is inevitable that such practice provided a fruitful source of income for registrant without incurring any risk or expense of maintaining inventories.

47. The Commission has frequently emphasized that inherent in the relationship of every broker-dealer with his customer is the implied vital representation that the customer will be dealt with fairly and honestly.[32/] In the instant case the record is replete with instances demonstrating that registrant made it a practice of leading customers to place complete reliance on it to act in the customer's best interest and then took gross advantage of the trust and confidence induced. In some instances customers were induced to liquidate their portfolios, including in some instances high-grade investment securities, and replace them with other securities of a highly speculative nature. The record indicates that registrant failed to inquire of the investment aims and needs of its customers and,

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32/ Duker & Duker, 6 S.E.C. 386 (1939); Pinsker & Co., Inc., 40 S.E.C. 285 (1960).

indeed, Bilotti stated under oath that he did not believe it is any of his business to inquire as to the income or needs of his customers.

48. Respondents further urge that suspension is not in the best interest of the subordinated creditors and point to the fact that two of such customer creditors testified that suspension would not be in their best interest. In considering the impact of suspension on investors, regard must also be had not only for existing customers of the registrant but also whether potential customers or investors in the market might be effected by the type of activities conducted by registrant.[33/] Respondents contend that the operations of registrant are not "boiler-shop" type operations and earnestly press that customers were encouraged to come to registrant's offices and are not urged to sell anything nor are they ever pushed on to anything. The argument is unsupported by the record. Registrant's operations were just as invidious as the type of operations which the Commission has heretofore characterized as "boiler room techniques."[34/] In the instant case Linder and Bilotti requested potential investors to sign documents, including one they designated a financial statement, all of which were carefully prepared to give the aura of propriety and legality to their fraudulent activities and to mask misrepresentations and omissions of material facts. True it is, customers were urged to come to registrant's offices but more often than not, the record shows,

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33/ Cf. Great Sweet Grass Oil Limited, 37 S.E.C. 683 (1957).

34/ See Barnett & Co., Inc., 40 S.E.C. 521, 523-4 (February 8, 1961); Alexander Reid & Co., Inc., 40 S.E.C. 986, 992 (February 8, 1962).

such visits culminated in transactions. There is no evidence that Bilotti or Linder ever sat down with a customer to discuss the customer's investment aims or objectives or prepare an investment program to take into consideration the manner best calculated to achieve a desired result. At least two of the witnesses who testified, stated that after talking with Bilotti they gave him complete discretion to buy and sell securities in their accounts, which he did. As noted above, such confidence was greatly misplaced and the record is clear that the customers were dealt with unfairly and dishonestly. To permit such a broker-dealer to continue to prey on unsophisticated investors would make a mockery of the disclosure and registration philosophy of the securities acts and their enforcement.

49. Under the circumstances herein the hearing examiner concludes that not only would the present customers of registrant be jeopardized by registrant's continued dealing with them but that potential customers and investors would equally be jeopardized by registrant's continuing in the securities business. The right and privilege to carry on the functions of a broker-dealer which involve the public investor should be available only to those who shall have demonstrated their ability to meet at least minimal standards of integrity and competence.[35/] No such demonstration appears in the instant record.

35/ See House Document No. 95, Pt.5, 88th Cong., 1st Session, pp 39-40.

Conclusion

In view of the foregoing the hearing examiner recommends that the Commission issue an order forthwith under Section 15(b) of the Exchange Act finding it is necessary and appropriate in the public interest and for the protection of investors to suspend the registration as a broker and dealer of the registrant pending final determination of whether such registration shall be revoked. 36/

This recommendation is not to be construed as a determination of the issues other than whether the registration should be suspended at this time. Those issues which are the subject of further proceedings have not been considered herein and are not now before the hearing examiner.

Respectfully submitted,

Irving Schiller
Hearing Examiner

Washington, D. C.
July 29, 1964

36/ To the extent proposed findings and conclusions submitted by the parties with respect to the issue of suspension pending revocation are in accord with the views set forth herein they are sustained and to the extent they are inconsistent therewith they are expressly overruled.