ADMINISTRATIVE PROCEEDING
FILE NO. 3-6196

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of :

RUSSELL G. DAVY :

:

INITIAL DECISION

January 25, 1984
Washington, D.C.

Irving Schiller
Administrative Law Judge

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APPEARANCES: Thomas O. Gorman, Laura R. Singer and James G. Mann for the Office of the Chief Accountant.

Stuart D. Perlman for the Respondent Russell G. Davy.

BEFORE: Irving Schiller, Administrative Law Judge

These proceedings were instituted by an order of the Securities and Exchange Commission dated November 30, 1982 (Order), pursuant to Rule 2(e) of its Rules of Practice, 17 CFR 201.2(e), to determine (1) whether Russell G. Davy (hereinafter referred to as Davy or respondent), a certified public accountant, licensed to practice in California, engaged in improper professional conduct and has willfully violated specified antifraud provisions of the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act) and (2) whether respondent should be temporarily or permanently disqualified from and denied the privilege of appearing or practicing before the Commission.

The Order, in essence, alleges that respondent appears and practices before the Commission, that he engaged in improper professional conduct, and that he willfully violated and willfully aided and abetted violations of the antifraud provisions of the securities acts [1/] in connection with his certification of certain financial statements of SNG & Oil Energy Co. (SNG) for the fiscal years ending August 31, 1977, 1978 and 1979. The Order states that the financial statements were included in a Form 10 registration statement [2/]

1/ Section 17(a) of the Securities Act, 15 U.S.C. 17q(a) and Section 10(b) of the Exchange Act, 15 U.S.C. 78j(b) and Rule 10b-5 promulgated thereunder, 17 CFR 204.10b-5.

2/ The financial statements comprised balance sheets (Statements of Conditions), Statements of Income (loss), Statements of Changes in the Stockholders' Equity, Statements of Sources of Application of Funds (cash) and notes to such financial statements.

which SNG filed with the Commission on December 3, 1980 to register its common stock pursuant to Section 12(g) of the Exchange Act. The registration statement also included a report dated October 26, 1979, signed by Davy, as a certified public accountant (hereinafter referred to as Davy's report or report), that stated that he had examined such financial statements, that his examination was made in accordance with generally accepted auditing standards (GAAS) and accordingly included such tests of the accounting records and such other auditing procedures as he considered necessary in the circumstances. Davy's report contained an unqualified opinion that such financial statements presented fairly the financial position of SNG and the results of its operations in conformity with generally accepted accounting principles (GAAP) applied on a consistent basis.

The Order further alleges that Davy did not, in fact, present fairly the financial position of SNG and results of its operations and his unqualified opinion was not in conformity with GAAP. The Order recites the following instances in which the financial statements departed from GAAP: (1) SNG's balance sheet as of August 31, 1979, included as assets of SNG, real estate, gas, oil and mineral rights, and reflected paid-in capital arising from a purported contribution by a shareholder when, in fact, no such contribution was made and such assets were

not assets of SNG as of August 31, 1979; (2) in SNG's income statements for the fiscal years ended August 31, 1978, and 1979, sales income and cost of sales were materially overstated because of the inclusion in sales of the proceeds from sales of money market investments and the inclusion in cost of sales of the purchase price of such investments; (3) that in SNG's Statement of Source and Application of Funds for the year ended August 31, 1978 a line item was designated "purchase of inventory" which, in fact, represented funds used for the purchase of investments, and (4) that some of the notes to the financial statements were materially misleading in certain specified respects. The Order also specified five instances in which the audit of SNG's financial statements was not conducted in accordance with GAAS.

After appropriate notice, evidentiary hearings were held in San Francisco, Calfornia.[3/] Proposed findings of

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3/ Prior to the evidentiary hearings, Davy filed a motion to dismiss these proceedings for lack of jurisdiction of the Commission which the Commission denied. Following a prehearing conference, Davy filed a motion to disqualify the undersigned which he denied. Upon review the Commission affirmed the order denying the motion to disqualify.

facts, conclusions of law and supporting briefs were filed by the Office of the Chief Accountant (OCA) and by Davy. At the request of Davy, oral argument was held in Chicago, Illinois.

The findings and conclusions herein are based upon the record and upon observation of the witnesses. Preponderance of the evidence is the standard of proof applied.

The Respondent

Respondent Davy is, and at all times pertinent herein, was a certified public accountant licensed to practice in the State of California. Respondent has been a CPA for approximately 40 years. For the past twenty years he taught accounting courses at Golden State University in California, and at San Francisco State University. He is a member of the American Institute of Certified Public Accountants (AICPA). His accounting practice consisted primarily of the preparation of tax returns for individuals and the preparation of various financial statements for certain privately held real estate companies, and for certain companies he was introduced to by Ian T. Allison (Allison). Allison was one of Davy's former students. One of the companies which Allison requested Davy to audit was SNG.

The record establishes that an unqualified audit report was issued by Davy with respect to the financial statements of SNG for the fiscal years ending August 31, 1977, 1978

and 1979, and that it was included in the registration statement filed by SNG under Section 12(g) of the Exchange Act. In light of the charges in the Order that the financial statements were not in conformity with GAAP, and the audit was not conducted in accordance with GAAS, it is deemed essential to review the events leading to the audit and circumstances surrounding the issuance of the report in order to determine whether the manner in which Davy conducted his audit of SNG was in accord with GAAS, and whether the financial statements and accompanying notes were in accord with GAAP.

Genesis of SNG and Events Preceding Davy's Audit of the Company

SNG was incorporated in 1976 in Delaware. During all relevant periods herein its principal offices were located at 849 Delaware Avenue, Buffalo, New York. It had authorized capital stock of one million shares, each with a par value of ten cents. In the latter part of 1978 the company amended its articles of incorporation to authorize 3,000,000 shares of its capital stock each with a par value of four cents. In April 1979 the articles were again amended to authorize 10 million shares of capital stock. From its inception to May 1983 (the date of the hearings), the company engaged in virtually no business activities. The record discloses that as of the end of fiscal 1977 the company had $990 in cash and total assets of $25,000,

consisting primarily of notes receivable. In fiscal 1978 an additional $100,000 in marketable securities was put into the company. SNG had no operating revenue.

In July 1979 Allison placed an advertisement in the Wall Street Journal offering to sell 80% of the voting stock in a shell corporation which could be "12(g)" and "for NASDAQ listing". 4/ Richard I. Johnson (Johnson), an attorney in Buffalo, New York, expressed an interest in the offer and requested additional information. By letter dated August 3, 1979 Allison informed Johnson that his management group would arrange the sale of 2,000,000 shares (80%) of the issued securities of a corporate shell named Olympic Gas & Oil, Inc. (Olympic) for $135,000 cash, subject to the contribution of additional assets to bring the total assets in excess of $1,000,000 "with a resultant net stockholders' equity in excess of $500,000." The sellers would also furnish audited financial statements that would be sufficient to meet SEC requirements, arrange for registration with the Commission on Form 10 under Section 12(g), pay SEC filing fees, furnish a transfer agent and, among other things, qualify with the National Daily Quotation Service for "pink sheet" quotations, as well as establishing at least two market makers to trade the shares.

4/ The reference in the ad obviously relates to registering the stock with the Commission, pursuant to Section 12(g) of the Exchange Act.

By letter dated August 9, 1979, Johnson advised Allison they proposed to place into the shell a parcel of real estate known as "The Meadows" owned by Lockport Meadows, Inc. (Lockport). Before the deal could be consummated, Allison sold the Olympic shell. In a letter dated August 31, 1979, Allison so informed Johnson and stated that if Johnson was still interested, Allison had another shell company [5/] similar to Olympic, which could be sold to Johnson on the same terms previously outlined regarding Olympic.

The record thus amply supports the finding that as of August 31, 1979 no agreement had been reached between Allison and Johnson relating to SNG and no commitment had been made by Lockport to convey any properties, rights, or assets to SNG or any other entity. Johnson testified that as of that date he had not even heard the name of SNG.

On September 12, 1979 Johnson advised Allison he was still interested and again offered "to place The Meadows into the shell." He also suggested that his "accountants would be Peat, Marwick & Mitchell". After receiving that letter, Allison telephoned Johnson and told him it would be better to use his (Allison's) accountant, that it would be less expensive and he was familiar with everything, and "would do whatever was required." Subsequently, Allison

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5/ This other shell company was not identified. However some time between September 25, and October 24, 1979 the company was identified as SNG.

informed Johnson that Davy would be the accountant.

On September 25, 1979 Johnson mailed certain documents to Allison relating to The Meadows which he intended to place in the shell. These included a copy of the title insurance policy, showing that title to The Meadows was in the name of Lockport, and a copy of a deed to a Morgan Hollow property owned by Alpha Svenska Ltd. (Alpha), which also owned the oil, gas and mineral rights on the property. Another property of 150 acres was owned by a company called Fox Ridge Estates, Ltd. (Fox Ridge). Fox Ridge also owned the mineral rights of the acreage. Alpha and Fox Ridge were owned by Phyllis Johnson who was Johnson's wife. Thus the record establishes that on September 25, 1979, SNG did not own either The Meadows or the oil, gas and mineral rights. As of that date Lockport held title to The Meadows and the mineral rights and the property was owned by Alpha and Fox Ridge.

Thereafter, Allison sent two contracts to Johnson to be signed by Lockport. On October 24, 1979 Johnson returned the agreements, signed by his wife on behalf of Lockport, and requested a copy be furnished to him after they were executed. One of the contracts between Lockport and SNG (Johnson Agreement) proposed a capital contribution to SNG of $985,000, and provided that Lockport would convey title of The Meadows to SNG, with a stipulated value of $1.2 million, together with the mineral rights, with a

stipulated value of $110,000.[6/] The other contract sent by Johnson to Allison was between Lockport and Donald L. Reachert & Associates (Reachert Agreement), and provided that Lockport would pay Reachert & Associates $150,000 cash in return for 80% of the issued shares of SNG.

The significance of these agreements, in light of the charges that Davy's audit failed to conform to GAAS is twofold. First, although the evidence discloses that both agreements were signed first on October 24, 1979 when only Lockport signed them, and finally executed some time between November 20th and November 30, 1979, when they were signed by the other parties. The record establishes that the agreements were back-dated to give the appearance that they were consummated prior to August 31, 1979, the end of SNG's fiscal year. Thus, the documentary evidence discloses that the Reachert Agreement was dated August 15, 1979, and the Johnson Agreement was dated August 31, 1979. Second, both agreements explicitly state that if the closing did not occur at the Crocker National Bank by a fixed date[7/] (August 24, 1979 for the Johnson Agreement and August 31, 1979 for the

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6/ The terms of the agreement were as follows: The total price of the properties (The Meadows and the mineral rights) to be transferred by Lockport was $1,310,000; SNG would assume a mortgage on The Meadows of $175,000, and SNG would pay Lockport $150,000 in cash. (This would result in the $985,000 capital contribution.)

7/ The agreements also stated that the closing was to be no later than 3:00 P.M. on the fixed date.

Reachert Agreement), each would be null and void. Johnson testified that neither of the contracts closed on the dates specified in each of the agreements. It is concluded that as of August 31, 1979, SNG fiscal year end, SNG did not own The Meadows or the mineral rights.

Davy's Audit of SNG for the Fiscal Years Ended 1977 and 1978 - Information and Documents Furnished - Manner in Which Audit Was Performed

The record reveals that Davy's introduction to SNG started in the middle of December 1978 when Allison came to Davy's office with a box containing the records of SNG, which Davy described as consisting of 8" by 12" index cards that constituted the general ledgers, cash journals and other records, and asked Davy to audit the financial statements and accompanying notes that Allison had already prepared in printed form, for the fiscal years ending August 31, 1977 and 1978. Davy testified that it was evident from the documents he was furnished, that SNG had nothing more than an automobile (carried at $3,700), and bankers acceptances of $100,000. Davy further testified that although he conducted his audit in January 1979, he signed the "Accountant's Report" that had been back-dated to December 11, 1978. He also testified that Allison had previously prepared and furnished the report to him for signature. The report

states, in substance, that Davy's examination was made in accordance with GAAS, and the financial statements were in conformity with GAAP.[8/] On or about January 15, 1979 Allison picked up the Davy report and took back his box of documents. Davy never saw or spoke to Allison again until sometime in September 1979. Thus, the record supports the finding that, with respect to the audit of SNG for the fiscal years 1977 and 1978, Davy did precisely what Allison asked him to do, namely, to audit the SNG financial statements and sign the accountant's report, all of which had been previously prepared by Allison. Other than checking that the figures on the index cards were accurately reflected on the financial statements furnished him, Davy made no independent review of such financial statements and asked no questions of Allison or anyone else concerning the statements or the accompanying notes.[9/]

8/ Davy testified it took him 14 hours over a five-day period to do what he described as a "simple" and "very easy" audit and described his work as adding up some columns of figures on the index cards and comparing the totals with the figures on the financial statements which Allison had prepared and furnished to him.

9/ The manner in which this report failed to conform to GAAS and GAAP will be discussed infra along with the discussion relating to the SNG report for the fiscal year ended 1979.

Davy's Audit of SNG for the Fiscal Year Ending August 31, 1979 - Information and Documents Furnished - Manner in Which Audit Was Performed

To thoroughly appreciate the manner in which Davy performed his audit of SNG for fiscal year 1979, consideration will be given first to the documents furnished him and the knowledge he acquired about SNG prior to October 26, 1979, the date he signed his accountant's report certifying his audit was made in accordance with GAAS, and the financial statements were in conformity with GAAP. Consideration will next be given to the documents he received after he signed his report, and the knowledge he acquired concerning his audit and the financial statements and accompanying notes of SNG. Consideration will then be given to Davy's audit in light of the GAAS and GAAP requirements.

Conduct of Audit Prior to October 26, 1979

In September 1979 Allison appeared in Davy's office with the same box of general ledger cards which he brought with him in December 1978 and asked Davy to again audit SNG. Davy testified the box contained financial statements and notes prepared by Allison similar to those he gave Davy in December 1978. Those statements marked "rough draft only" were similar to the statements he had prepared previously for the prior two fiscal years. They depicted very little change in business and did not have any reference to The Meadows or the mineral rights.

In addition the box also contained an unsigned "agreement" and a handwritten note which stated:

"Coming

(1) MAI appraisal
(2) Gas & oil evaluation letter
(3) Amendment/s article's ~~100%~~ for
~~stock dividends~~
10,000,000 . . . .?" */

*/ (The lines drawn thru the figures and words in item 3 are as appears in the note. The last word after the figure 10,000,000 is not legible).

Davy testified that the only statement Allison made when he delivered the box was that there "may be a few more journal entries." Davy asked him no questions concerning the entries that were to come, nor did he read the "agreement", or ask any questions about it. When asked by his counsel whether he made any inquiry of Allison at the time he was given the documents as to what was happening, Davy testified: "That's his business, I did not ask anything further". The unsigned "agreement" Davy was given was the Johnson agreement (referred to earlier) between SNG and Lockport. Davy wrote at the top of the agreement that it had not been signed. Davy testified that after Allison left he read the agreement and knew that it provided that if the deal did not close by August 24, 1979, the agreement would be irrevocably void. Davy further testified after reading that provision he made no attempt to ascertain whether the closing took place as specified.

Davy testified that in late September 1979, Allison returned to his office with a new set of financial statements and the accompanying notes he had prepared for fiscal 1977, 1978 and 1979. He also gave Davy two new journal entries, at which point Davy asked him whether the deal had gone through. Davy testified:

> "As I say. . . I don't know definitely whether he said yes, it has, just reflect these. I don't know just what. But he did not say, no, they haven't . . . . I accepted it. That's it."

What he accepted was the journal entries, given to him by Allison, reflecting that SNG owned The Meadows as of August 31, 1979. The record demonstrates, and indeed Davy testified, that he made no independent attempt to find out either from the Crocker Bank or Johnson whether the properties had in fact been transferred to SNG on August 24, 1979 as specified in the agreement.

Davy commenced his audit in the latter part of September 1979. According to his work papers he performed his audit in the following manner, he: (1) compared the general ledger card balances to SNG's total balances; (2) added work sheet columns; (3) checked trial balance totals to the typed financial statements given him by Allison; (4) added check stub totals and cash disbursements and on September 24, 1979, "sent request to bank for confirmation"; (5) on the same date "sent request to confirm the marketable securities", (6) checked Federal tax liability, and (7) for the income statement furnished him, checked general ledger card for sales and cost of sales.

Davy's Conduct After October 26, 1979 and Prior to November 30, 1979

The record discloses that on October 26, 1979 Johnson mailed an appraisal of The Meadows to Allison. Davy testified that in October 1979, (he was unable to recall the exact date) he received the appraisal from Allison through the mail. The appraisal stated an inspection and appraisal was made of the property on October 24, 1979, and that the "property owner" was listed as Lockport in whose name the title to the property had been recorded. Despite his knowledge that the agreement in his possession required the property to be transferred to SNG no later than August 24, 1979, or the agreement would be null and void, Davy merely put the appraisal among his work papers and did nothing further. Davy's implausible explanation for his action was, he ". . . figured that Mr. Allison had already arranged or was arranging for the legal transfer of title with the people in Buffalo, New York, and that's the faith I had." In light of the fact that Davy knew from reading the appraisal in his possession that on October 24, 1979 the record owner of the property was Lockport, his assumptions and "faith" were wholly insufficient to form a basis upon which to certify on October 26, 1979 that SNG owned The Meadows as of August 31, 1979.

In addition, on October 19, 1979 Allison requested

the Marine Midland Bank in Buffalo, New York to confirm the balance due the bank by Lockport on a mortgage loan secured by a lien on The Meadows, located in Lockport, New York. The letter requested that the confirmation be sent to Davy. On November 9, 1979 the bank confirmed to Davy by letter that on October 31, 1979 Lockport owed the bank $175,000 on the mortgage, and it expected to be paid the entire amount from the proceeds of the sale of the property or through other arrangements to be made by Johnson. Payment was to be made by December 31, 1979.

Davy also received a letter dated November 7, 1979 which was signed by Charles J. Cazeau,[10/] for CPF Associates, addressed to Alpha Svenska, Ltd. appraising the mineral rights at approximately $100 per acre. After receiving the foregoing letters, Davy merely put them in his work papers and did nothing.

All of the foregoing demonstrates that Davy possessed sufficient material, including the appraisal of The Meadows, the confirmation letter from the bank informing him that Lockport owed the bank $175,000, which it expected to be paid when the property was sold and the letter appraising the mineral rights that had been sent

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10/ Ceazeau was President of SNG at the time and was also an appraiser. He gave the appraisal to Johnson who mailed it to Allison who sent it to Davy.

by the appraiser to the then owner of such rights, to put him on notice that a searching inquiry was obligatory since on October 26, 1979 he had certified that SNG owned The Meadows and the mineral rights as of August 31, 1979. To read all of these documents and do nothing but place them in a file, manifests an utter disregard of meaningful red-flag warnings which should have prompted Davy, at the very least, to make further inquiry.

Davy's Conduct Between December, 1979 and February, 1980.

The most significant event illustrating Davy's complaisant attitude toward Allison and his failure, or inability, to comprehend the impact that certification of financial statements may have upon shareholders and others is demonstrated by Davy's testimony that Allision delivered a copy of a due diligence file of SNG to him in January or February 1980. According to Davy's testimony, Allison showed up at his office, handed him a file entitled "SNG Due Diligence File," dated November 30, 1979, and told him "your statements are in here." Davy testified in the January-February period he "was very busy" with his tax work so he merely thumbed through the file Allison gave him without reading it, looked at his financial statements which seemed to be those he had certified, and "stuck it on a shelf." Davy admitted he did not think the due diligence file was important and testified that "No one ever told me

it was important" and "Nobody ever said you had to read it."

The importance of the due diligence file, that Davy failed to comprehend, was that it contained the Form 10 registration statement filed by SNG with the Commission on December 3, 1980, pursuant to Section 12(g) of the Exchange Act, which included the financial statements of SNG certified by him. The record reveals that page one of the due diligence file disclosed that SNG's common stock had been registered for trading with the National Quotation Bureau (publisher of the pink sheets), and that SNG was an issuer of securities covered by Section 12(g) of the Exchange Act. Page 4 of the file entitled "Disclosure Statement Pursuant to Rule 15c2-11" Securities Exchange Act of 1934", sets forth in items 8 and 9 that Form 10 Registration Statement is filed with the Commission. Page 7 is the facing page of Form 10 reflecting that SNG's common stock, $.04 par value is registered with the Commission pursuant to Section 12(g) of the Act.

Davy's claim that he did not know that his certified report would be used for a public offering is without merit and is rejected. The evidence shows that Davy audited and issued certified reports, on the financial statements of Lumbermans Acceptance Company (Lumbermans), for six fiscal years starting in 1975, and WCS-International (WCS) for four fiscal years from 1975, both of which are public

companies registered under Section 12(g) of the Exchange Act. Davy obtained retainers to audit the foregoing financial statements of both of these companies from Allison.

Thus the undisputed fact that Davy glanced at or thumbed through the SNG due diligence file, plus his past experience of issuing certified financial statements for two of Allison's companies that had registered securities with the Commission over a period of five years, are deemed to be sufficient to have alerted him and made him aware that the financial statements he certified for SNG would to be utilized in connection with purchases and sales of the company's securities.

The Audit in Light of the GAAS

As noted earlier Davy's report for the fiscal years ended 1977, 1978 and 1979 included as part of the Form 10 registration statement filed by SNG with the Commission, stated that his examination of the financial statements of the company was made in accordance with GAAS.[11] Expert testimony delineating the pertinent standards applicable to the conduct of an audit by an independent certified public accountant was furnished by Mr. Glen Perry (Perry), a certified public accountant, and presently Chief Accountant

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11/ The American Institute of Certified Public Accountants (AICPA) has promulgated a Code of Professional Ethics. Rule 202 of the Ethics Code requires that a CPA adhere to the GAAS promulgated by the AICPA. The GAAS constitutes the standards governing a CPA's performance of an audit.

of the Division of Enforcement. 12/ Prior to testifying Perry reviewed all of the documents, information and related material furnished to Davy which formed the basis upon which Davy issued his October 26, 1979 report. Perry also reviewed the documents Davy received in November 1979, and January or February 1980 13/ which impacted upon his report.

Perry testified that the function of an auditor essentially is to act as an independent expert and conduct appropriate tests in order to obtain sufficient competent evential material to issue an opinion with respect to the financial statements. These testing procedures are governed by GAAS and the interpretation of these standards. At the conclusion of the audit process the auditor issues a report or opinion as to

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12/ Perry's extensive accounting background amply establishes his competence as an expert witness. He became a CPA in 1971 and is licensed in five states. In 1969 Perry was employed by Peat, Marwick, Mitchell & Co. as a staff accountant, and became a partner in 1975. In 1979 Perry became an audit partner and an SEC reviewing partner responsible for reviewing filings made by public companies with the Commission. He is the author of a number of articles published in professional accounting periodicals. Perry is a member of the AICPA and served on their Ethics Committee.

13/ The documents Perry reviewed included the SNG financial statements audited by Davy for the fiscal years 1978 and 1979, and the accompanying notes (no review was made for fiscal year 1977); Davy's work papers for the two fiscal years, Davy's unqualified opinion, the SNG due diligence file given to Davy, the contracts furnished to Davy by Allison, the appraisal dated October 24, 1979 received by Davy, Davy's and Johnson's investigative testimony, and Johnson's testimony at the hearing.

whether the audit was conducted in accordance with GAAS.[14/]
Perry testifid that Davy's audit of the SNG's financial statements for fiscal 1978 and 1979 had not been performed in accordance with GAAS.

When an audit is made of financial statements which reflect an acquisition of real estate the auditor is required to determine whether the entity owns the property and that the costs are properly reflected. This requires an examination of the deed, the title policy, closing documents and contracts to ascertain that the acquisition has been completed. The record reflects that the only document Davy examined prior to issuing his report was the unsigned Johnson contract and the journal entries prepared by Allison. The contract stated the transaction will close on August 24, 1979, when the "seller will deliver the deed, bill of sale and forms necessary to convey good title to subject assets." None of these documents were furnished to or examined by Davy. Perry also testified that the journal entries Davy received, entitled "SNG & Oil Energy Company for the month of August 31, 1979", that were used to record the purchase of the real estate, gas, oil, and mineral rights and the related obligations, and additional paid-in

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14/ The report or opinion is also required to state whether the financial statements comply with GAAP. Consideration of the GAAP requirements will be considered *infra*.

capital as of August 31, 1979, were nothing more than management's unverified oral representations which did not constitute a sufficient basis upon which to issue an opinion under the requirements of GAAS.

In addition, Perry explained that a related party transaction, as defined under the Auditing Standards [15/] of GAAS, requires an auditor, such as Davy to perform more stringent audit tests on a transaction that involves a related party. In this case the contribution from the majority shareholder, Johnson, constituted a related party transaction. GAAS required Davy to obtain a management representation letter, at the completion of the field work, which should include, among other things, that the financial statements were in accord with GAAP, that the company has title to all the assets, and that all related party transactions have been disclosed. Davy's work papers did not contain any such letter.

In a comparable manner the audit procedures used by Davy to compute the sales and cost of sales also failed to conform to GAAS. The SNG income statement for fiscal year 1979 audited by Davy reflected sales income of $1,010,789 less cost of sales $978,264. [16/] Substantially

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15/ Auditing Standards are issued by the Auditing Standards Board of AICPA. The reference referred to hereunder by Perry are the pertinent provisions of Sections 335.02 and 335.09. (CCH Professional Standard's Compilation)

16/ For fiscal year 1978 the income statement reflected cost of goods sold $89,725 and cost of sales $81,838.

all of these figures represented the purchase and sale of securities. Under the principles of GAAP it was improper for SNG to reflect securities transactions as a convential purchase and sale of goods. According to the GAAP securities transactions are reported after revenues and operating costs as other income or expenses. Gain or loss of such assets should be reported net. Davy testified he first "took the matter up with Allison" when he conducted the audit for the fiscal years 1977 and 1978 and Allison told him "the only asset the company made any money with" were the securities and he said "oh, let it stand." Which is what Davy did. With respect to the audit for fiscal 1979 he again talked to Allison who said the company was not really doing anything except for investing in securities and it was "the same thing as last year." Davy testified "for the sake of consistency, I let it go."

In addition, Perry testified that the notes to the financial statements for fiscal 1978 and 1979 as audited and certified by Davy, also failed to conform to the GAAS. Note "A" for both fiscal years under "Accounting Principles" states, "Inventories are neither maintained nor carried over because of the present operating nature of the Company." The note obviously conveys the impression that the company has inventories when, in fact, it had no inventory nor did it have any operations as of August 31, 1979. Note "A" further states, "Exploration: Expenditures for exploration

are expensed as incurred". Davy testified that although no one on behalf of SNG told him they were seeking out properties for exploration, it was just an assumption on his part, based upon the name of the company, rather than a fact. He felt it would do no harm, and he relied on Allison who prepared the notes which were given to him. Such conduct manifests Davy's willingness to do what Allison asked of him, rather than conduct an independent audit.

It has been noted earlier that subsequent to issuing his report, dated October 26, 1979, Davy admitted he received three documents indicating his report was incorrect. These included a copy of an appraisal on The Meadows which stated, that as of August 31, 1979 the property was owned by Lockport, a letter concerning the value of the mineral rights addressed to the then owner of such rights, and a letter from the Midland Bank indicating that after the balance sheet date, Lockport was still obligated on the mortgage which encumbered The Meadows. Perry testified that the GAAS requires an auditor, who subsequent to the date of his report becomes aware of facts which impacts on the financial statements, is required to advise his client that he (the client) must inform persons who may be relying or are likely to rely on the report, that the report should not be relied upon. If the client refuses, the auditor is required to notify such persons, and, in cases where the company is regulated by a governmental agency, that agency

should be notified by the auditor.[17/] The record clearly reflects that Davy failed to follow any of the foregoing GAAS procedures.

All of Perry's testimony with respect to his review of the documents and information furnished to Davy prior to Davy's issuance of his report on October 26, 1979, and the documents received by Davy subsequent thereto, which testimony furnished the nexus of the opinions he expressed concerning the GAAS, was not controverted by respondent and is accepted. The opinions Perry expressed regarding the improper manner in which Davy conducted his audit, and Perry's opinions that Davy failed to comport with the requirements of the GAAS, are found to be supported by the record and are accepted.

<u>The Audit in Light of the GAAP</u>

Davy's report for SNG's fiscal years 1977, 1978 and 1979 states, that in Davy's opinion the balance sheets and statement of income, source and application of funds and changes in stockholders' equity present fairly the financial position of SNG and the results of its operations, in conformity with GAAP applied on a consistent basis. As noted earlier herein, Perry examined the foregoing financial and other related material [18/]

17/ The pertinent provisions of the GAAS requirements are embodied in Section 561 of the Statements on Auditing Standards (SAS) (See CCH Professional Standard's Compilation of these standards).

18 See fn. 13, *supra*.

to ascertain whether Davy's audit conformed with GAAP. Perry testified that if the financial statements do not comply with GAAP, or if sufficient competent evidential matter is not obtained, the auditor is required to render a qualified opinion or disclaim an opinion and explain in his report the reasons therefor. Davy does not dispute that the audit report he issued, dated October 26, 1979, is an unqualified accountant's report.

Perry explained that in general the GAAP treat with the manner in which transactions are to be accounted for, how the financial data is to be presented within the financial statements themselves, including the disclosure in footnotes, which are an integral part of the financial statements.

The record reveals that the SNG financial statements were prepared by Allison and given to Davy to conduct his audit. The financial statements, to which the Davy report relates, disclose the following: The SNG "Statement of Conditions" for the fiscal year ended August 31, 1979 reflects that, the company, as of August 31, 1979, owned "real estate" valued at $1,200,000 and "gas, oil and mineral rights" valued valued at $110,000. The income statement as of the same fiscal year end reflects "Sales Income of $1,010,789, Less: Cost of Sales $978,264." The Statement of "Changes in Stockholders' Equity" shows "Contributed Capital 8-31-79 in the amount of $985,000." The "Statement of Source of Application

of Funds (cash)" for fiscal 1979 shows under "Source of Cash," a line item,"Increase in paid-in capital", the same figure of $985,000 noted above under contributed capital. Another line item, "Increase in notes payable" $130,000, and an "Increase in mortgages payable" $175,000. Under "Application of Cash", in the same statement, a line item reflects "Purchase of real estate" $1,200,000, and another line item, "Purchase of oil, gas and mineral rights" $110,000. Finally under the same "Cash" heading a line item states, "Purchase of inventory" $103,675 for the fiscal year ended August 31, 1978.

In addition, Notes A,D,F,G, and H accompanying the financial statement, contain references to the transactions relating to The Meadowns and the mineral rights, including related aspects of the note and mortgage payable, and additional paid-in capital, as though SNG owned the properties as of August 31, 1979. Since the evidence clearly establishes that SNG did not own the real estate or the mineral rights as of that date, the inclusion of such properties in SNG's balance sheet (Statement of Conditions) was improper. Similarly, the Statement of Changes in Stockholders' Equity showing contributed capital, and the Statement of Source of Application of Funds (cash), as noted above, were also improper since SNG did not own the properties, nor was cash contributed to the company as of August 31, 1979. The inclusion of a line item called, "Purchase of Inventory" for

the fiscal year 1978 which Davy concedes related to securities transactions was also improper, since it gives readers the impression the company had goods for resale, when in fact it had none.

Perry testified that all of the foregoing items included in the financial statements and the accompanying notes that reflected that SNG owned real estate and mineral rights as of August 31, 1979 were not presented in accordance with GAAP. Perry explained that under GAAP a company may not reflect ownership of property in its financial statements as of a specified date absent proof it, in fact, had title to, and owned the property on such date. Davy does not dispute that all he had on October 26, 1979 when he signed his report were the journal entries Allison had given him reflecting SNG's ownership of real estate and mineral rights, and an unsigned contract (the Johnson Agreement) he had read, stating that the contract for the acquisition had to close at the bank no later than August 24, 1979, or it would be null and void. Since Davy had no evidence, and made no effort to ascertain whether the deal had been consummated on that date or prior to August 31, 1979, his report that the SNG financial statements were in accord with GAAP was improper. In addition, it was equally improper under GAAP for Davy to do nothing about the financial statements or his report after October 26, 1979, when he received the appraisal and other documents showing

that title to the property was held by Lockport.*/

The table below illustrates the manner in which the financial statements deviated from GAAP. In preparing the table, Perry selected the above noted items as depicted in various financial statements of SNG and compared them in the column labeled "As Adjusted", with what should have been depicted according to GAAP. The $0 figures are intended to reflect that the item, under GAAP, should not have been included in the financial statements as of August 31, 1979.

SNG & OIL ENERGY STATEMENT
OF CONDITION-SELECTED ACCOUNTS
AS OF AUGUST 31, 1979

	AS REPORTED	AS ADJUSTED
Real Estate	$1,200,000	$0
Gas, Oil & Mineral Rights	110,000	0
Total Assets	1,435,805	125,805
Note and Contract Payable	150,000	0
Mortgage Payable	175,000	0
Additional Paid-in Capital	997,768	12,768
Total Stockholders' Equity	1,108,647	123,647
Total Liabilities & Stockholders Equity	1,435,805	125,805

*/ The reasons stated on page 25 supra, for accepting Perry's opinions concerning GAAS are equally applicable hereunder for accepting his opinions relating to GAAP.

When shown the above table at the hearing, Davy testified as follows:

> Q. . . . I am asking you whether . . . you believe his (Perry's) testimony was correct in saying that . . . the real estate should have a zero value, that the gas and oil mineral rights should have a zero value under the generally accepted auditing standards?
>
> A. I do absolutely agree with you.
>
> Q. All right. And you agree with the exhibit completely.
>
> A. Yes.

Davy contends that none of the interested parties ever made any comment or representation about any further activity by the corporation, other than what was set forth in the documents, and that on the basis of his past experience with Allison, he "accepted" the journal entries Allison gave him. The contention is without merit. The function of an auditor is, in essence, to act as an independent expert, to obtain sufficient competent evidential material from either inside the company or outside sources, so that he is in a position to issue an opinion as to whether the financial statements are in accord with GAAP. If no such evidence is obtained, the auditor is required by GAAP to issue a qualified opinion or explain his reasons for disclaiming an opinion. From the meager information Davy had concerning the ownership of property by SNG, he issued an unqualified opinion which, as found above, violated GAAP.

Respondent Practices Before the Commission

The Order alleges that respondent practices before the Commission. Respondent, in his answer and throughout the proceeding, denied the allegation. As a threshold matter, it must be determined whether Davy practices before the Commision. The record shows that Davy, as a certified public accountant, had issued a report on the financial statements of Lumberman's Acceptance Co., a public company for each of the fiscal years ending December 1975, 1976, 1977, 1979, 1980 and 1981, each of which were included in filings with the Commission. Similarly, Davy issued audit reports on the financial statements of WCS for the fiscal years 1975, 1976, 1977, and 1978, that were included in filings made with the Commission. On October 26, 1979, Davy issued his report on the financial statements of SNG which was included in the Form 10 registration statement filed by that company on December 3, 1979 pursuant to Section 12(g) of the Exchange Act. The record supports the finding that Davy, as a certified public accountant, practices before the Commission.

Jurisdiction of the Commission

Davy urges that the Commission lacks jurisdiction over him because he never gave his approval or consent that his report and financial statements be filed with the Commission. Davy also urges that since he believed those financial

statements he prepared were for a private, closely-held company, which were never intended to be made public, the Commission lacks jurisdiction. The arguments have no validity and are rejected. A filing under the Exchange Act does not require the consent of the independent public accountant. 19/ The only requirement under Section 12 of that Act is that a manually signed copy of the accountant's report be included in the Form 10. Davy's belief that the SNG financial statements were not intended to be made public is not supported by the record. There is no evidence in the record that Allison told Davy, at the time he asked him to do the audit for SNG, that his audit was solely for internal use by the company. The record reveals that Davy was aware, at the outset of his audit, that Allison, though he was an accountant, could not put his signature on financial statements because, as Davy testified, Allison's signature "wouldn't be accepted by the bank, or bankers, or by the stockholders to be, present or to be... a CPA's opinion is absolutely necessary. . . ." Of utmost importance is Davy's testimony concerning his perception of his auditing work. He testified:

> "In every case where I make an audit, I had to feel satisfied that I am acting for the consumer, the eventual consumer, and the stockholders, and bankers and any other people who read the financial statements."

19/ See Section 12 of the Exchange Act. In accordance with Section 7 of the Securities Act of 1933, the Commission's regulations require the consent of an expert to be filed in connection with registration statements under that Act. No registration statement was filed by SNG under the Securities Act.

To now claim he believed that the financial statements he was auditing and would certify would somehow be sealed in the SNG's records and would never be seen or read by anyone other than Allison, and possibly one or two persons associated with SNG, defies credulity. In any event, Davy's unjustified belief that the SNG financial statements, would not be filed with the Commission or otherwise made public, does not deprive the Commission of jurisdiction to institute these proceedings.

Alleged Violations of Antifraud Provisions of the Securities Laws

The Order alleges that respondent willfully violated, and willfully aided and abetted violations of the securities laws. Davy denies the charges. He repeats his assertion that he never knew or was aware that the opinion he signed with respect to SNG's financial statements would be used in filing with the Commission, that no one ever indicated any public involvement with SNG or trading in the company's stock, and that under the circumstances, he cannot be held liable for any violation of the securities laws. His arguments are not supported by the record and are rejected.

To determine if Davy violated the securities acts as charged, consideration is given first, whether within the meaning of such acts a fraud was perpetrated upon the investing public, and second whether Davy's conduct was such

that he may be held liable for fraud. False representations or untrue statements of material fact made in connection with the purchase and sale of securities have consistently been held to constitute fraud under the securities acts. [20/] In the instant case the representations and statements which were untrue, were included in the SNG financial statements certified by Davy, and contained in the Form 10 registration statement filed by the company with the Commission. The financial statements stated that as of August 31, 1979, SNG owned specified real estate and mineral rights valued at $1,310,000. Since the record shows that as of that date SNG did not own such assets, the financial statements and the accompanying notes relating to such ownership are found to contain untrue statements of material fact and constitute false representations that the company owned substantial assets. These financial statements are the type of documents that investors rely upon to furnish them with the information upon which to base a decision to purchase or sell a company's securities. S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833, 860 (2d Cir. 1968), cert. denied sub nom.; Coates v. S.E.C., 394 U.S. 976 (1969). [21/] An accountant who issues an opinion

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20/ See, e.g., Aaron v. S.E.C., 446 U.S. 680 (1980).

21/ The filing of the Form 10 to initiate trading of the SNG securities is sufficient alone to meet the requirement that the false representations be made "in connection with" the purchase and sale of securities. S.E.C. v. Savoy Industries, Inc., 582 F.2d 1149, 1171 (D.C. Cir. 1978)

and certifies that financial statements have been reviewed by him, and are in accordance with accounting standards is found to be liable for false representations contained in such statements. Not only was Davy's audit inadequate and violative of GAAS and GAAP, but it was his signed report which made possible the registration of the securities in the first instance, for without it trading could not have commenced in the the over-the-counter market. 22/

Moreover, the record also demonstrates that after Davy completed his audit, he received documents reflecting that as of August 31, 1979, the real estate was owned by Lockport, and the mineral rights owned by two other entities. Instead of immediately correcting his report he merely places the documents in his files because he had faith in Allison. Of utmost significance, as pointed out earlier, is the fact that in January 1980, he is given a copy of the SNG due diligence file, thumbs through it when told by Allison it contains his financial statements, he does nothing but put it on his shelf because he was too preoccupied with his tax matters and did not believe and no one told him the file was important.

Davy's defense throughout the proceeding has been

23/ See Rule 15c-2-11; 17 CFR 240.15c-2-11. The record discloses that the SNG common stock was offered and sold through the Pink Sheets and NASDAQ in the over-the-counter market. Davy's report was distributed to broker-dealers and investors in connection with such offers and sales.

he did not know, and no one ever told him that SNG did not, on August 31, 1979, own the assets listed in the financial statements at the time he issued his report. The record shows that his lack of knowledge was due to the inadequacy of his audit and his failure to comply with the auditing standards in GAAS. Since the financial statements were also not in accord with GAAP, they are deemed to be false. In addition, it is abundantly clear from events which transpired after he completed his audit, as noted, *supra*, that he had a duty to take appropriate action in accordance with GAAS to prevent future reliance on his report by anyone, and to advise SNG to make appropriate disclosure in the statements or issue revised financial statements. Davy also had an equally affirmative duty to make at least an effort to take some action which would have alerted investors of the fact that on August 31, 1979, SNG was nothing more than a corporate shell. His failure to do anything and his claimed lack of knowledge does not absolve him from his duty and responsibilities. Respondent's conduct manifests such a marked indifference to the evidence available to him when he conducted his audit, and to the information furnished him afterwards, and to the consequences of his actions and of his failure to act, that his conduct is found to be reckless with respect to investors who had every right to rely on his unqualified report.

The courts have held that under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Section 17(a)(1) of the Securities Act, proof of scienter is required. Scienter as used in those acts refers to one's knowledge, not to one's purpose. See e.g., Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1979). "Knowledge means awareness of the underlying facts, not the labels that the law places on the facts ... a knowledge of what one is doing and the consequences of those actions suffices." S.E.C. v. Falstaff Brewing Corp., 629 F.2d 62, 77 (D.C. Cir.), cert. denied, sub nom., Kalmanovitz v. S.E.C., 449 U.S. 1012 (1980). In Aaron v. S.E.C., 446 U.S. 680, 690 (1980) the Supreme Court held that proof of scienter is established by "knowing or intentional conduct" (emphasis supplied). The courts have repeatedly emphasized that scienter does not require a purpose, motive or "plan to deceive" under Section 10(b). Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 45 (2d Cir. 1978), cert. denied, 439 U.S. 1039 (1978); Nelson v. Serwold, 576 F.2d 1332 (9th Cir), cert. denied, 439 U.S. 970 (1978). The record in the instant case amply warrants the finding that Davy acted with the necessary scienter. When Davy signed his audit on October 26, 1979, the only evidence he had that SNG owned real estate and mineral rights as of August 31, 1979, were the financial statements given him by Allison and an unsigned contract. He knew then that SNG did not own the properties. Within a week or two after he issued his report, he received documents

showing that the properties were owned by other entities. He then knew the financial statements were improper and false. Finally, in January when he received the due diligence file, he became aware that the SNG securities were registered with the Commission for sale to the public, and was told by Allison, and saw that his false financial statements were included as part of that statement. The sequence of events, establishes that Davy acted with the requisite knowledge, if not the actual intent to defraud. Furthermore, it was earlier concluded that Davy's conduct with respect to his false financial statements in light of all of the information he unquestionably had in January 1980, after receiving the due diligence file, constituted reckless behavior. Recklessness has been held sufficient to satisfy the scienter requirement. See e.g. Mansbach v. Prescott, Ball & Turbeu, 598 F.2d 1017, 1023-1025 (6th Cir. 1979); Edward J. Mawood & Co. v. S.E.C., 591 F.2d 588, 595-597 (10th Cir. 1979). It is concluded that Davy willfully[24/] violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Section 17(a) of the Securities Act.[25/]

24/ Willfullness does not require an intent to violate the law. It is sufficient if the respondent intends to commit the acts which constitute the violation. See Arthur Lipper Corp. v. S.E.C., 547 F.2d 171 (2d Cir. 1976), cert. denied, 434 U.S. 1009; Tager v. S.E.C., 344 F.2d 5, 8 (2d Cir. 1965).

25/ It is noted however, that scienter is not necessary to establish violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act. Aaron v. S.E.C., supra.

Davy urges that the only purported wrongdoing was allegedly that he did nothing when he received the due diligence file, and that "mere inaction" does not create liability on the part of a person who had nothing to do with the sale of securities. Respondent's reliance on Wessel v. Bukler, 437 F.2d 279 (9th Cir. 1971) to suppport his argument is misplaced. The Court in that case pointed out that none of the three financial statements prepared by the accountant was publicly disseminated in any way, there was no evidence that any investors ever saw the statements until after the litigation began, "no one before suit saw them except the officers and directors of RMC and the agencies to which they were directed." The Court further noted "The evidence demonstrated that whoever wrote the prospectus, picked out the figures he found attractive in the balance sheet, discarded those he did not like, and simply made up the rest. The result was fiction, but there was no proof that Jordan (the accountant) created it." The distinction between the Wessel case and this matter is obvious. In the instant case Davy knew that his financial statements and his report were included in the due diligence file disseminated to broker-dealers prior to trading and distributed to investors and that the GAAS imposed a duty upon him to take action to correct them and prevent investors from receiving the false information included in the financial statements. Respondent's

reliance on ITT v. Cornfeld, 619 F.2d 909 (2nd Cir. 1980) is also misplaced. Judge Friendly wrote "Accountants do have a duty to take reasonable steps to correct misstatements they have discovered in previous financial statements on which they know the public is relying." The Court further stated, "Anderson (the accounting firm) has no independent duty to see to the correction of the prospectus other than the financial statement it prepared." (Emphasis supplied) In the instant case, as noted above, Davy had a duty to correct the financial statements to which his report related.

Respondent in his brief quotes from In re Nielson, CCH Fed. Sec. L. Rep. ¶82,446, in which the Commission permanently disqualified an accountant from appearance or practice before it, when it found the accountant had certified a financial statement that he knew to be fraudulent. Apart from the fact that Davy neglects to mention that the quotation is from a dissent, by a former Commissioner, which dealt with the authority of the Commission to promulgate Rule 2(e), the portion [26/] of the dissent he quotes demonstrates the distinction between that case and this one. The quoted portion states, "No document prepared by the respondent in this matter was filed . . . with this agency." Moreover, the quoted portion further specifically states that in a case involving an offering by the use of false financial

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26/ The Commission's authority under Rule 2(e) was affirmed in Touche Ross & Co. v. S.E.C., 609 F.2d 570 (2d Cir. 1979).

statements, the accountant should not be subject to a Rule 2(e) proceeding "except for knowing conduct which results in the certification of false financial statements in a document filed with the Commission." This is precisely what happened in the instant case. Davy's false financial statements were filed with the Commission. Davy's argument under Nielson is without substance and is rejected.

In his brief Davy sets forth a set of financial statements he prepared premised on a "hypothetical merger" between SNG and Lockport in which Lockport is depicted as becoming a subsidiary of SNG on November 30, 1979. These hypothetical financial statements concocted by Davy are not a part of the record, were not even proffered at the hearing, and are contrary to the evidence in the record including Davy's own testimony. Davy's report on the financial statements purport to reflect the ownership of assets as of August 31, 1979, not some hypothetical date such as November 30, 1979. Under the circumstances, no consideration will be given to the hypothetical financial statements contained in respondent's brief.

Alleged Aiding and Abetting

The Order in addition to alleging that Davy willfully violated the antifraud provisions of the securities acts, also alleges that Davy willfully aided and abetted violations of such provisions. The facts detailed above

which formed the basis for the conclusion reached, that Davy willfully violated the aforesaid provisions are also sufficient to establish that Davy willfully aided and abetted violations of the said provisions. Proof of aiding and abetting requires that three elements be established: (1) a violation of the securities acts by a primary violator, (2) a general awareness of the unlawful conduct of the primary violator by the aider and abettor and (3) the aider and abettor rendered substantial assistance to the primary violator. The record establishes that SNG willfully violated the antifraud provisions of the securities acts in connection with the offer and sale of its securities in the over-the-counter market pursuant to a registration statement filed with the Commission on Form 10 that included the Davy report on the company's financial statements. The record further establishes, as found above, that Davy had a general awareness of SNG's unlawful conduct. The facts relating to the manner in which Davy substantially assisted SNG by furnishing the ingredient in the registration statement essential for such statement to become effective, to wit, supplying the certified financial statements that have been detailed earlier herein. It is concluded that Davy willfully aided and abetted violations of the antifraud provisions of the securities acts.

Rule 2(e) Allegations of Improper Professional Conduct

The remaining questions to be resolved are whether, as charged in the Order, Davy engaged in improper professional conduct and, if so, whether it is appropriate to impose a sanction. Rule 2(e) does not set forth any guidelines or criteria for determining what type of conduct would be deemed to be improper for a professional such as an accountant, attorney, engineer or any other occupation that may be classified as professional. 27/ However, in the instant case, there are means by which the propriety of Davy's professional conduct, as a certified public accountant, may be judged. The AICPA has adopted a Code of Professional Ethics which requires certified public accountants to adhere to the applicable generally accepted auditing standards promulgated by the AICPA. Consideration has been given earlier herein to certain pertinent provisions of GAAS and GAAP. It is these standards and principles which set forth the manner in which auditing procedures are to be conducted and the principles to be followed in the preparation of financial statements. Davy has been a certified public

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27/ This is not intended to be critical of the rule. Rather it recognizes the inherent difficulties of drafting a set of guidelines or criteria that would be applicable to the various occupations that may be classified as professional. To determine whether the conduct of a particular professional is improper must necessarily depend on the facts of a particular case and the nature of the conduct being questioned.

accountant for approximately 40 years, and practiced his profession for the past 20 years in California. He has taught accounting in several universities, in New York and California where he taught CPA review courses and in Ankara, Turkey. He is thus chargeable with knowledge of the GAAP and GAAS promulgated by the AICPA. Indeed, Davy's report specifically states his examination was made in accordance with GAAS and his opinion on the financial statements was in conformity with GAAP. The evidence concerning the manner in which Davy conducted his audit, and his failure to comply with GAAS and GAAP are detailed above and need not be repeated hereunder.

The picture which emerges is one of utter indifference, and a flagrant disregard of the professional accounting requirements which Davy certifies he knew. Davy's constant reiteration of the lack of knowledge or awareness of the true facts were due solely to either his ineptitude to properly conduct an audit in accordance with GAAS or GAAP, or his inability to comprehend the appropriate provisions of those requirements. An analysis of his testimony relating to the conversation with Allison, leads to the perception that the manner in which he made his audit, was to do exactly what Allison wanted him to do without exercising the independent judgment required of him because, as he testifed, he had "faith" in Allison. Added to this is the consideration which must be given to Davy's conduct when

he started receiving documents in November 1979 showing on their face that SNG did not own the properties on August 31, 1979, which he had certified it owned as of that date. Even later when he received the due diligence file from Allison, in January 1980, and told it contained his financial statements, he made no effort to ascertain the significance of that document. His testimony that he put it on his shelf because he did not think it was important, and no one told him it was, demonstrates his desire to do only what Allison asked, and no more. A phone call to the AICPA or a visit to the Commission's San Francisco Office, within walking distance of his office, would have alerted him that SNG's securities had been registered for trading in the over-the-counter market. To do nothing but put the file on the shelf, evinces a lack of sensitivity to his obligations as an independent CPA and a willingness to become an amanuensis for Allison. His conduct and his failure to act when action was required, were significant factors in the fraud being perpetrated upon investors, since absent his signed report, the registration statement could not have been filed. Respondent's repetitious testimony "I don't know" or "I was not aware" does not absolve him from the responsibility for his violative conduct.

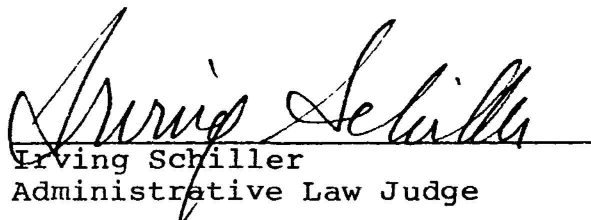
In light of findings that Davy willfully violated and willfully aided and abetted willful violations of the anti-fraud provisions of the securities acts, and the failure of Davy to comply with the GAAS and GAAP under the circumstances

disclosed in this case, it is concluded that it is in the public interest to impose the sanction noted below.

IT IS ORDERED that Russell G. Davy is hereby denied privilege of appearing or practicing before the Commission.

The ORDER shall become effective in accordance with, and subject to Rule 17(f) of the Commission's Rules of Practice, 17 CFR 201.(f).

Pursuant to Rule 17(f), this initial decision shall become the final decision of the Commission as to each party that has not within fifteen (15) days after service of this initial decision upon him, filed a petition for review of this initial decision pursuant to Rule 17(b), unless the Commission pursuant to Rule 17(c), determines on its own initiative to review this initial decision as to him. If a party timely files a petition for review, or the Commission takes action to review as to a party, the initial decision shall not become final with respect to that party. 26/



Irving Schiller
Administrative Law Judge

Washington, D.C.
January 25, 1984

26/ All proposed findings, conclusions and supporting arguments of the parties have been considered. To the extent that the proposed findings and conclusions submitted by the parties are in accordance with the findings, conclusions and views stated herein, they have been accepted, and to the extent they are inconsistent therewith, they have been rejected. Certain proposed findings and conclusions have been omitted as not relevant or as not necessary to a proper determination of the material issues presented. To the extent that the testimony of various witnesses is not in accord with the findings herein, it is not credited.

ADMINISTRATIVE PROCEEEDING
FILE NO. 3-6265

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of :

TRENTON H. PARKER & ASSOCIATES, :
INC.
(8-18218) :
TRENTON H. PARKER & ASSOCIATES
ASSET MANAGEMENT :
CORPORATION
(801-12440) :
TRENTON H. PARKER
:

Filed 1/31/84

INITIAL DECISION

January 31, 1984
Washington, D.C.

Warren E. Blair
Chief Administrative Law Judge

ADMINISTRATIVE PROCEEDING
FILE NO. 3-6265

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of :

TRENTON H. PARKER & ASSOCIATES, :
INC.
(8-18218) :
TRENTON H. PARKER & ASSOCIATES
ASSET MANAGEMENT :
CORPORATION
(801-12440) :
TRENTON H. PARKER
:

INITIAL DECISION

APPEARANCES: Lillian H. Filegar and Edward A. Lewkowski, of the Denver Regional Office of the Commission, for the Division of Enforcement.

Trenton H. Parker, *pro se* and for Trenton H. Parker & Associates, Inc., and Trenton H. Parker & Associates Asset Management Corporation.

BEFORE: Warren E. Blair, Chief Administrative Law Judge.

These public proceedings were instituted by an order of the Commission dated July 6, 1983 ("Order") issued pursuant to Sections 15(b) and 19(h) of the Securities Exchange Act of 1934 ("Exchange Act") and Sections 203(e) and 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") to determine whether Trenton H. Parker & Associates, Inc. ("Associates"), Trenton H. Parker & Associates Asset Management Corporation ("Asset Management"), and Trenton H. Parker ("Parker") had engaged in the misconduct alleged by the Division of Enforcement ("Division"), whether Associates and Parker had been permanently enjoined from violations of the Securities Act of 1933 ("Securities Act"), whether Parker had pleaded guilty to federal income tax violations and mail fraud in the purchase and sale of securities, and what, if any, remedial action would be appropriate in the public interest.

In substance, the Division alleged that Associates and Parker wilfully violated Sections 5(a) and (c) and 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder in the purchase and offer and sale of unregistered securities of The International Mining Exchange, Inc. ("Mining") by fraudulent means, and that Associates, wilfully aided and abetted by Parker, wilfully violated Sections 15(b) and 17(a) of the Exchange Act and Rules 15b3-1 and 17a-5(d) thereunder by failing to file an amended Form BD and required audited financial statements.

The Division also alleged that Associates and Parker had been permanently enjoined on or about May 21, 1981, as amended June 2, 1981, by the United States District Court for the District of Colorado from violations of the Securities Act and Exchange Act in connection with the offer and sale of securities of Mining and that Parker pleaded guilty before the United States District Court for the District of Colorado to federal income tax violations and mail fraud in connection with the offer and sale of Mining securities. Additionally, the Division alleged that Asset Management, wilfully aided and abetted by Parker, had wilfully violated Section 204 of the Advisers Act and Rule 204-1 thereunder by failing to file an amended Form ADV setting forth the current business address of Asset Management and failing to file required annual reports on Form ADV-S.

In an undated letter mailed in an envelope postmarked July 26, 1983 which was deemed a sufficient answer for the purposes of Rule 7 of the Rules of Practice, [1/] Parker advised that he was acting *pro se* in this matter and demanded that the Commission take whatever steps necessary to assure his presence at the hearing. By letter dated August 9, 1983, Parker was advised that the hearing would be held at either the federal prison camp at Safford, Arizona or the

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1/ 17 CFR 201.7.

Metro Correctional Center in Tucson, Arizona, depending upon where he would be incarcerated on October 18, 1983, the date to which the hearing was postponed. In the same letter Parker was advised of his right to be represented by counsel of his own choosing and of other rights he had as a respondent appearing *pro se*. He was further advised that if he had good reason for not appearing on October 18, 1983, he should write stating the reason and requesting a change of date for the hearing.

No request for postponement was received from Parker, but at the hearing on October 18, 1983 held at the Metro Correctional Center, Tucson, Arizona, he complained that the prison facility had denied him his rights to obtain an attorney. Upon consideration of his arguments, the facts relating to that complaint, and his failure to communicate with the Commission before commencement of the hearing, it was concluded that Parker had not been diligent in seeking to obtain counsel and that the hearing should not be delayed.[2]

During the course of the hearing Parker appeared *pro se* and represented Associates and Assets Management. As

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2/ Parker also moved to transfer the hearing to Denver, Colorado, to enable him to obtain evidence he asserted would contradict the Division exhibits. That motion was also denied because of his lack of diligence and the unlikely probative value of the documents he sought to produce.

part of the post-hearing procedures, succesive filings of proposed findings, conclusions and supporting briefs were specified. A timely filing thereof was made by the Division, but respondents did not take advantage of the opportunity to do so.

The findings and conclusions herein are based upon the preponderance of the evidence as determined from the record and upon observation of the witnesses.

RESPONDENTS

Associates, a Delaware corporation with its principal place of business in Colorado, has been registered as a broker-dealer under the Exchange Act since March 5, 1975, and Asset Management, a Colorado corporation located in Colorado, has been registered as an investment adviser under the Advisers Act since December 20, 1976. Parker is president and sole owner of Associates and of Asset Management. During the periods alleged, he also was president and chief executive officer of Mining.

PERMANENT INJUNCTION

As a result of a complaint filed by the Commission, a permanent injunction was entered on May 21, 1981 [3/] by the United States District Court for the District of Colorado enjoining Parker and Mining from conduct in violation of the registration provisions of the Securities Act

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3/ As amended June 2, 1981.

and the antifraud provisions of the Securities Act and Exchange Act in connection with the offers, purchases, and sales of any securities and, in particular, investment contracts based upon gold tax shelter investment programs offered by Mining.[4/] Although Associates was also named as a defendant by the Commission, the Court's order did not enjoin Associates from antifraud violations but directed Associates and Parker to file amendments to Associates' Form BD correcting inaccurate information therein. The Court further ordered Associates to file audited financial statements while registered with the Commission.

It appears from the record that Parker was permanently enjoined from violations of Sections 5(a), 5(c), and 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, but the record does not sustain the Division's allegation that Associates was enjoined from committing such violations. Further, it is concluded from review of the Court's order and the record otherwise that neither Associates nor Parker has been permanently enjoined from engaging in or continuing violations of Sections 15(b) and 17(a) of the Exchange Act and Rules 15b3-1 and 17a-5(d) thereunder within the meaning of Section 15(b)(4) of that Act.

4/ S.E.C. v. International Mining Exchange, Inc., 515 F. Supp. 1062 (D. Col. 1981).

CRIMINAL CONVICTIONS

As evidenced by the Judgement and Probation/Commitment Order [5/] entered March 29, 1982 in the United States District Court for the District of Colorado, [6/] Parker pleaded "Guilty" on March 26, 1982 to mail fraud, [7/] wilfully assisting in the preparation of fraudulent income tax returns, and failure to file income tax returns. [8/] As charged in the indictment, Parker's crimes arose out of the offer and sale of Mining securities in the form of gold mine tax shelters.

Parker was immediately sentenced to serve five years imprisonment on three tax counts. Imposition of sentence was suspended and Parker placed on probation for five years on one count of mail fraud. A special condition of probation requires Parker to make full restitution to defrauded mining investors.

VIOLATIONS

Underlying the permanent injunction and his criminal convictions were Parker's activities, and those of Mining, in offering and selling investment contracts of Mining which were represented to afford gold tax shelters to investors.

5/ Div. Ex. 10

6/ United States v. Trenton H. Parker, 81-CR-122 (D. Col. March 26, 1982).

7/ 18 U.S.C. §§1341, 1343 and 2.

8/ 26 U.S.C. §§7203 and 7206(2).

The same activities are the predicate for the Division's allegations in these proceedings that Associates and Parker violated the antifraud provisions of the securities acts. Details regarding those activities are spelled out in considerable detail in the counts of the indictment on which Parker was convicted and the findings in the injunctive order against Parker and Mining. 9/

Sections 5(a) and (c) of the Securities Act 10/

It appears from the record that commencing on or about September, 1979 and continuing to about May 21, 1981, Parker and Mining offered and sold contracts for a "Gold Tax Shelter Investment Program" ("Gold Tax Shelters") based on placer gold mining concessions located in French

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9/ Parker is collaterally estopped from relitigating issues that were actually litigated and adjudicated in his prior criminal proceeding and he and Associates are estopped from relitigating issues actually litigated and adjudicated in the injunctive action. Parklane Hoisery Co. v. Shore, 439 U.S. 322 (1979); United States v. Podell, 572 F.2d 31, 35 (2d Cir. 1978); S.E.C. v. Dimensional Entertainment, 493 F. Supp. 1270 (S.D.N.Y. 1980); S.E.C. v. Everest Management Corp., 466 F. Supp. 167 (S.D.N.Y. 1979). Relying upon the doctrine of collateral estoppel and documentary evidence, the Division called no witnesses in support of its allegations.

10/ Sections 5(a) and (c) of the Securities Act, 15 U.S.C. §§77e(a) and 77e(c), make unlawful the use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell or offer to sell any security unless a registration statement is in effect as to a security sold, or a registration statement has been filed as to a security being offered for sale.

Guiana, South America, and from about December 20, 1979 until May 21, 1981 offered and sold an identical program based upon unpatented gold mining claims located near Juneau, Alaska. It further appears, as determined in the Parker injunctive action,[11/] that the Gold Tax Shelters constituted "investment contracts" and were therefore "securities" within the meaning of the Securities Act. Inasmuch as no registration statement had been filed or was in effect under the Securities Act with respect to the Gold Tax Shelters offered and sold by Parker, and no exemption from registration was available, it is concluded that in offering and selling those securities Parker wilfully violated Sections 5(a) and (c) of the Securities Act.

A different conclusion is reached with respect to Associates' alleged violation of Section 5 because the record does not sustain the Division's position that Associates participated in the offer and sale of the Gold Tax Shelters. Although named as a defendant in the Commission's injunctive action, it is clear from a reading of the several orders entered therein upon which the Division relies to establish the violations by Associates[12/] that the Court's findings with respect

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11/ S.E.C. v. International Mining Exchange, Inc., supra, at 1070.

12/ Division Exhibits 8, 9, 13, and 14.

to the Section 5 issue were limited to the activities of Parker and Mining. Accordingly, it is concluded that the Division has failed to prove that Associates committed the alleged violations of Section 5 of the Securities Act.

Fraud Violations [13/]

The fraudulent conduct of Parker in offering and selling the Gold Tax Shelters is established by the Court's findings in the injunctive action and in the charges in the indictment on which Parker was convicted. As alleged by the Division, Parker's fraud entailed the making of false statements regarding the applicable tax deduction available in connection with the Gold Tax Shelters and a failure to disclose an intention to convert the proceeds from the sales of those investment contracts to his own use after depositing the proceeds into offshore bank accounts.

In the injunctive action, the Court found "overwhelming evidence of misrepresentation and material omissions of fact on the part of defendants [Parker and Mining] in the marketing and selling of this program [Gold Tax Shelters]." [14/] Findings were also made that

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13/ Sections 17(a) of the Securities Act, 15 U.S.C. §77q(a), and Section 10(b) of the Exchange Act, 15 U.S.C. §78j(b), and Rule 10b-5, 17 CFR 240.10b-5, thereunder.

14/ S.E.C. v. International Mining Exchange, Inc., supra, at 1070.

Parker and Mining represented to investors that a federal income tax deduction equal to 500% of their investment would be realized when, in fact, such a tax deduction would be impermissible and fraudulent because Mining did not incur the developmental expenses required by the rules and regulations of the Internal Revenue Service. Additionally, the Court found that Parker and Mining omitted to inform investors that on March 17, 1980, the Internal Revenue Service issued Revenue Ruling 80-72 which limits an investor to a tax deduction equal to his actual investment, thereby precluding the 500% tax deduction.

The indictment further evidences Parker's misrepresentations regarding an investor's tax deductions by the charges that as part of Parker's fraudulent scheme an investor was falsely told that by following the business procedures outlined in a Mining brochure an investor in the Gold Tax Shelters could realize a tax deduction of four to five times his initial investment in the current year and defer the tax for up to eight years. Another part of Parker's scheme and artifice to defraud was to cause investors' funds to be deposited into offshore bank accounts in Georgetown, Grand Cayman or Zurich, Switzerland and to transfer investors' funds from a bank in the United States into a secret Swiss bank account.

Nothing, however, in either the criminal charges

against Parker or the findings in the injunctive action connects Associates with the fraudulent activities of Parker and Mining. Consequently, the Division's reliance upon that proof to inculpate Associates in the fraud is unwarranted. Accordingly, it is concluded that Parker wilfully violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and that Associates has not been shown to have participated in those violations.

Regulatory Violations

Section 15(b) of the Exchange Act and Rule 15b3-1 thereunder 15/ and Section 17(a) of the Exchange Act and Rule 17a-5(d) thereunder 16/

Rule 15b3-1 requires that a registered broker-dealer file amendments to its application for registration whenever information in the application becomes inaccurate for any reason. Rule 17a-5(d) requires a registered broker-dealer to file audited financial statements annually on a calendar or fiscal year basis.

As found in the injunctive action 17/ and otherwise proved by the Division exhibits, an amendment to Associates' application for registration was not filed as required under

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15/ 15 U.S.C. §78o(b) and 17 CFR 240.15b3-1.

16/ 15 U.S.C. §78q(a) and 17 CFR 240.17a-5(d).

17/ S.E.C. v. International Mining Exchange, Inc., supra, at 1073.

Rule 15b3-1 to disclose that on October 29, 1979 the State of Colorado had revoked Associates' authority to do business in that State because of failure to comply with applicable Colorado laws and regulations. Similarly, the record reflects that Associates failed to file an audited financial statement pursuant to Rule 17a-5(d).

In view of the foregoing, it is concluded that Associates, as alleged by the Division, wilfully violated Sections 15(b) and 17(a) of the Exchange Act and Rules 15b3-1 and 17a5-(d) thereunder and that Parker, who as sole owner of Associates had the responsibility and duty to assure Associates' compliance with those regulatory provisions, wilfully aided and abetted Associates' violations.

Section 204 of the Advisers Act and Rule 204-1 Thereunder 18/

The Division alleges that Asset Management, wilfully aided and abetted by Parker, wilfully violated Section 204 of the Advisers Act and Rule 204-1 thereunder by failing to file an amended Form ADV setting forth the current business address of Asset Management and by failing to file annual reports on Form ADV-S. The Division correctly notes that Rule 204-1 requires every registered investment

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18/ 15 U.S.C. 80b-4 and 17 CFR 275.204-1.

adviser to promptly file an amendment reflecting its current business address whenever the business address of the registrant is changed and that a registered investment adviser is also required under Rule 204-1 to file annual reports with the Commission.

In support of its allegation that Asset Management failed to file annual reports, the Division introduced the attestation of the Commission's Records Officer, an official duly authorized to execute that attestation, that a diligent search of the Commission's records and files on August 1, 1983 had not disclosed that any annual report of Asset Management had been received by the Commission. To the contrary, Parker testified that the Commission in fact had been given certified annual reports up to the time of his incarceration, and asserted that the filing was made in accordance with Judge Kane's order in the injunctive action. It appears, however, that Parker identified broker-dealer filings made on behalf of Associates as those made in compliance with Asset Management's responsibilities under the Advisers Act. Asset Management was not a defendant in the injunctive action and Judge Kane's order was directed to Associates, not to Asset Management. Accordingly, it is concluded that the record supports a finding that annual reports required under Rule 204-1 were not filed by Asset Management.

With respect to the alleged failure of Asset Management to file an amendment setting forth Asset Management's current business address, the Division introduced a further attestation of the Commission's Records Officer that a diligent search of the Commission's records and files did not disclose any amendments as having been received under the name of Asset Management since the date of March 30, 1977. Inasmuch as Parker testified to the effect that there had been amendments filed in 1977, 1978 and 1979, that Asset Management had moved and that the new addresses were included in the amendments, it is clear that the current business address of Asset Management is other than the 777 Pearl Street, Denver, Colorado shown in the amendment filed by Asset Management on March 30, 1977. Because it appears that the amendments referred to by Parker have never been received by the Commission, it must be concluded that Asset Management has failed to comply with Rule 204-1 with respect to reporting its current business address. The fact that Parker's attorneys may, as he testified, have copies of the amendments cannot affect this conclusion in view of the fact that papers required to be filed pursuant to the rules and regulations promulgated under the Advisers Act are "deemed to have been filed with the Securities and Exchange Commission on the date when they are actually received by it." 19/

19/ 17 CFR 275.0-4(a).

Accordingly, it is concluded that Asset Management, wilfully aided and abetted by Parker, its sole owner, wilfully violated Section 204 of the Advisers Act and Rule 204-1 thereunder.

PUBLIC INTEREST

Having found that Asset Management wilfully violated the Advisers Act, that Associates wilfully violated the Exchange Act, and that Parker wilfully violated the Securities Act and Exchange Act, and that he has been permanently enjoined from engaging in certain practices in connection with the offer and sale of securities and has been convicted of felonies, including mail fraud, in connection with the offer and sale of securities, it is necessary to consider the remedial action appropriate in the public interest.

The Division argues that Parker's violations, the permanent injunction, and his convictions are of a nature and extent that a bar against his associating with a broker-dealer or investment adviser is necessary, and that because Associates and Asset Management are under Parker's absolute control, their registrations should be revoked. A careful consideration of the record and of the views of the Division leads to the conlusion that the public interest requires the remedial action proposed by the Division.

The record argues strongly that Parker's activities were motivated by selfish greed without concern for the interests or welfare of the investors who relied upon his representations in placing their money at risk. Additionally, there is nothing in the record that suggests that after his incarceration Parker could be trusted to act in accordance with the high standards expected and required of broker-dealers and investment advisers.[20/] He has abused the trust and the confidence of the investing public and has done so with a callousness that clearly establishes the need to protect investors from his further possible predations by barring him from the securities business.

As to Associates and Asset Management, the wilful violations of the laws and rules regulating their operations are bases for revocation of their registrations. Each is a creature created by Parker to advance his personal interests and each has existed and operated under his absolute control. Under the circumstances, it is concluded that the registrations of these registrants should be revoked.[21]

20/ Cf. Joseph P. D'Angelo, 11 SEC Docket 1263 (1976).

21/ All proposed findings and conclusions submitted have been considered, as have the contentions. To the extent such proposals and contentions are consistent with this initial decision, they are accepted.

ORDER

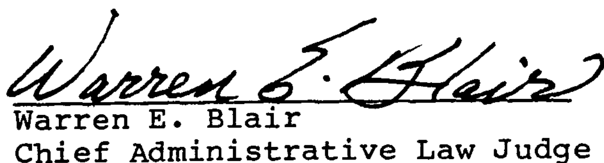
Accordingly, IT IS ORDERED that the registration of Trenton H. Parker and Associates, Inc., as a broker-dealer is revoked;

FURTHER ORDERED that the registration of Trenton H. Parker & Associates Asset Management Corporation as an investment adviser is revoked; and

FURTHER ORDERED that Trenton H. Parker is barred from association with a broker-dealer or an investment adviser.

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

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



Warren E. Blair
Chief Administrative Law Judge

January 31, 1984
Washington, D.C.