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UNITED STATES OF AMERICA

Before the

SECURITIES AND EXCHANGE COMMISSION

In the Matter of
SCHMIDT, SHARP, McCABE & CO., INC. 1717 Stout Street Denver 2, Colorado
File No. 8-8261

Filed 11/30/64

RECOMMENDED DECISION

Sidney Ullman
Hearing Examiner

Washington, D.C.
November 30, 1964

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In the Matter of SCHMIDT, SHARP, McCABE & CO., INC. 1717 Stout Street Denver 2, Colorado File No. 8-8261	RECOMMENDED DECISION

BEFORE: Sidney Ullman, Hearing Examiner.

APPEARANCES: Robert E. Watson, Gerald E. Boltz, John E. Jones and John M. High, Esqs., Denver Regional Office, for the Division of Trading and Markets.

Stephen T. Susman, Esq., Denver, Colorado, for Schmidt, Sharp, McCabe & Co., Inc., and for Robert D. Schmidt.

Donald P. Shwayder, Esq., Denver, Colorado, for William N. Sharp.

Minoru Yasui, Esq., Denver, Colorado, for Ben T. Kumagai.

C. Henry Roath, Esq., Denver, Colorado, for James W. Bates.

I. NATURE OF PROCEEDINGS

These are public proceedings instituted by order of the Commission dated January 2, 1964, pursuant to the provisions of Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") to determine whether, by reason of alleged willful violations of certain provisions of the Exchange Act and the Securities Act of 1933 ("Securities Act"), any remedial action against Schmidt, Sharp, McCabe & Co., Inc. ("registrant") is appropriate in the public interest and, if so, whether, pursuant to Section 15A(b)(4) of the Exchange Act, Robert D. Schmidt, William N. Sharp, Ben T. Kumagai and James W. Bates, or any of them, should be found to be a cause of any such action.[1/]

Registrant has been registered as a broker-dealer pursuant to the Exchange Act since February 23, 1960, and was a member of the Midwest Stock Exchange, a registered national securities exchange, from June 16, 1961 to May 21, 1963. The order for proceedings alleged in substance that registrant, as well as Schmidt, Sharp, Kumagai and Bates, willfully violated the anti-fraud provisions of the Securities Act and the Exchange Act in offering and selling to the public a new issue of the common stock of a

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1/ As applicable here, Section 15(b) of the Exchange Act provided, at the time of the order for proceedings, that the Commission shall revoke the registration of a broker or dealer if it finds it is in the public interest and that such broker or dealer or any officer, director, or controlling or controlled person of such broker or dealer has willfully violated any provision of that Act or of the Securities Act of 1933 or any rule thereunder.

Under Section 15A(b)(4) of the Exchange Act, in the absence of the Commission's approval or direction, no broker or dealer may be admitted to or continued in membership in a national securities association if the broker or dealer or any partner, officer, director or controlling or controlled person of such broker or dealer was a cause of any order of revocation which is in effect.

company called Autrol Corporation ("Autrol") during the period November 22, 1961 to February 23, 1962, by making false and misleading statements of material facts and by omitting to state material facts concerning the business operations, financial condition and earnings of Autrol, and the market value and potential of its common stock.[2/] These violations allegedly occurred in connection with registrant's activity as the underwriter of the issue of Autrol stock offered to the public during the above-mentioned period.

In addition, the order alleged willful violations by registrant, aided and abetted by its officers, Schmidt and Sharp, of Regulation T, promulgated by the Board of Governors of the Federal Reserve System pursuant to Section 7 of the Exchange Act, in failing to receive payment from customers for purchases of securities within the time prescribed in Section 4(c)(2) of said Regulation and not promptly cancelling or otherwise liquidating the transactions or the unsettled portion thereof.[3/] Further charges are made against registrant, allegedly aided and

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2/ The order alleged violations of Section 17(a) of the Securities Act and Sections 10(b) and 15(c)(1) of the Exchange Act and Rules 10b-5 and 15c-2 thereunder. The composite effect of these anti-fraud provisions is to make unlawful the use of the mails or facilities of interstate commerce in the sale or purchase of securities by means of a device to defraud, a false 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 means of any other manipulative, deceptive, or fraudulent device.

3/ Section 7(c)(2) of the Exchange Act, as here pertinent, makes it unlawful for a member of a national securities exchange or a broker or dealer who transacts a business in securities through the medium of any member, to extend or arrange for credit to any customer without collateral or on any collateral other than exempted or listed securities, except in accordance with regulations prescribed by the Federal Reserve Board.

Regulation T provides, in Section 4(c)(2), that if a customer purchases a security in a cash account and does not make full cash payment within seven business days thereafter, the broker or dealer shall promptly cancel or otherwise liquidate the transaction.

abetted by Schmidt and Sharp, (1) of willfully violating the provisions of Section 15(c)(3) of the Exchange Act and Rule 15c3-1 thereunder in effecting transactions in securities over-the-counter on or about September 30, 1963, at which time its net capital was deficient under the net capital rule,[4/] and (2) for its failure during specified periods of time to make and keep current certain books and records, in willful violation of Section 17(a) of the Exchange Act and Rule 17(a)(3) thereunder.[5/]

Registrant and all individuals appeared herein and denied the alleged violations in answers submitted by their respective counsel. A hearing on the charges was held before the undersigned at the Denver Regional Office of the Commission during the period May 4 to May 7, 1964. The parties were represented by counsel as indicated on the facing sheet hereof. However, inasmuch as Kumagai and Bates, salesmen of the registrant, were charged only with violations in the offer and sale of the Autrol stock and not with violations relating to Regulation T, the net capital rule, or the failure to keep books and records, their attorneys did not participate in portions of the hearing during which counsel for the Division of Trading and Markets

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4/ Section 15(c)(3) of the Exchange Act prohibits the use of the mails or interstate facilities by any broker or dealer in securities transactions otherwise than on a national securities exchange, in contravention of Commission rules prescribed thereunder providing safeguards with respect to the financial responsibility of brokers and dealers. Rule 15c3-1 provides, that in accordance with computations discussed, infra, that no broker or dealer shall permit his aggregate indebtedness to all persons to exceed 2,000 per cent of his net capital as specified in the Rule.

5/ Section 17(a) of the Exchange Act requires registered brokers and dealers to keep such books and records as the Commission by rule and regulation may prescribe as necessary or appropriate in the public interest or for the protection of investors. Rule 17a-3 specifies the books and records which must be maintained and kept current.

("Division") presented evidence relating to these latter violations.

At the conclusion of the hearing a recommended decision by the Hearing Examiner was requested. All parties filed proposed findings of fact, conclusions of law and briefs in support thereof.

During the course of the hearing, motions were made by counsel for all parties for dismissal of the proceedings or portions thereof. All of the motions were denied by the Examiner, the denials being expressly grounded in part on the requirements and limitations of Rule 11(e) of the Commission's Rules of Practice.[6/]

Based upon the entire record of these proceedings and the Hearing Examiner's observation of the individual respondents, each of whom testified either as a witness called by the Division or in his own behalf, as well as the Examiner's observation of all other witnesses presented by the Division and by respondents, he makes the following findings of fact and conclusions of law.

II. FINDINGS OF FACT AND CONCLUSIONS OF LAW

A. Registrant and Individual Respondents

1. Registrant is a Colorado corporation which has been registered as a broker-dealer pursuant to Section 15(b) of the Exchange Act since February 23, 1960. Robert D. Schmidt is President, a director, and beneficial owner of 10% or more of registrant's common stock. William N. Sharp was Secretary-Treasurer of registrant from about

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6/ Rule 11(e) precludes the Hearing Examiner from disposing of the proceeding in whole or in part, except in the recommended decision.

February 8, 1960 to about October 14, 1963, and was a director and beneficial owner of 10% or more of registrant's common stock from about February 8, 1960 to about October 10, 1960. Registrant was a member of the Midwest Stock Exchange from June 16, 1961 to May 21, 1963.

2. Ben T. Kumagai was employed by registrant as a securities salesman from about September 1960 through August 1963 and was a registered representative of the National Association of Securities Dealers, Inc. ("NASD") during that time. Kumagai had the title of "Assistant to the President" of registrant but performed no functions in that capacity. At the time of the hearing Kumagai was employed as an agent in selling life insurance.

3. James W. Bates was employed as a securities salesman by registrant from about August 1961 through July 1963, and during this time was a registered representative of the NASD. At the time of the hearing Bates was unemployed.

4. Registrant had four branch offices, and a main office in Denver. At the time of the Autrol offering it employed approximately 17 securities salesmen, nine of whom were at its Denver office. A large percentage of registrant's business was in the sale of over-the-counter securities, especially because of the "hot issue" market. Registrant engaged in several Regulation A underwritings during the "hot issue" market. As stated above, registrant was a member of the Midwest Stock Exchange for almost two years. However, it was suspended from membership for a period of 30 days. It is significant, in connection with the discussion of the

net capital charge, infra, that the membership terminated before September 30, 1963. Registrant maintained at the Denver office a library which was apparently of a relatively substantial size and included the books on the recommended reading list of the Midwest Stock Exchange and books on Regulation A offerings, purchased a sales training program put out by Kalb, Voorhis & Co., and subscribed to financial services. The firm contributed one-half the cost of tuition for training courses of its salesmen.

5. Prior to forming the registrant corporation, Schmidt had been office manager of the Denver office of an over-the-counter securities firm for approximately two years. At the time of the hearing Schmidt was 32 years of age. He was then engaging in securities transactions through registrant, primarily for his own interest, and not as a retail business.

6. Prior to his becoming an officer of registrant in February 1960, Sharp was employed for approximately one year by the over-the-counter securities firm whose office Schmidt managed. He is a college graduate with a major in Finance and with one year of law school education. Sharp's primary duties at registrant's office were concerned with financial matters and books and records. At the time of the hearing he was employed in selling securities for an over-the-counter securities firm.

B. The Fraud Charge

(a) The Autrol Offering

7. During the period November 22, 1961 to about February 23, 1962 registrant acted as underwriter of the offering of common stock of Autrol on a best efforts basis. This was a public offering pursuant to

the provisions of Regulation A, adopted under Section 3(b) of the Securities Act, consisting of 60,000 shares to be sold at $2.50 per share.[7/] During this period registrant sold 32,999 shares of the offered stock and received from the public a total amount of $82,497.50. From the proceeds, registrant received an underwriting discount of $12,374.64 and reimbursement of expenses of $671.47 paid by it or for its account. After deduction of total costs and expenses of $17,441.10, the net proceeds to the issuer were $65,056.40.

8. In connection with this offering, Autrol filed with the Commission on September 13, 1961,a notification on Form 1-A and an offering circular relating to the proposed offering, for the purpose of obtaining the Regulation A exemption. Amendments were filed at various times up to the date of commencement of the offering.

9. The offering circular represented that Autrol was organized as a Colorado corporation on August 29, 1961, with its principal office in Denver, and improved real estate in Manitou Springs, Colorado, wherein it proposed to assemble the various parts to manufacture a coin-operated automatic vending machine which would dispense cellophane and plastic bags; that the machine or unit is completely self-contained and

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7/ Regulation A provides for exemption from registration when an issuer offers securities with an aggregate public offering price not exceeding $300,000 provided, among other things, that the issuer files with the Commission a notification and an offering circular containing certain minimum information.

that, in effect, it makes and cuts the bag from a large roll of plastic material and dispenses it to a purchaser inserting a coin. The definitive offering circular also represented that the machine was invented by Harry A. Mead, a director and shareholder of the company, who transferred to the company his entire right, title and interest in the invention of this coin-operated bag-making machine throughout the United States for 30,000 shares of Autrol common stock and an agreed royalty of 5% of all manufacturing costs. The offering circular also stated that Autrol had purchased its real estate at Manitou Springs from Marjorie E. Bruntjen, the wife of Herman A. Bruntjen, an officer, director and promoter of Autrol, for a consideration of $25,000, $5,000 of which had been paid, and 40,000 shares of Autrol common stock.

10. Following herein are some excerpts from the offering circular and discussion of other provisions therein which appear to be material to the issues discussed below in connection with the alleged fraud of the registrant and its salesmen in their efforts to sell Autrol stock to the investing public. At least in some measure these excerpts and provisions serve to reflect upon, color, or add background to some of the representations affirmatively made by registrant's representatives and to omissions of facts which the Division contends were material, with consequent violation of the anti-fraud provisions.

11. With respect to competition for the product, the offering circular stated in part:

> "There are many firms engaged in the automatic merchandising field, and there are firms which at the present time are vending plastic bags through vending units. These units, however, vend the plastic bag but do not actually manufacture, cut and seal the bag as does the Company's machine."

12. The offering circular also stated in a paragraph titled "Novelty of the Machine and Risk of Emulation", that the company presently had no sales force and anticipated that marketing would be a difficult process for the newly-formed company with no experience in selling such a machine, and that it had no assurance of obtaining sufficient purchasers and distributors in the areas proposed to be franchised. Also that "No assurance can be given that the Company's product will be accepted in retail establishments wherein it may be located, without which acceptance the Company cannot sell its product."

13. As to the machine itself, the offering circular stated that a few working models, or prototypes, of the machine which the company proposed to manufacture, assemble and sell, had been constructed, all of which were operating efficiently, and that a sealing and cutting device in the machine

> "forms and seals the edges of the bag, after which the bag is delivered through the front of the machine to the purchaser. All of the aforementioned is controlled by the coin inserted in a slot provided for that purpose. The machine will receive a 10¢ coin or a 25¢ coin, depending upon the size of bag desired by the customer."

And again the offering circular then stated:

> "It should be noted that the machine itself, upon the insertion of the proper coin, actually manufactures the plastic bag from the plastic material contained in the machine."

14. The offering circular represented that Autrol proposed to designate franchise areas throughout the United States, and after advertising and soliciting and interviewing, to select and appoint dealers and distributors who would purchase the machines and the plastic materials and attempt to locate the machines within their respective franchised areas. On page 7 of the offering circular the following appeared:

> "At the present time the Company has issued a franchise covering an area consisting of metropolitan Denver, Colorado, to a group of persons unaffiliated with management of the Company. The terms of the franchise obligate the holders thereof to maintain a specified number of operating machines in their area, after delivery thereof, in order to be assured of exclusivity in such area. The holders of this Denver franchise have paid the Company $10,000.00 toward the purchase of their requisite number of machines.
>
> "In addition to the Denver franchise, the Company has granted a franchise for the distribution of its machines in the area embracing all of Montana, North Dakota, South Dakota, Nebraska, Minnesota, and portions of Iowa and Wisconsin. The franchise holder, a corporation completely unaffiliated with management of the Company, has agreed to purchase 100 of the Company's bag-vending machines, for which it has already paid 10% of the total purchase price, a down payment of $5,875.00. The term of this franchise is six months, commencing November 5, 1961, and is renewable at the option of the franchise holder for six-month periods, provided that the holder purchased at least 100 additional machines from the Company in the preceding six-month period. If and when the holder has purchased a total of 1,000 machines, its franchise is renewable at its option without the requirement of further machine purchases. The holder is obligated to purchase its entire inventory of polyethelene bag material from the Company.

> "The Company assumes that the most logical place for its machines will be laundromats and self-service dry cleaning establishments, and such other places where persons might need the use of a plastic bag. There is, of course, no assurance that the Company will be able to find sufficient purchaser-distributors or that such persons will be able to place the machines in such locations. Reference is hereby made to the discussion of the Company's competition hereinabove."

15. The offering circular stated that if all of the offered shares were sold, the proceeds would be used for the payment of the balance due Mrs. Bruntjen for the real estate, for the purchase of equipment, plastic bag material inventory, operating expenses, advertising and promotion, and for working capital and other expenses.

16. The underwriting agreement between Autrol and registrant gave to the latter the exclusive right for 120 days to offer the common stock for public sale, and provided for a commission of 15% on all monies received and for the payment of expenses, not to exceed $6,000. In addition, Autrol sold to registrant at a price of 1 cent per warrant or a total of $250, warrants to purchase 25,000 shares of its common stock, exercisable at $2.50 per share on or before September 1, 1966. The underwriting agreement also permitted the registrant to appoint one person to the Board of Directors of the company after the termination of the public offering.

17. Herman A. Bruntjen, Autrol's president, was initially brought into the Autrol picture by Schmidt, who had worked for Bruntjen several years earlier. According to Schmidt, in the Spring of 1961 registrant applied to the New York Stock Exchange for "a broad tape . . .

a record of daily transactions . . . " to be placed in its office, and gave Bruntjen's name as a reference. In a subsequent long-distance telephone conversation Schmidt advised Bruntjen of the bag-making machine invented by Harry A. Mead and when Bruntjen subsequently came to Denver, Schmidt arranged a meeting.

18. Schmidt testified that Bruntjen became the driving force at Autrol. He also testified that Bruntjen became sick during the offering period and was hospitalized for about two weeks for a respiratory ailment which Schmidt did not then believe was serious. Bruntjen died sometime after the offering was closed in February 1962.

19. Both Schmidt and Sharp visited Autrol's plant during the offering period. On one visit, probably in December 1961, Schmidt saw no finished machines but saw parts being made on "a sort of production line basis." Schmidt was impressed with the machine tools at the plant and with what appeared to him might have been 500 machines in the process of manufacture.

20. Prior to or during the early part of the offering period, registrant arranged for Bruntjen to visit its offices at a meeting with its securities salesmen, at which time Autrol's machine was displayed, and plans for merchandising it were explained. A machine was then left on registrant's premises. It was thereafter operated by some of the salesmen by inserting a coin, and this operation was shown to customers of registrant, some of whom bought Autrol stock.

21. This machine was thereafter replaced, probably in late January 1962, by another, called the "Pike's Peak" model. The replacement

occurred after the original model was found to have some bugs, including an inability to reject Mexican pesos and an overheating of a cutting bar. The Pike's Peak model did not manufacture the bags; it merely dispensed them. Schmidt concluded, from inspection of this machine, that it was not properly constructed and that it had a flimsy coin mechanism.

22. Neither Schmidt nor Sharp was able to get satisfactory or sufficient information from the persons carrying on Autrol's business and both became concerned about this sometime around December 15, 1961, after sufficient proceeds from the offering had been turned over by registrant to Autrol's management to permit operations and development of the company's business as originally planned.

23. Other adverse factors included damage in transit to a shipment of 200 machines of the Pikes Peak model to California. When it was thereafter learned that the transit company had refused to pay for the damage it became apparent to some of registrant's personnel that the company might not have sufficient funds to continue production. This occurred in early 1962 and within the offering period.

24. Schmidt had recognized the speculative nature of the Autrol venture. At sales meetings he advised registrant's salesmen to sell the stock in relatively small blocks for this reason, and sales rarely were made in blocks exceeding 200 or 300 shares. The sales meetings were held regularly under Schmidt's supervision and usually were attended by Sharp as well as the salesmen. Although several witnesses testified that Schmidt also advised or warned the salesmen not to make representations which went beyond the material in the offering circular, this advice

or warning was not heeded. Nor could it possibly have been, for the exposure of the salesmen to principals of Autrol Corporation, to the two successive prototypes or models of the machine in registrant's office, and to such information as might have been received concerning anticipated orders, obviously precluded even semi-literal adherence to such a caveat in the selling effort. Merely by way of example, Bates testified that in selling Autrol to his customers he

> "went through the offering circular, detailing the things in there. I described the machine we had in the office, and also I described my wife's and some of my friends' wives' reactions to the bags."

More important departures from the material in the offering circular are discussed below in connection with material misrepresentations made in selling the stock. It should also be noted that although Schmidt testified that he advised the salesmen of the speculative nature of the stock, the more detailed evidence discussed below indicates a failure of the salesmen in many instances where the stock was offered to unsophisticated customers to include such statement in their sales presentations.[8/]

25. Most of the sales of Autrol were made by registrant prior to December 15, 1961. Although sales after that date probably were less than 2,000 shares, efforts to sell the stock continued until the closing date of the offering, February 23, 1962. Registrant used the mails and means or instruments of interstate commerce in offering and selling the stock.

8/ Only two of the investor witnesses presented by the Division could possibly be described as sophisticated investors or sophisticated speculators in securities.

(b) James W. Bates: Sales Activities

26. As indicated above, James W. Bates participated in registrant's efforts to distribute Autrol stock to the public. He is charged, in connection with his selling activities, with being a cause of any action the Commission may take against registrant for its allegedly fraudulent selling activity.

27. Mr. C testified,as a Division witness, that his account was serviced by Les Hosman, one of registrant's salesmen, until he was advised in the Fall of 1961 that Hosman was entering the military service. Hosman introduced C to Bates and advised that Bates thereafter would handle his account. Sometime later, C received a telephone call from Bates concerning two stocks which he stated registrant was then underwriting and selling, and at least on one occasion C visited registrant's office and discussed these stocks with Bates. The stocks were Autrol and Larr Optics. C testified that Bates described Autrol's business and recommended Autrol over Larr Optics for purchase, inasmuch as Autrol was about to sign a big contract which would result in the placement of its machines in many establishments and which, Bates represented, would increase the price of the stock. C bought 40 shares of Autrol at the offering price of $2.50 per share.

28. A conflict in the evidence exists as to whether the stock was sold to C by Bates or by Hosman. Mr. C testified at great length concerning several statements and representations by Bates regarding Autrol's business and prospects, and he was certain that he at no time discussed Autrol with Hosman.

29. Although C was not a model witness in the precision or accuracy with which he testified, the Examiner credits his testimony as to Bates' representations that Autrol was about to enter into a big contract which would increase the price of its stock. This conclusion is reached despite testimony by Hosman, appearing on behalf of Bates, to the effect that he, Hosman, effected the sale to C by taking the order or indication of interest before he left the firm around November 11, 1961 or "approximately the second week of November" [9/] to enter the military service. The confirmation of sale, which was mailed to C by registrant, reflected the date of this purchase as November 27, 1961. This was five days after the November 22 date on which the Autrol offering commenced and approximately sixteen days after Hosman left registrant's employ. Although Hosman was paid commission on this sale by registrant sometime after his entry on military duty, and although the order slip or indication of interest was in his handwriting, he denied having discussed Autrol with C except "to the point of just the general idea", and added "I hadn't seen the offering description." The Examiner believes that C was told much more than "just the general idea" of Autrol's business and credits his testimony of conversations regarding Autrol and Larr Optics and the relative merits of these stocks. He is of the view that despite testimony to the contrary by Bates, the latter made representations to C regarding Autrol as stated above, prior to the trade date of November 27, 1961, and that even though Hosman may have taken C's indication of interest prior to November 11, as he testified,

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9/ In November 1961, the second week ended on November 11. Hosman testified that he left at that time because he "had a few things to take care of before entering the Army." He was inducted on November 20, 1961.

(a matter of no immediate importance to this decision), Bates thereafter discussed Autrol with C and in these discussions induced the definitive decision by C to purchase the Autrol stock.[10/]

31. Although C testified that he did not receive an offering circular on Autrol until after he had made payment for the stock, his testimony was vague and indefinite on this matter, and the Examiner concludes from all of the testimony that the offering circular was mailed to C by registrant with the confirmation of sale, on or about the trade date November 27, 1961.[11/]

32. Another witness, Mrs. G, testified that Bates telephoned her in November 1961 and represented that Autrol was "going to get more franchises in the middle west, and that this would increase their business volume and earnings, and also the price of their stock." This representation, among others, convinced Mrs. G that Autrol was "a good long-term investment" and after about three telephone conversations with Mr. Bates she bought 100 shares on December 1, 1961. The Examiner credits the testimony of Mrs. G.

10/ Other details in C's testimony support the conclusion that his relatively detailed conversations were with Bates rather than with Hosman. For example, he testified that he advised Bates that he had $100 to invest and that after weighing the relative merits of a purchase of Autrol stock or stock of Larr Optics ". . . we decided we would put the hundred dollars in Autrol Corporation." The Examiner credits the testimony that such a conversation took place and concludes that it occurred with Bates and not with Hosman.

11/ The former cashier of registrant testified as to the firm's practice of sending offering circulars with confirmations of sale of new issue stock. The Examiner sees no reason to discredit this testimony, at least with respect to sending the offering circular to C.

33. The Division presented the testimony of one additional witness who bought Autrol stock after being contacted by Bates. Mr. E considered his occupation as that of "stock-trader" and also did some work for a mutual fund. Bates telephoned Mr. E and in one or two conversations discussed Autrol briefly. In addition, Autrol was discussed in one or two visits which E made to registrant's office. These conversations took place over a period of one or two weeks prior to E's purchase of 100 shares of Autrol on November 27, 1961. Around this time he saw the bag-making machine in operation at registrant's office. E testified that Bates, after discussing the low overhead of the company, its existing orders and others being negotiated, as well as further favorable aspects of the company's operations, represented that the stock would go up substantially higher than the offering price when the underwriting was completed and the stock was being traded. E also testified that Bates advised him in November 1961 that the company "was negotiating for" larger orders in the State of California. 12/

34. The legal effect of these representations made by Bates to the several customers and the reasons why some of them constitute violations of the anti-fraud provisions and why Bates must be regarded as a cause of any action which the Commission may take against registrant are discussed, infra.

(c) Ben T. Kumagai: Sales Activities

35. Ben T. Kumagai was called by the Division and testified that he sold approximately 10,700 shares of Autrol during the offering

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12/ This is not inconsistent with C's testimony, supra, but it is contrary to Bates' testimony.

period. He attended sales meetings called by Schmidt, during which the Autrol offering and other stocks were discussed, and during at least one of these meetings Bruntjen and other representatives of Autrol appeared and discussed the company's machine and its plans for a profitable operation.

36. Kumagai denied having any knowledge until after the termination of the offering in February 1962, of difficulties which the issuer was having with its machines, although some of these difficulties were known to Schmidt, to Sharp and to Bates long prior to the termination date, as discussed in detail, infra. However, his testimony reflected confusion with respect to dates, among other matters, and some rather extreme views with regard to the suitability of speculative stocks as investments for persons who lacked sufficient funds to make large purchases of conservative stocks. For example, he sold 20 shares of Autrol to a 14 year old boy who delivered newspapers with his son, but did not sell it to a wealthy doctor client "Because he was in a financial status that he needn't buy speculative stock. I recommended blue chip[s]." He also stated:

> "If he was a medical doctor, who is making all the money these days, I was led to believe that a gentleman of that caliber needn't invest in highly speculative stocks, only blue chip(s)."

37. A witness F testified that in late November 1961, Kumagai telephoned him and represented that the issuer was producing bag-vending machines which were already sold, and needed additional capital to continue

its production of machines for which there was a ready market. He also represented that registrant was offering the stock in small amounts inasmuch as it had a limited quantity to sell, and that the price of the stock would go higher. As part of his sales talk Kumagai stated, referring to a small profit F had previously made on the purchase and sale of another stock through Kumagai:

> "You have never lost money with me before, and you won't this time."

F bought 100 shares of Autrol following this conversation.

38. F testified that the only stocks he had purchased were speculative issues, and that he had made money in several purchases of stock prior to his investment in Autrol.

39. Mrs. GF also testified that Kumagai telephoned her two or three times in November 1961 and after informing her of Autrol's product, stated that the stock would probably open up on the trading market in 30 days at $3.00 per share and Mrs. GF could make 50 cents a share. He also advised that it would be a good long term investment. However, Mrs. GF understood that Autrol was a new company and that the stock was speculative. She testified, with the benefit of somewhat costly experience and hindsight, that although she knew it was a gamble, " . . . I didn't realize it was such a gamble as I do now." She also stated: " . . . I was sold on it; I thought it was a good stock." She bought 40 shares and had her mother buy 100 shares. Mrs. GF had previously invested

> "in other speculative stocks which really came out on the market fast, and at high prices, and [she] . . . just thought that all stock . . . would . . . come out fast."

40. The legal effect of Mr. Kumagai's sales activities is discussed, infra.

(d) Robert D. Schmidt: Sales Activities

41. Schmidt testified that he made perhaps two sales of Autrol stock. Mrs. O was employed by registrant as a part-time bookkeeper during the offering period. She testified to a conversation with Schmidt in November 1961 in which he advised her that Autrol was a good deal on which she could make some easy money in a couple of weeks when it would go on the market. He also stated, according to Mrs. O, that she could sell half of it and get her money back and let the other half ride. Although Mrs. O's testimony was not credible in its entirety, and although Mr. Schmidt testified that he did not recall having had any conversations with her regarding Autrol, the Examiner credits the testimony relating to these representations. He also credits Mrs. O's testimony that Mr. Schmidt and a Mr. Yamamoto, a salesman of registrant who confirmed Mr. Schmidt's statements to Mrs. O regarding Autrol stock and through whom she bought her 100 shares of Autrol, "had three kinds of stock to sell at the time, Autrol, and Larr Optical, and I don't remember the other one. He [Schmidt] said this [Autrol] was a good deal."

42. Mrs. O tried to sell her Autrol stock one or two days after she bought it, but was advised by Yamamoto that she could not do so until it went on the market. Two or three weeks later, she confronted Mr. Schmidt, asking when it was going on the market and he replied "anytime now, anytime."

43. Mr. K testified that he did business with a securities salesman named Sherr, who was employed by registrant. In November 1961, Sherr advised him that registrant was coming out with a new issue which looked like a good buy and should be "a hot stock". Sherr knew that K was interested at that time in making quick profits on his investments, and K had bought stock of several new offerings which proved to be "hot stocks" and he testified that he assumed that Autrol would be another "in the same category." After K had placed an order for 400 shares but before he made payment, he spoke with Schmidt about the stock. Schmidt showed him the vending machine on display in registrant's office and spoke of a substantial backlog of orders already received by the issuer. He also stated that registrant would make a market in the stock and would interest other broker-dealers in it.

43. No other customers testified with regard to sales or representations made by Schmidt and none testified with regard to Sharp's direct activities in the sale of the stock. Sharp testified that he sold about 400 shares of Autrol to personal friends, all of whom were interested in speculative issues. His responsibility for the violations which occurred in the offer and sale of Autrol derives from his position in the registrant, as indicated below.

(e) Other Salesmen: Sales Activities

44. Mr. Yamamoto was not named in the order for proceedings as a person who should be found to be a cause of any action taken by the Commission against registrant. However, the above testimony of Mrs. O indicates representations by him of the same nature as those made by Schmidt.

45. Other witnesses testified, on behalf of the Division, to selling activities of salesmen of registrant who were not named as causes in this proceeding, but for whose misrepresentations and omissions of material facts registrant is, of course, responsible under the law, as discussed below. Thus, Mr. B testified that Roger Furst told him in November 1961, that Autrol had an established product which was in use in many places at that time, that the company was in good financial shape but needed money to fill large manufacturing orders, that they had a substantial and rapidly growing backlog of orders, and that the company looked very sound and its stock would be a good investment. Furst also represented that the stock could almost be classified as a blue chip, stated that it was earning a small amount, and that with the proceeds from the offering it should easily make 30 to 40 cents per share in 1962; also, that there was "probably a good chance they could easily be paying dividends in 1963" and a good possibility the stock would appreciate 50 to 100 per cent in three to six months. B bought 200 shares of Autrol in November 1961, and in a subsequent discussion with Furst in January 1962, he was advised that when the offering was closed registrant would make a market in the stock and his shares could then be sold. B also testified, as to Furst:

> "I think that what he told me he told me in honest sincerity. I think every word he told me he believed to be true."

(f) Legal Effect of the Sales Activities

46. Much in point in any effort to evaluate or judge the activity of registrant and its representatives in offering Autrol stock to the public is the above-quoted testimony of Mr. B with respect to the salesman, Furst, to the effect that Furst honestly believed all that he stated. So too, as to Bates and Kumagai, who testified in this proceeding, the Examiner believes that they did not intend, either by their affirmative representations or by their omission of material facts, to defraud the persons to whom they sold Autrol stock. Evaulation of their selling activities in the light of their exposure to optimistic plans and projections outlined by Autrol's officials at meetings in registrant's office, in the light of their observation and operation of a bag-making machine which was placed in registrant's office, in light of the offering circular which spoke of $15,875 in orders already received, and in light of the enthusiasm of Schmidt for an underwriting undertaken after some investigation of the issuer's product and potential, leads to a conclusion that at least during the early portion of the offering period the salesmen might have been somewhat optimistic, if not enthusiastic, not only about the prospects of an increase in the price of the stock but, more importantly, about the company's prospects for success. Indeed, if they participated in a selling campaign and recommended the purchase of Autrol stock without having honest views that the company had a reasonable chance of financial success they would probably do so in violation of the anti-fraud provisions of the Securities Acts which demand of the securities salesman a moral integrity correlative with

the trust and confidence which the customer reposes in him. See William Harrison Keller, Jr., 38 S.E.C. 900 (1950), where the Commission noted that inherent in the dealer-customer relationship is the implied representation that the customer will be dealt with honestly and fairly and in accordance with the established standards of the profession. Cf. the "obligation of fair dealing imposed on broker-dealers and their salesmen by the securities laws." Ross Securities Inc., Securities Exchange Act Release No. 7069, April 30, 1963. And cf. Article II, Sec. 1(c) of the NASD Rules of Fair Practice, reading in part: "Registered Representatives of members shall be under the same duties and obligations as a member under the Rules of Fair Practice."[13/]

47. But a belief or opinion, however honest, that an issuer's product has sufficient merit to bring success to the company is not, without more, an adequate basis for representations to a customer that the price of the issuer's stock will increase. In Alexander Reid & Co., Inc., 40 S.E.C. 986 (1962), a case similar to the instant matter in some respects, the Commission stated at page 990:

> "A broker-dealer in his dealings with customers impliedly represents that his opinions and predictions respecting an stock which he had undertaken to recommend are responsibly made on the basis of knowledge and careful consideration. [citing, in the margin, S.E.C. v. William Harrison Keller, supra]. Without such basis the opinions and predictions are fraudulent . . . And it is not a sufficient excuse that a dealer personally believes the representation for which he has no adequate basis."

13/ Although registrant was not a member of the NASD, Bates and Kumagai were registered representatives, and the quoted Rule illustrates the standards expected of persons selling securities. See also, William J. Steelmack Corp., 11 S.E.C. 601, 623 (1942); Lawrence R. Leeby, 13 S.E.C. 499, 505 (1943).

The Commission continued, at page 991:

> "On the record before us, registrant had no basis for the opinions and predictions of specific price rises and other optimistic statements as to Woodland's prospects made to the customer witnesses. The asserted facts that Speed-O-Fax actually performs the function claimed for it and was demonstrated to Silberman and the salesmen, that Woodland had received letters of interest concerning Speed-O-Fax, and that the company's current balance sheet showed working capital of $50,000 afford no such basis. There were no tangible or calculable profits or measurable expectations from the as yet unexploited Speed-O-Fax machine, . . ."

Thus, there was no justifiable basis for Bates' representations of a price rise in Autrol stock following "a big contract" for machines or for any of his other statements of anticipated price rise which were testified to as related above, and which are credited by the Examiner. Apart from the many uncertainties inherent in the issuer's production and merchandising of a machine which was untried commercially, there was no indication of any analysis of the issuer's financial statements or of other material which would support a conclusion that the stock was worth more than $2.50 per share or would rise above that figure, even if a "big contract" were secured and the machines could be produced and delivered under it. So too, the representation that the stock would go substantially higher when the underwriting was completed and the stock was being traded was entirely unwarranted. Firstly, of course, the offering was never in fact completed and the implication that registrant would make a market in the stock never came true. More important, there was no basis for expressing the view that either of these events would occur. These representations appear to be founded largely on the hope or expectation that the public would jump at the stock just as it had jumped previously

at hot new issues of marginal quality which became available during the bull market then under way - a hope or expectation that should not properly have constituted any basis for a "buy" recommendation. The representation to Mrs. G that the stock was a good long term investment was also a misstatement of a material fact, just as was the failure to state the converse - that it was in fact a speculation - an omission of a necessary material fact.

48. Kumagai's representations went even further beyond the pale of the law. Not only did he represent in general terms, without adequate basis therefor, that the stock would increase in price, but he also predicted, more specifically, that Mrs. GF could make a profit of 50 cents per share in 30 days.[14/] And in predicting this, he impliedly promised that registrant would then make a market in Autrol. That Mrs. GF understood that the stock was speculative did not absolve the salesman from the duty to refrain from making unsupported representations: that a salesmen may be expressing an opinion rather than making a definitive statement of fact or a promise does not absolve the fraud. Cf. Isthmus Steamship & Salvage Co., Inc., Securities Exchange Act Release No. 7400, August 20, 1964, where the Commission stated:

> "Certain of the investor witnesses acknowledged that they recognized the speculative nature of the stock, and certain others stated that they did not believe or rely upon the statements made to them. Neither of these factors can absolve the fraudulent representations." [Citing in the margin Leonard Burton Corporation, 39 S.E.C. 211, 214 (1959).] (Continued)

14/ The Commission has frequently stated that predictions of specific price rises are a "hallmark of fraud." Linder, Bilotti & Co., Inc., Securities Exchange Act Release No. 7460, November 13, 1964; Alexander Reid & Co., Inc., 40 S.E.C. 986, 991 (1962); Equity General Investment Corp., Securities Exchange Act Release No. 7388, August 13, 1964.

> "The assertion that some of the statements attributed to salesmen were couched in terms of 'opinion' does not negate the fraud inherent in them, nor does confidence justify the fraud." [Citing, among other cases, in the margin, MacRobbins & Co., Inc., Securities Exchange Act Release No. 6846 (July 11, 1962), affirmed sub nom. Berko v. S.E.C., 316 F.2d 137 (C.A. 2, 1963); S.E.C. v. Okin, 137 F.2d 862, 864 (C.A. 2, 1943); S.E.C. v. F. S. Johns & Co., 207 F.Supp. (D.N.J., 1962); Ross Securities, Inc., Securities Exchange Act Release No. 7069 (April 30, 1963).]

In S.E.C. v. F. S. Johns & Co., cited in the above quotation, the court said, speaking of the financing of corporate enterprises by the sale of stock:

> "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."

49. The blatantly false representations by Furst, which the Examiner credits as having been made, require added comment despite what has been said above concerning the impropriety of the representations of Bates and Kumagai. Furst must have known from the offering circular and from the sales meetings that he was speaking falsely in stating that Autrol was in good financial shape, could almost be classed a blue chip, would have earnings in 1962, or that the stock would appreciate in price as he predicted. His knowledge or reasonable grounds to believe these statements were untrue constitutes a "manipulative, deceptive or fraudulent device" under Section 15(c)(1) of the

Exchange Act and Rule 15c1-2. And his failure to temper these representations by advice that the issuer had produced no machines excepting a few prototypes was at the least an omission of necessary material facts. The statements by Schmidt and Yamamoto to Mrs. O, and the failure to warn her of the speculative nature of the issue were fraudulent. The representation by Sherr to Mr. K concerning the issuer's "substantial backlog of orders" was false and his representation that registrant would make a market in the stock and would interest other brokers in it was unwarranted.

50. Registrant's responsibility for the false and unwarranted statements of its representatives and for their failure to state necessary material facts in accordance with the required principles of fair dealing are, of course, well-established in the securities law. Reynolds & Co., et al., 39 S.E.C. 902, 916 (1960). As the court said in R. H. Johnson & Co. v. S.E.C., 198 F.2d. 690 (C.A.2, 1952), a contrary rule "would encourage ethical irresponsibility by those who should be primarily responsible." And the responsibility of Schmidt and of Sharp, both of whom participated actively in the business and by reason of their positions are charged with the duty of controlling or supervising its activities so as to preclude violations of the Exchange Act, is also clear. Aldrich, Scott & Co., Inc., 40 S.E.C. 775 (1961); Luckhurst & Co., Inc., 40 S.E.C. 539 (1961). Sharp's argument in his brief that his position was in many respects an absentee principal is neither in accord with the facts nor meaningful under the rules of law declared in the aforementioned cases.

C. Alleged Net Capital Violation

51. Otto P. Gustte, an investigator for the Denver Regional Office of the Commission, testified that on November 21, 1963, he examined a financial report filed by registrant on Form X-17A-5 speaking as of the date September 30, 1963, and that registrant then had an "aggregate indebtedness" of $27,223.88. He testified that the amount of net capital required to carry this aggregate indebtedness under the rule administered by the Commission is $1,361.19. He concluded, in summary, that as of September 30, 1963, registrant showed the following:

Aggregate Indebtedness	$27,223.88
Required Net Capital (2,000% rule)	1,361.19
Net Capital Deficit	17,450.37
Total Net Capital Deficiency	$18,811.56

Included in the aggregate indebtedness found by the witness were two subordinated notes: one note in the amount of $5,000 was dated January 25, 1961, due January 25, 1962, and was payable to Pacific International, Inc.; the other note, in the amount of $17,500 was dated August 23, 1962, due September 23, 1963, and was payable to one Abraham L. Berenbeim.

52. There is no argument between the Division and registrant with respect to the validity of the figures used by Mr. Gustte in computing the net capital position of registrant. However, each of these notes was subject to a subordination agreement, and the issue whether registrant was in violation of the net capital rule on or about September 30, 1963, as alleged in the order for proceedings, depends upon an evaluation of

the subordination agreements and a determination whether these two indebtednesses were properly included in the computation of aggregate indebtedness.[15/] By definition under Rule 15c3-1(c)(1), "aggregate indebtedness" includes money liabilities such as those represented by these promissory notes but excludes all "indebtedness subordinated to the claims of general creditors pursuant to a satisfactory subordination agreement as hereinafter defined." And under this rule a "satisfactory subordination agreement" is defined as stated in the margin.[16/]

53. Registrant points out that both subordination agreements contain all the requirements of a "satisfactory subordination agreement," as defined. The Division contends, however, that the subordination agreements were not satisfactory subordination agreements within the rule, for the

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15/ The net capital rule does not apply to any member of the Midwest Stock Exchange, among other exchanges, all of whose rules and settled practices are deemed by the Commission to impose requirements more comprehensive than the requirements of that rule. However, the registrant was no longer a member of the Midwest Stock Exchange on or about September 30, 1963.

16/ Rule 15c3-1(c)(7) reads:

The term "satisfactory subordination agreement" shall mean a written agreement between the broker or dealer and a lender, which agreement is binding and enforceable in accordance with its terms upon the lender, his creditors, heirs, executors, administrators, and assigns, and which agreement satisfies all of the following conditions:

(A) it effectively subordinates any right of the lender to demand or receive payment or return of the cash or securities loaned to the claims of all present and future general creditors of the broker or dealer;

(B) it is not subject to cancellation at the will of either party and is for a term of not less than one year;

(C) it provides that it shall not be terminated, rescinded or modified by mutual consent or otherwise, if the effect thereof would be to

(Continued)

reason that:

> "In the case of each of the above subordination agreements, the underlying instruments of indebtedness had matured and the sums due thereunder were due and payable as of and prior to September 30, 1963; moreover, demand for payment has been made with respect to each.[17/] The subordination agreements have thus been modified by the actions of the parties thereto, by their allowing the underlying indebtedness to mature without payment or without provisions for extension thereof, and the subordination agreements therefor cannot be considered as 'satisfactory subordination agreements' as the Rule provides."

The Examiner finds a basic distinction between the two subordination agreements, which is not discussed either by the Division or by registrant, but which compels the conclusion that the Berenbeim obligation should

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16/ Continued

> make the agreement inconsistent with the conditions of this rule, or to reduce the net capital of the broker or dealer below the amount required by this rule;
>
> (D) it provides that no default in the payment of interest or in the performance of any other covenant or condition by the broker or dealer shall have the effect of accelerating the maturity of the indebtedness;
>
> (E) it provides that any notes or other written instruments evidencing the indebtedness shall bear on their face an appropriate legend stating that such notes or instruments are issued subject to the provisions of a subordination agreement which shall be adequately referred to and incorporated by reference;
>
> (F) it provides that any securities or other property loaned to the broker or dealer pursuant to its provisions may be used and dealt with by the broker or dealer as part of his capital and shall be subject to the risks of the business.

17/ According to the testimony, Berenbeim inquired in December 1963 as to when he would be paid. Pacific International made a demand for payment which registrant asserts is not due because of an offset of some kind, and this is discussed, infra.

not be included in computing aggregate indebtedness but that the Pacific International obligation should be included.

54. In addition to the required provisions for a satisfactory subordination agreement as indicated in footnote 16, supra, the Berenbeim subordination agreement contains language providing that it shall be effective

> "so long as said note is unpaid and outstanding, but in any event not less than thirteen (13) months from the date hereof." (underscoring supplied)

Because of this provision, the life and the effectiveness of the subordination agreement persisted beyond the due date of the note, September 23, 1963, and, indeed, beyond the date September 30, 1963. The note remained unpaid and by its express terms the subordination agreement remained effective. This precludes the inclusion of the $17,500 in the computation of aggregate indebtedness as of that date, inasmuch as a subordination agreement which satisfied the rule remained effective on September 30, 1963.

55. Conversely, however, the Pacific International subordination agreement contains no provision extending its life beyond January 25, 1962, the due date of that obligation. This agreement provides, in part:

> "This agreement shall not be cancelled or terminated prior to January 25, 1962, and shall not be subject to cancellation at the will of either party." (underscoring supplied)

It also provides that it

> "shall not be terminated, rescinded or modified by mutual consent or otherwise if the effect thereof would be to make the agreement inconsistent with the conditions of [Rule 15c3-1], or to reduce the net capital of Schmidt-Sharp below the amount required by said rule."

The two above-quoted provisions were properly included in the subordination agreement: the first, because such agreement must be for "not less

than a year" and may not be subject to cancellation by unilateral act; the second, because the rule requires that such a limitation on termination by mutual consent be included. But nowhere in the agreement is there any provision extending its life beyond January 25, 1962, the date which the parties appear to have intended as the termination date. The result is that so long as the agreement was effective it was a satisfactory subordination agreement and the obligation to Pacific International was subordinated in accordance with the rule. On termination of the agreement, however, the subordination no longer persisted. The second excerpt, prohibiting termination if the effect thereof would be to reduce registrant's net capital below the amount required, is effective and viable only so long as the agreement itself is alive. It does not continue or extend the life of the agreement so long as the obligation is unpaid, as does the express language of the Berenbeim agreement.

56. Registrant contended at the hearing that it was advised by its counsel that an offset existed against Pacific International in "some amount equal to the amount set forth in the subordination agreement." However, no factual evidence of the details of such offset was presented, and I am unable to accept the conclusion that the $5,000 obligation was not due Pacific International on September 30, 1963. It follows that this obligation is properly included in the computation of aggregate indebtedness. Recomputation by including the $5,000 but excluding the $17,500 debt to Berenbeim indicates a net capital deficiency of $436.56 as of September 30, 1963. It is clear that registrant effected transactions in and induced the purchase and sale of securities otherwise than on a national securities

exchange on or about September 30, 1963. In doing so at a time when it had a net capital deficiency, however small, it violated the statute and rule.

D. Bookkeeping Violations

57. The order for proceedings alleges that during the periods August 1, 1963 to September 30, 1963, and October 1, 1963 to November 12, 1963, registrant failed to make and keep current the general ledger, the sales blotter, the purchase blotter and other records required under Section 17(a) of the Exchange Act and Rule 17(a)(3) thereunder. In accordance with this section and rule, a broker-dealer must make and keep current, among other records,

1. "Ledgers (or other records) reflecting all assets and liabilities, income and expense and capital accounts."

2. "Blotters . . . containing an itemized daily record of all purchases and sales of securities . . . "

3. "A record of the proof of money balances of all ledger accounts in the form of trial balances. . . prepared currently at least once a month."

58. The witness, Gustte, testified that on November 12, 1963, he visited registrant's office and noted that its general ledger had not been posted for August or October 1963; that he examined the purchase blotter and the sales blotter and found that they did not reflect any transactions for October 1963. He also testified that one week earlier, during a visit on November 5, he had been advised by Schmidt that registrant's trial balances for the months of August and September 1963 had not been prepared, that on November 8 he was again advised by Schmidt to

this effect, and that on the November 12 date he was given a trial balance for September 30, 1963, and was informed that the August trial balance had not been prepared.

59. Registrant does not contest the accuracy of this testimony, but seeks to excuse the violations or mitigate their seriousness by asserting that the firm had ceased doing a retail securities business as of August 1, 1963, and that the failure to make and keep current records was due to a personal disability of its accountant. There is little question but that registrant's retail operation was markedly curtailed around the time claimed, but this, of course, would not excuse a failure to comply with the salutary requirements of record-keeping which are so essential to the Commission's supervision of a broker-dealer's operations and, indeed, so essential to the proper operation of the business itself. Nor can the disability of the accountant serve to excuse the dereliction of duty. A similar situation was considered in Sebastian & Co., 38 S.E.C. 865 (1959), and the Commission stated:

> "With respect to the violations of the record-keeping requirements, the illness of registrant's accountant does not satisfactorily explain or excuse registrant's failure to record transactions. It was clearly incumbent upon him to take steps to ensure the keeping of the required records at all times."

60. Evidence of additional violation of the record-keeping requirements was given by William Klein, another investigator of the Denver Regional Office, during his testimony as to Regulation T violations discussed below. He testified that in January 1962, while examining registrant's records, he discovered that its customers' ledgers were not up to date in listing securities held in safekeeping, and that Mr. Kersenbrock, registrant's controller, informed him that the delay was caused by turnover in bookkeeping personnel. On February 5, 1963, the witness was again advised that the posting had not been accomplished. 18/

61. The responsibility of Schmidt for the violations of the record-keeping is clear. Sharp is also responsible for failing to insure proper record-keeping by the firm for the period of time up to October 14, 1963, when he resigned his position as an officer of the registrant firm. Cf. Aldrich, Scott & Co., Inc., supra.

18/ This violation was not alleged in the order for proceedings, but the evidence was received without objection and seems appropriate for consideration at this time, although argument to the contrary is made in registrant's brief. Firstly, if objection had been made at the hearing, the order for proceedings might readily have been amended, and registrant should not benefit by remaining silent under these circumstances. In addition, there seems to be no issue on the facts, and Kersenbrock was available as a witness to contradict any misstatement in the testimony.

Under Rule 17(a)(3), a broker-dealer is required to make and keep current records of customers' securities held in safekeeping.

E. Regulation T Violations

62. In August 1940, in a discussion of Section 4(c)(2) of Regulation T, the Board of Governors of the Federal Reserve Bank stated:

> "An inquiry was presented as to a situation in which a broker or dealer does not obtain full cash payment within the period applicable to the transaction but is offered payment promptly after the period and before he has cancelled or otherwise liquidated the transaction. The question was whether the broker or dealer in such circumstances may accept such payment and consider the provisions requiring cancellation or liquidation for failure to obtain payment to have been met.
>
> "The section provides various exceptions for cases where a period other than the seven-day period would be more appropriate. These exceptions do not include any provision for a payment which is offered promptly after the period applicable to the transaction, and it does not appear why any additional time should be permissible in such circumstances if there is no other ground for additional time." From a Legal Standpoint, Federal Reserve Bulletin, August 1940, p. 773.

As pointed out by the Division in its brief, this principle was recognized by the Commission In the Matter of Coburn and Middlebrook, Inc., 37 S.E.C. 583, 590 (1957).

63. William J.Klein testified that on January 23, 1963, he examined customers' ledgers and confirmations of registrant for the period from approximately June 26, 1961 to approximately December 27, 1962, and found 30 violations of Regulation T during that period, in the failure to receive payment within seven business days from the respective trade dates

or to promptly cancel the trades. The number of days in which registrant was in violation ran from one day for nine transactions up to 32 days for one transaction, and averaged approximately 4½ days. Other than the 32-day violation, none of the others were in excess of 8 days.

64. Registrant contends that 15 of the alleged violations involved the sale of new issues under Regulation A offerings and urges an exception under Section 4(c)(3) of Regulation T, which reads as follows, in pertinent part:

> "If the security when so purchased is an unissued security, the period applicable to the transaction under subparagraph (2) of this paragraph shall be 7 days after the date on which the security is made available by the issuer for delivery to purchasers."

Registrant introduced evidence that under the underwriting agreement with Autrol, the stock certificates were not required to be delivered by the issuer until after payment therefor was received from the underwriter. It urges that the securities were "unissued" within the meaning of Section 4(c)(3) and that payment need not have been made until the securities were "made available by the issuer." This contention is a bootstrap argument which would subvert the purpose of Section 4(c)(2), for if the securities remained "unissued" until after payment was made, indefinite delay in payment would be permissible[19/]. From a standpoint of pure logic, the argument

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19/ Registrant made some effort to introduce evidence of similar provisions in underwriting agreements between registrant and other issuers under Regulation A, but the effort was abandoned. Some of the 30 violations involved purchases of these issues. In its brief, registrant makes the same argument with respect to these purchases as it makes with respect to the Autrol purchases. The argument, of course, is specious, as indicated above.

is untenable. Moreover, the Federal Reserve Board has issued an interpretation of Section 4(c)(3) which destroys registrant's contention. In its Bulletin of November 1962, at page 1427, an article entitled "Time of Payment for Mutual Fund Shares Purchased in a Special Cash Account" states that:

> "The purpose of [the section] is to recognize the fact that, when an issue of securities is to be issued at some fixed future date, a security that is a part of such issue can be purchased on a 'when-issued' basis and that payment may reasonably be delayed until after such date of issue, subject to other basic conditions for transactions in a special cash account."

Autrol, of course, was not being sold on a "when-issued" basis.

65. Registrant also urges that two of the 30 transactions represented sales to customers whose accounts "contained credit balances adequate to offset the debit resulting from these sales."The evidence with respect to one of these purchases (by Jesse Y.Masunaga)supports its contention.This was a violation of one day, according to the Division. A second situation, as urged by registrant, appears to involve a debit balance of $34.38 for two days. Schmidt testified that "it isn't necessary to get an extension under Regulation T for an amount under $100." He was correct in his contention, for Section 4(c)(7) of Regulation T gives the creditor the option to "disregard any sum due by the customer not exceeding $100."

66. Schmidt and Sharp, of course, were responsible for the supervision of registrant's transactions and business operations during

the period of these violations.

F. Summary

67. From the above, it follows that registrant, aided and abetted by Schmidt and Sharp, wilfully violated Section 17(a) of the Securities Act and Sections 10(b) and 15(c)(1) of the Exchange Act and the rules thereunder, as charged, in the sale of Autrol stock;[20/]

that Kumagai and Bates wilfully violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and the rule thereunder, in the sale of Autrol stock;

that registrant, Schmidt and Sharp wilfully violated Section 15(c)(3) of the Exchange Act and Rule 15c3-1 thereunder by engaging in transactions at a time when registrant's net capital was less than required;[21/]

that registrant, Schmidt and Sharp wilfully violated Section 17(a) of the Exchange Act and Rule 17(a)(3) thereunder in failing to make and keep current the records of registrant, as discussed above;

that registrant, Schmidt and Sharp wilfully violated Section 7 of the Exchange Act and Regulation T, in connection with 28 transactions.

20/ The actions of Furst in the course of his employment were those of registrant. Idaho Acceptance Corp., Securities Exchange Act Release No. 7383, August 7, 1964; Barnett & Co., Inc.,40 S.E.C. 1 (1960).

The violations in selling Autrol were wilfull. Hughes v. S.E.C., 174 F.2d 969, 977 (C.A.D.C.1949).

21/ Perhaps the net capital offense is somewhat mitigated, though not excused, by the fact that the Denver Regional Office requested a modification of the Pacific International subordination agreement in January 1962, without suggestion or warning to registrant that the agreement would terminate on January 25, 1962, as concluded herein by the Examiner. (At that time registrant was a member of the Midwest Stock Exchange, and the net capital rule was inapplicable to it.)

III PUBLIC INTEREST

68. The Division argues that "The technique of offering a highly speculative stock in small blocks to unsophisticated investors of modest means is one of the hallmarks of 'boiler room' type sales." It cites, as authority, Berko v. S.E.C., 297 F.2d at 117 (C.A.2, 1961), "for a description of 'boiler room' activities."

69. The Examiner views the operation of registrant's firm in selling Autrol stock as vastly different from the boiler room type of operation discussed in Berko and in scores of other decisions by the courts and Commission. Although many violations of law by registrant have been found, they do not suggest to the Examiner a deliberate and planned scheme or device to defraud the investing public, by any of the persons charged in this proceeding.

70. This is not to minimize the seriousness of any of the violations. Schmidt, as President of the firm and as the guiding force in bringing the offering into the organization, failed the public in not making an earlier decision to terminate the offering when information on the issuer's finances and progress continued to be unavailable to registrant and when, conversely, information with respect to set-backs and problems did become available. It appears at this time that Schmidt's decision to terminate was too-long-delayed beyond the time when the automatic bag-making machine was no longer the product which could be sold by Autrol because of its inability to reject Mexican pesos and because of the overheating of the sealing bar. The importance of the bag-manufacturing process, as indicated

and repeated in the offering circular, suggests that when the Pike's Peak model was brought into registrant's office in replacement of the bag-making prototype, if not earlier, bold and effective action rather than a continuation of registrant's efforts to sell the stock was called for. And nothing in the testimony indicates that Schmidt directed the salesmen even to inform the investing public of the serious departure from the machine with the unique feature which was so fully described in the offering circular. Nothing indicates that he confided to anyone his views that this Pike's Peak model had a flimsy coin mechanism, as he testified. And Sharp must share in this responsibility for inaction, even though his position in the firm was very definitely subordinate to that of Schmidt in all respects. Registrant argues that the seriousness of any violations in the sale of Autrol was mitigated by the distribution of an offering circular which warned of the speculative nature of the offering. In Ross Securities, Inc., Securities Exchange Act Release No. 7069, April 30, 1963, the Commission stated:

> "At the expense of restating the obvious, we emphasize that compliance with these requirements for delivery of a prospectus or offering circular does not, however, license broker-dealers or their salesmen to indulge in false or fanciful oral representations to their customers. The anti-fraud provisions of the Securities Act and the Securities Exchange Act apply to all representations whether made orally or in writing, during or after the distribution."

Moreover, the failure to inform customers of the inability of the issuer to market a bag-making machine becomes even more important when viewed in light

of the importance given in the offering circular to this feature of the company's product.

71. Because of the violations in the sale of Autrol and the many other violations for which Schmidt and Sharp are responsible, the Examiner recommends that the Commission find that it is appropriate in the public interest that registrant's registration be revoked and that Schmidt and Sharp be found to be causes of such action.

72. The offenses of Kumagai and Bates are sufficiently serious to compel the recommendation that they also be found to be causes of the revocation.

72. Kumagai's testimony indicated an inability, during the offering period, to appreciate the risks involved in the speculation he was selling; a failure or refusal to recognize the important difference between a machine which was able to manufacture bags, as discussed in the offering circular, and one which merely dispensed bags. That his enthusiasm for the machine did not waiver, while all about him were losing theirs, indicates a lack of circumspection and sophistication which is inconsistent with effective activity as a securities salesman. His views on the suitability of speculative issues for persons with little income represented extreme departures from the traditionally more conservative concepts and, more importantly, seemed predicated on the naive view that during the bull market of 1961 it was inconceivable that purchase of a new issue could result in a loss.

73. Bates, on the other hand, appeared to understand his responsibilities as a securities salesman, albeit he did not adequately control his representations on Autrol and did not adequately advise his customers of the risks involved. Despite these aberrations, the Examiner recommends that if Bates seeks to engage in the securities business at a future date, the Commission should, in its sound discretion and upon a proper showing by Bates, give serious consideration to permitting re-entry into the business and re-employment. 22/

Respectfully submitted,

Sidney Ullman
Hearing Examiner

Washington, D. C.
November 30, 1964

22/ To the extent that the proposed findings and conclusions submitted to the Hearing Examiner are in accord with the views set forth herein they are accepted, and to the extent that they are inconsistent therewith they are expressly rejected.