ADMINISTRATIVE PROCEEDING
FILE NO. 3-6310

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	:
BOBBY BRUCE	:
CLETUS MARION HODGE	
JOHN KILPATRICK	:
CARLOS ARTURO SMITH, JR.	
ROBERT HARDEE QUARLES	:
WILLIAM EDWARD SHELTON, IV.	
	:
(G. WEEKS & CO., INC.)	
	:
(8-18520)	

INITIAL DECISION

December 20, 1984
Washington, D.C.

Jerome K. Soffer
Administrative Law Judge

ADMINISTRATIVE PROCEEDING
FILE NO. 3-6310

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	
BOBBY BRUCE CLETUS MARION HODGE JOHN KILPATRICK CARLOS ARTURO SMITH, JR. ROBERT HARDEE QUARLES WILLIAM EDWARD SHELTON, IV. (G. WEEKS & CO., INC.) (8-18520)	INITIAL DECISION

APPEARANCES:

Joseph L. Grant and David C. Prince, of the Atlanta Regional Office, for the Division of Enforcement.

James F. Arthur, III, for Cletus Marion Hodge.

Neal S. Comer and Anthony V. Labozzetta (Labozzetta and Hass), for John Kilpatrick.

Steven B. Johnson, for Robert Hardee Quarles.

Bobby Bruce, *pro se*.

William Edward Shelton, IV, *pro se*.

Carlos Arturo Smith, Jr., *pro se*.

BEFORE: Jerome K. Soffer Administrative Law Judge.

On December 9, 1983, the Commission issued an Order for Public Proceedings (Order) pursuant to Section 15(b) and 19(h) of the Securities Exchange Act of 1934 (Exchange Act) naming as respondents G. Weeks & Company, Inc., Gerald Dean Weeks, Cletus Marion Hodge, John Kilpatrick, Patrick Michael, Bobby Bruce, [1/] Randy Neal Vallen, William Edward Shelton, IV, Robert Hardee Quarles and Carlos Arturo Smith, Jr. [2/]

The Order is based upon allegations of the Division of Enforcement (Division) that the respondents willfully violated and willfully aided and abetted violations of the anti-fraud provisions of the securities laws, specifically Sections 17(a)(1), (2) and (3) of the Securities Act of 1933 (Securities Act), and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, in connection with the sale of certain securities designated as "standby with pair-off agreements" for the purchase and sale of government securities; that they further willfully violated and willfully aided and abetted violations of the registration

---

1/ The order incorrectly referred to him as "Robert" Bruce.

2/ As the result of an offer of settlement submitted by Randy Neal Vallen, and accepted by the Commission, the administrative proceedings have been terminated against him and remedial sanctions imposed upon him by an order dated May 29, 1984 (SEA Release No. 20999). Because of the failure of respondents G. Weeks and Company, Inc., Gerald D. Weeks, and Patrick Michael to file an answer or otherwise appear in these proceedings, sanctions were entered against each of them pursuant to Rule 7(e) of the Commission's Rules of Practice [17 C.F.R. 201.7(e)]. SEA Release Numbers 20731, 20792 and 20886. While the decision herein may contain references to these respondents, the findings are binding only upon the remaining respondents.

provisions of Section 5(a) and 5(c) of the Securities Act in the offer and sale of the described "standby with pair-off" securities; and, further, that preliminary injunctions against further violations of the registration provisions were entered against some of the respondents on January 29, 1980 and upon the remainder of the respondents on May 5, 1980 by the United States District Court for the Western District of Tennessee.

The Order directed that a public hearing be held before an administrative law judge to determine the truth of the allegations set forth and what, if any, remedial action is appropriate in the public interest for the protection of investors. Eight days of hearing were held between May 1 and 10, 1984, in Memphis, Tennessee. Respondents Hodge, Kilpatrick and Quarles were represented by counsel. Respondents Bruce, Smith and Shelton appeared without counsel and represented themselves _pro se_.

Following the close of the hearings, successive proposed findings of fact, conclusions of law and supporting briefs were filed by the Division and by respondents Smith, Kilpatrick, Hodge, Quarles and Shelton. None was filed by respondent Bruce. The Division served a reply brief to those of respondents.

The findings and conclusions herein are based upon the evidence as determined from the record and upon observation of the demeanor of the witnesses. The preponderance of evidence standard of proof has been applied. [3/]

3/ See _Steadman v. S.E.C._, 450 U.S. 91 (1981).

The Parties

Respondent G. Weeks & Company, Inc. ("Registrant" or "GWC") had been registered as a broker-dealer with the Commission since January 2, 1976 and was a member of the National Association of Securities Dealers, Inc. On April 23, 1984, its registration was revoked in this proceeding (See footnote 2, above). During the period from at least 1978 to October 26, 1979 ("the relevant period") it had been engaged as a broker and dealer in municipal bonds.

G. Weeks Securities, Inc. (GWS) was a dealer in government securities. 4/ It has been affiliated with registrant GWC by virtue of common ownership and control under Gerald D. Weeks, the president and controlling shareholder of both corporations. During the relevant period they occupied the same offices and were operated by the same personnel. On November 6, 1979 GWS filed a petition under Chapter XI of the Bankrutpcy Act.

Respondent Hodge had been the financial officer of GWC and GWS since December 1973. During the relevant period, he was in charge of the back office of both corporations and responsible for their books, records, and financial reporting.

Respondent Kilpatrick was the vice-president of and the principal trader in government securities for GWS. 5/

4/ Brokers and dealers in U.S. Government securities are exempt from the registration provisions of Section 15 of the Exchange Act. However, GWS was registered in the state of Tennessee for the intrastate sale of such securities.

5/ The Division alleges that Kilpatrick was also vice-president of GWC, which he denies. See discussion hereinafter as to the extent of Kilpatrick's affiliation with resigistrant GWC.

All of the remaining respondents were employed during the relevant period as sales persons for both corporations. They were also designated as vice-presidents of sales, but this seems to have been a title conferred by respondent Gerald Dean Weeks on many of his salesmen as a reward for successful sales efforts but for no other purpose. The sales force numbered between 30 and 40 people. Respondents Smith, Quarles and Bruce do not appear to have had any securities sales experience prior to their employment by GWS. In fact, each was in a different and unrelated line of work. Respondent Shelton, however, may have had some prior experience in investments, the details of which are not clear in this record.

The salesmen sold municipal bonds for GWC and U.S. Government bonds and securities for GWS. They were compensated by the former at the rate of 40% of the profits made on municipal bond transactions and at the rate of 35% of the profits from government bond transactions for GWS.

The Transactions

In or about the Spring of 1978 respondent Kilpatrick had been contacted by a representative of a large broker-dealer in government securities known as Cantor, Fitzgerald Agency Corp. (Cantor) with respect to engaging in "standby with pair-off" transactions in "GNMA" mortgage certificates. Prior to that time, Kilpatrick had never heard of this type of transaction.

The government securities involved consist of mortgage-backed pass-through certificates which are issued by private institutions, primarily mortgage bankers, which evidence an interest in a pool of government-underwritten residential mortgages. The timely payment of principal and interest to the holder of these certificates is guaranteed by the Government National Mortgage Association (GNMA) an agency of the federal government and the certificates are known as GNMAs (or "Ginnie Maes"). They are freely transferable from one investor to another.

The "standby with pair-off" transactions involve a "forward contract" for the purchase and delivery of GNMA certificates at a fixed date in the future (the "settlement date") for a price determined at the time the contract is written ("trade date").

The transactions also concern a forward contract on a standby basis ("standby") in which one party obligates itself to buy GNMA certificates from the seller at a specified date in the future at a specified price. The seller thereof pays a "commitment fee" to the buyer for the latter's firm agreement to "standby" to take future delivery on the settlement date. A feature of the standby contract is that the seller has the option, should the market price on settlement date be greater than the standby price, to decline the sell to the buyer and sell to the market and make an additional profit.

A "pair-off" in trading in government and other types of securities occurs when the settlement date for the sale of a security coincides with the settlement date for the purchase of the same security. The transactions then are "paired-off". In such case, there is usually no physical delivery of the certificates between the parties involved, since this would merely result in additional bookkeeping and shifting of the same paper back and forth. Instead, the difference in the buy price and the sell price is adjusted by cash transfer between the parties. The two transactions need not have the same trade date. So long as they embrace the same security and the same settlement date they may be paired off.

After learning of the details and agreeing with the arrangements with Cantor, Kilpatrick assisted by Hodge conducted a series of meetings with the sales staff of GWS to explain the new investment that was to be sold to GWS customers and how it worked. Specifically, the standby with pair-off transaction involved a simultaneous sale by GWS at a fixed price to the customer of a forward contract of a block of GNMA certificates[6/] paired-off with a standby purchase by GWS from the customer of the same block of GNMAs at a higher price for settlement on the same future

---

6/ Transactions in GNMA certificates are usually in million-dollar units, although half units ($500,000) or quarter units ($250,000) may be sold.

date for which the customer would pay GWS a commitment fee to so stand by.

The spread between the forward price and the higher standby price, as fixed by Kilpatrick in his role as trader, would be sufficent to yield to the customer an amount equal to the commitment fee paid to GWS plus an agreed fixed profit expressed as a rate of return. On settlement date GWS would remit to the customer this difference in price without the execution of any actual payment for or delivery of securities.

At the same time, GWS was to enter on its own into a similar transaction with Cantor for the same securities with the same settlement date and for the payment to Cantor by GWS of a commitment fee to stand by on its end of the bargain.

The commitment fee paid Cantor by GWS was less than the similar fee received by GWS from its customer, the difference representing the profit to GWS on the transaction. Moreover, the commitment fee received from the customer would provide the funds to GWS for the payment to Cantor and to pay the salesman's commission out of the profit of GWS.

In essence, by executing simultaneously a pair-off of both the standby and the forward contracts, there would never be any necessity for the customer either to take delivery and pay the purchase price involved under the forward contract, or to deliver the GNMAs called for under the standby commitment on settlement date, which was usually many months or

several years later. Since the favorable spread between the purchase and sale prices was already fixed, the customer was effectively guaranteed to receive from GWS, the return of the commitment fee plus the profit already fixed in advance. From the standpoint of GWS, so long as it had hedged the transaction with Cantor or some other dealer or customer it would have earned the funds sufficient to fulfill its obligation to its customer and for its own profit. Otherwise, GWS was at risk for the full amount.

Among other things told at these training sessions by Kilpatrick was that there was no risk to the investor since there were GNMA certificates on both sides of the pair-off, although he also stated that the pair-off was not a government-secured investment. Kilpatrick also explained that if at the time of settlement the market price of the government security had moved higher than the price agreed upon in the standby, the customer had the option of taking delivery from GWS under the forward contract but not selling to GWS, under the standby, and, instead, to sell the GNMAs at market at the higher price, thereby making an even greater profit. The salesmen were given to understand that under the standby with pair-off arrangements their customers could not lose and that GWS would issue a guarantee to this effect.

Thereafter, commencing in April 1978 the salesmen proceeded to solicit standby with pair-off transactions from their customers who included credit unions, trust funds and

other institutions as well as individual investors. The representations made by the salesmen in connection therewith will be discussed hereinafter in connection with the allegations of the Division that there were violations of the anti-fraud provisions of the securities laws.

A study by a staff investigator of the Division of GWS records from the time it began offering the standby with pair-offs until November 6, 1979, the date it filed in bankruptcy, shows that it had engaged in some 273 such transactions. Further, 157 of the trades, involving about 68 customers, reflecting some $11,931,000 in commitment fees received, were still open, in that the settlement date had not as yet been reached. 7/ Out of these commitment fees received by GWS transactions involving commitment fees from its own customers totaling $5,138,189 as of the date of bankruptcy do not appear to have been "hedged" with Cantor or with some other dealer or outside party.

As of the date of the hearing, the trustee in bankruptcy for GWS had made distribution to unsecured creditors, including the standby with pair-off customers, of about 28% of their claims. He anticipates that over the next 12 years

---

7/ An audit of the books and records of GWS by an independent auditor retained by the creditors' committee in bankruptcy shows a similar amount of outstanding commitment fees which, when added to the interest or profit due, brought the total liability up to $12,781,673. This included some transactions which had not been paid, even though they were to have settled prior to the bankruptcy.

there would be a further distribution of about 20% so that by 1989 roughly 50% of the claims of unsecured creditors would have been satisfied.

The bankrupt estate has filed suit against Cantor seeking damages in the amount of $15,000,000, based upon allegations that Cantor wrongfully sold out all of GWS positions prior to the bankruptcy and in fact caused the bankruptcy. To the extent that the trustee would be successful in this suit there would be additional distribution available for the unsecured creditors.[8/]

The "Securities" Issues

The Order charges that the standby with pair-off agreements, sold as an entire transaction to members of the public by the respondents, constituted securities, specifically "investment contracts" or "evidences of indebtedness", which were required to be registered pursuant to Section 5 of the Securities Act.

In determining whether any particular situation or interest is a "security", the term is to be broadly construed in order to carry out the remedial purposes embodied in the Federal securities laws, and, in searching for the meaning of that

---

8/ As of the date of bankruptcy, Mr. Gerald Weeks, the president of GWS, owed the company $288,670 advanced to him for personal obligations and expenditures. The audit also shows that under an expense sharing arrangement between GWS and the registrant GWC, GWS had overpaid as its share of expenses the sum of $703,045.

term, form should be disregarded for substance with the emphasis placed upon "economic reality". See SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1953); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963); and Tcherepnin v. Knight 389 U.S. 332, 336 (1967).

Concededly, the transactions involved were never registered. It is also clear that GNMA certificates, guaranteed by an agency of the United States Government, are securities (Section 2(1) of the Act), but exempt from the registration provisions of that Act [Section 3(a)(2)]. It has also been held that a GNMA forward contract (and a standby contract is a type of forward contract) is not a security, although it is a contract to buy or sell a security. See Abrams v. Oppenheimer Government Securities, Inc., (7th Cir.) CCH Fed. Sec., L. Rep. (1984), ¶91,512; and SEC v. G. Weeks Securities, Inc., 678 F.2d 649, 652 (6th Cir. 1982).

Looking at the form the standby with pair-off transaction took, we find that the GWS salesmen would solicit customers whether a credit union, pension fund, or an individual, to invest a sum of money equal to a commitment fee, for a period of time ranging from several months to several years, at the end of which time the customer would be repaid its investment plus an additional fixed amount, usually designated as "interest" or "profit", based upon

a stated rate of return. 9/

Upon the agreement by the customer to enter into the transaction and the payment of the investment ("commitment fee"), GWS would prepare and transmit a group of documents including: a "confirmation" of a sale at a stated price from GWS to the customer of a GNMA certificate described by the principal amount (usually in multiples of $1,000,000) and the coupon rate, and showing the trade date, the settlement date, and usually containing the language "customer may pair-off with standby"; a "confirmation" showing a purchase from the customer by GWS, on a "standby" basis, of the same described certificate at a higher price, the trade date, and the same future settlement date; so-called "GNMA acknowledgements" with respect to each side of the purchase and sale; and a "GNMA confirmation" concerning the purchase by GWS of the certificates and containing the amount of the commitment fee paid by the customer to GWS.

Finally, the package of documents usually (but not always) included a form letter from GWS guaranteeing the future repayment of the investment plus the agreed upon interest or profit. Exhibit 66 in evidence on the letterhead of GWS, is typical of these "guarantee letters". The Exhibit is

---

9/ The amount of the investment, the period of time, and the amount of the return would be determined by respondent Kilpatrick as the government trader. He would have written this information on a blackboard in the trading room for all the salesmen to see. He would also have written at the same time, the profit inuring to GWS on the deal.

quoted below with those portions underlined representing blanks which would be filled in to conform with the terms relating to the individual investment involved:

"This document will serve as your written guarantee from G. Weeks Securities, Inc., that your investment of $102,000 for 8 months (4-21-81), will accrue interest during the 8-month period in the amount of $9,125.00.

The annual rate of return on your investment will be 13.41%. This means that in April 1980, you shall receive from G. Weeks Securities, a check in the amount of $111,125.00.

The letter was usually signed by respondent Hodge, or, on a number of occasions, by respondents Kilpatrick or Weeks.

It is quite clear from the manner in which the customers were solicited and the way the sales were executed that it was never intended by the customer or by GWS that there would actually be a delivery of GNMA certificates or a payment for such certificates on settlement date. This was assured by the deliberate creating of an immediate pairing-off between the same parties of a sale of the securities with a simultaneous purchase of the same described securities. Most of the transactions in this proceeding as expressed in million-dollar units far exceeded the capability of the customer or of GWS to deliver either the purchase price or GNMAs in the amounts described in the documents surrounding the transactions.

All of the customer-witnesses concur that they never contemplated an actual purchase and/or sale of GNMA certificates, but that they were involved only with investing a sum of money for a period of time, at the end of which they were to be paid by GWS the investment plus a stated profit or interest at a specified rate. Some of the investors recognized subsequently that theoretically they could have exercised an option under the standby contract of selling to market on settlement date rather than to GWS and perhaps make a greater gain. Nevertheless, at the time they made their investment, the idea of doing so never entered their minds. As a matter of fact, in every transaction that went to settlement, no GNMA certificates were ever brought or sold under these agreements, nor was the alleged "option" ever exercised.

The "guarantee letter" from GWS summed up the actualities of the transaction, i.e., the investor was obligating itself only for advancing the so-called commitment fee which GWS was obligated to repay with interest in the future. Significantly, this letter nowhere mentions GNMAs, a forward commitment, a standby commitment, or a commitment fee.

The customers were under the belief that the paper work in setting up what appeared to be offsetting transactions in GNMAs was done to enable GWS to engage in similar transactions with Cantor and others in order for GWS to make the profit needed to meet its guaranteed commitments to them.

The record shows that in many instances GWS did enter into a standy with pair-off transaction with Cantor simultaneously or thereafter, in the same Ginnie Maes for the same settlement date.[10/]

From all of the foregoing, it would appear that the so-called standby with pair-off transactions between GWS and its customers were, as judged by the economic realities, nothing more than investments of a sum of money with GWS to be repaid at a future date at a fixed rate of interest and in a specified amount. The trappings surrounding this advance of monies, as reflected in the purported forward contract and the purported standby agreement, had nothing to do with the obligations of GWS to its customers who were never subject to the market risks involved had they in fact been engaged in actual forward or standby contracts.

Section 2(1) of the Securities Act[11/] includes within the definition of a "security" any "note . . . evidence of indebtedness . . . [or] investment contract".[12/] It is the contention of the Division that the "standby with pair-off

---

10/ It would appear that the Cantor transactions might have been agreed upon even prior to the ones with the customers in order for the GWS trader to know what commitment fee to charge to insure a profit to GWS over and above the profit to its customer.

11/ 15 U.S.C. §77b(1).

12/ Similar language is found in Section 3(a)(10) of the Exchange Act, 15 U.S.C. §78c(a)(10).

constitutes both an investment contract as well as an evidence of indebtedness.

An "investment contract" involves (1) an investment of money (2) in a common enterprise (3) with a reasonable expectation of profits to be derived solely from the efforts of others. SEC v. W. J. Howey Company, 328 U.S. 293 (1946).

In the standby with pair-off transaction it is clear that there was, under the first test, an investment of money on the part of the customers of GWS. The parties to the transactions referred to the commitment fees paid as an "investment", and it was so referred to in the "guarantee letter" that accompanied the papers in most of the transactions. Although the investment was to be repaid with a stated amount of "interest" (a term used in the guarantee letter and in other places), respondents have strenously urged that there was present the theoretical opportunity under the standby portion of the transaction for the investor to sell the security on the open market rather than to GWS. Even from this standpoint, the commitment fees paid in by the customers were investments rather than commercial loans. Compare Union Planters National Bank v. Commercial Credit Business Loans, Inc., 651 F.2d 1174, 1181-1183 (6th Cir. 1981).

The second test of the Howey formula is that there exists a common venture. There is a split in court decisions as to whether a given relationship between parties to a transaction satisfies the common venture element. Thus, the Fifth and

Ninth Circuits have adopted a so-called "vertical commonality" test in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment of third parties. It requires only that the investor and promoter be involved in some common venture without requiring the involvement of other investors. See SEC v. Continental Commodities Corp., 497 F.2d 516, 521-22 (5th Cir. 1974); SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d, 476, 482 n.7 (9th Cir., 1973); Brodt v. Bache and Company, Inc., 595 F.2d 459, 461 (9th Cir. 1980). On the other hand, the Sixth Circuit has decided upon a horizontal commonality test which ties the fortunes of each investor in a pool of investors to the success of the overall venture. In fact, a finding of horizontal commonality requires a sharing or pooling of funds. See Union Planters National Bank v. Commerical Credit Business Loans, supra, at page 1183.

It is apparent from the standby with pair-off transactions not only as they were actually carried out, but in the verbal and written promotion statements by the GWS staff to potential customers, that commonality existed under either test. The relationship that existed between GWS and its standby with pair-off customers clearly qualified under the vertical enterprise test, particularly as it involved hedging through additional standby with pair-offs between GWS and either Cantor or some other third persons. Moreover, in almost half the situations, GWS had not hedged the transactions but kept the

customers commitment fees, and in some cases even hedged with itself. As a result, there occurred a pooling of funds, (there was no segregation of individual clients' investments) which would have had to be reinvested by GWS by taking positions with third parties in order to earn the profits guaranteed to the individuals investors by GWS.

The final element of the Howey test, that the profits be derived from the "managerial or entrepreneurial efforts of others", is found to have existed under transactions as offered to and entered into by the investors and as described in the offering statements both verbal and written.

GWS guaranteed to the investor that he would, at some point in the future, receive back his investment plus a guaranteed fixed profit. Obviously, if GWS merely took the investors' funds and held them until the settlement date it would not have had the wherewithal to meet its obligation to them. In fact, the company salesmen advised their prospects that GWS was relying upon someone else somewhere to be picking up the bonds or taking positions in them. Thus, Mr. A.V. McDowell, the so-called "house counsel" and compliance officer for GWS, in a letter addressed to a prospective customer, stated as follows (Exhibit 49):

> G. Weeks Securities, Inc. acts as principal in its transactions with Houston [Houston Hospital Employees Stock Ownership Plan], but as a practical matter, G. Weeks Securities, Inc. passes the commitment fee along to a large national broker-dealer and becomes the originator of a "standby" with the broker-dealer. G. Weeks Securities, Inc. has "hedged"

> its position by passing along the market risk to a larger broker-dealer that is able to bear that risk for a commitment fee.

Patently, the profit that was to be earned by the investors had to be generated by GWS either through its transactions with Cantor and others, or by taking appropriate positions in the forward markets relating to GNMAs or, for that matter, other securities.[13/]

From the foregoing, it is concluded that the standby with pair-off transactions as entered into between GWS and its customers constituted "investment contracts" as defined in Section 2(1) of the Securities Act.

An "evidence of indebtedness" has been defined to include "all contractual obligations to pay in the future for consideration presently received." United States v. Austin, 462 F.2d 724, 736 (10th Cir.) cert. denied, 409 U.S. 1048 (1978). The same case finds the intent of Congress was that the Securities Act and the term "security" should be broadly construed in order to carry out the purposes of the act.

Section 2(1) states that the term "security" embraces any number of instruments, including investment contracts and evidence of indebtedness, "unless the context otherwise requires". (emphasis added) As pointed out in the well-

---

13/ Moreover, the fact that GWS was thrown into bankruptcy because Cantor unexpectedly closed out all of GWS positions indicates not only the commonality of the undertakings but the dependence of the investor upon the efforts of others.

reasoned decision in Wolf v. Banco Nacional de Mexico, 549 F. Supp. 841, 844 (N.D. Cal. 1982), appeal dismissed as premature, 721 F.2d 660 (9th Cir. 1983), the inquiry into "context" has largely superseded the language of the acts and in some cases has yielded results that squarely conflict with that language. The District Court states at Page 843, note 2:

> Typically, however, the courts simply look at the judicially established criteria of a "security" without attempting to fit the instrument or transaction into one of the statutes' terms. (citing cases)

In other words, if a transaction has the attributes of a security, then whether it is an investment contract or evidence of debt does not really matter. Thus, although different courts in different judicial circuits have come up with tests described either as "risk capital" or as "commercial-investment", they basically come up with the same result.

Finally, the Court in the Wolf case points out that where there are instruments or transactions that exhibit the elements most commonly associated with securities then it is proper to include them within the meaning of a security unless they fall into certain well-defined categories. The Court concludes that under the cases cited it has been established that a transaction in which one person ("the investor") provides funds to another with the expectation of a financial or economic benefit is a security unless:

(a) the benefit derives largely from the managerial efforts of the investor; or

(b) the investor receives something of intrinsic value which he intends to use or consume; or

(c) the provider of the funds is in the business of lending funds in such transactions; or

(d) the person to whom the investor provides funds is merely the investor's agent; or

(e) the transaction is virtually risk-free to the investor by reason of governmental regulation.

It does not require much discussion to see that the standby with pair-off does not fall into any of the execeptions. It is further apparent that whether you deem the transaction as an "investment contract" or an "evidence of indebtedness" does not really matter. As seen before, it does fit into the classic Howey definition of a security. 14/

In an action heretofore brought by the Commission against the same respondents herein for an injunction based upon the same standby with pair-off transactions as are involved in this proceeding, the District Court issued a preliminary injunction in which it found the transaction to be both an investment contract as well as evidence of indebtedness under Section 2(1). SEC v. G. Weeks Securities, Inc., 483 F.Supp. 1239 (D.C., W.D. Tennessee, January 30, 1980). This

---

14/ In its brief the Division adds the thought that the guarantee letter accompanying the papers involved in the standby with pair-off is a security in and of itself, under Section 2(1) which expressly includes within the definition a "guarantee of the enumerated instruments and transactions." This is not among the allegations contained in the Order for Proceedings. Moreover, it is merely redundant to the findings herein made.

portion of the District Court's decision was affirmed on appeal to the Sixth Circuit (678 F.2d 649, May 19, 1982), which held that the District Court could, as a matter of law and without hearing, preliminarily determine that the arrangement was a security subject to registration. (Since these decisions do not constitute a final adjudication on the merits after a full evidentiary hearing, the doctrine of res judicata or collateral estoppel is not applicable). Upon the record adduced at this administrative hearing, the administrative law judge finds himself in complete agreement with the findings made preliminarily and without a hearing in the injunction suit. 15/

In their respective briefs, respondents Hodge and Kilpatrick argue that the standby with pair-off transaction is akin to a "straddle" and hence not a security subject to the registration provisions, citing a case in the Florida Third District Court of Appeal, Blacker v. Shearson Hayden Stone, Inc., 358 So. 2d 1147, cert. den., 367 So. 2d 1122 (1979). Specifically, respondents cite the Florida Court's definition of a straddle as involving commodities futures in "a simultaneous purchase and sale of commodities contracts on two different commodities exchanges for different prices". (underlining added). This is not descriptive of the trans-

---

15/ In addition, the Seventh Circuit in Board of Trade of the City of Chicago v. SEC, 677 F.2d 1137, 1158 (7th Cir.), vacated as moot, 103 S. Ct. 435 (1982), found itself in accord with these findings of the District Court in SEC v. G. Weeks Securities, Inc.

actions in this proceeding, since they do not involve transactions on two different exchanges, but rather those executed simultaneously between the investors and GWS. 16/

The pertinent provisions of the Securities Act are as follows:

> Sec. 5. (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly -
>
> > (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security . . .
>
> * * *
>
> (c) It shall be unlawful for any person, directly or indirectly, . . . to offer to sell . . . any security, unless a registration statement has been filed as to such security, . . . (underlining added). 17/

Since it is undisputed that no registration statement had been filed or was in effect with respect to the standby with pair-off transactions, and that instruments of communication in interstate commerce and of the mails have been used in selling these transactions, a prima facie violation

---

16/ A straddle has also been defined in the field of stock options by the Commission's Report of the Special Study of the Options Markets, H.R. Print IFC 3, 96th Cong., 1st Sess. (1978) as a combination option position consisting of one put and one call of the same class. Either option is exercisable or salable separately and the exercise prices and expiration dates are usually identical. In the standby with pair-off, the exercise prices of the 2 sides of the transaction are not identical.

17/ Paragraph "(b)" of Section 5 also refers to unlawful conduct by any person "directly or indirectly".

of the registration provision of Sections 5(a) and (c) of the Securities Act has been established. 18/

The record shows that all of the respondents, _directly or indirectly_, engaged in activities violating the proscriptions of Section 5. In his brief, Kilpatrick asserts that he is not liable because he never sold a "security", specifically a "standby with pair-off", and that he was not a "control" person, nor an "aider or abetter". However, Kilpatrick was the principal mover behind these transactions. It was he who made the arrangements with Cantor and introduced the transaction to GWS. He instructed the salesmen at his training sessions as to all of the aspects of the standby with pair-offs and promoted their sale. He established the details of, and approved of, each transaction by GWS. It was he who determined the spread between the offering and selling price as expressed in the confirmations making up the transaction and determined the amount of commitment fee required, the profit promised to the investor and the commissions earned by the salesmen. 19/ Whatever knowledge the salesmen had concerning these transactions was derived through Kilpatrick and also to a considerable extent through respondent Hodge, whose brief makes the same

---

18/ Respondents do not contend, nor has any proof been offered by them, that any of the exemption provisions of Section 4 of the Act apply.

19/ See the testimony of former Respondent Randy Neal Vallen, transcript Volume 5, pages 123-127.

claim of not being a principal or an aider or abetter. Hodge participated in the training sessions, signed the transaction documents including the letters of guarantee, and in general assumed responsibility with respect to these transactions along with Kilpatrick and the president of the company, Gerald Weeks.

Kilpatrick and Hodge have been such substantial participants (and indeed prime movers) in the sales of the standby with pair-off transaction as to be liable for its unlawfulness in terms of nonregistration.

Some courts have expounded a doctrine of participant liability. As the Court of Appeals for the Seventh Circuit stated in S.E.C. v. Holschuh, 694 F.2d 130, 139 (1982):

> The doctrine of participant liability has evolved in enforcement actions brought by the SEC to enjoin future violations of Section 5. Defendants have been held liable where they have been a "necessary participant" and "substantial factor" in the offer and sale of unregistered securities. (citing cases)

The Court in Holschuh also rejected the contention that primary liability may not be imposed absent some showing of direct contact between a defendant and offerees, saying (at page 140):

> Rather the relevant inquiry in an enforcement action is whether the evidence shows that the defendant was a substantial and necessary participant in the sales transactions. To hold that proof of direct contact is necessary would be to ignore and render meaningless the language of Section 5, which prohibits any person from "directly or indirectly" engaging in the offer of sale of unregistered securities. . . (underlining added).

Finally, as pointed out in Holschuh, (at p. 142), where primary liability has been established it is unneccessary to probe the question of whether secondary liability (i.e., "aider and abetter") should also attach.

In sum, both Kilpatrick and Hodge have at least indirectly violated Section 5 as principals. Their arguments concerning their status otherwise are not well based. They were, in fact, the prime movers behind every sale or offer to sell standby with pair-offs, and a vital part of every transaction.

The position of the salesmen-respondents is to some extent different. Prior to the introduction of the standby with pair-off transactions to GWS by Kilpatrick and Hodge, these salesmen were engaging in transactions in exempt government-backed securities such as GNMAs, including separate standby contracts, forward contracts, and sales generally. They then were presented by Kilpatrick and Hodge with what on the surface appeared to be a pairing off of the familiar exempt securities transactions. They chose to rely on the failure of the house counsel for GWS to advise them that the new investment vehicle they were peddling was not what it appeared to be on the surface. But they were the ones who directly participated in the sale of standby with pair-off investments.

It is apparent that all of the respondents including salesmen are ultimately responsible for having willfully

engaged in the sale of unregistered securities. [20/] The language of Section 5 makes it clear that scienter, or guilty knowledge is not an element of the offense. It would appear that nothing more need be shown than the willfull sale of unregistered securities. A good faith sale of unregistered securities under the belief that they were exempt from registration is not a defense to Section 5 liability. SEC v. Guild Films Co., Inc., 279 F.2d 485 (2nd Cir. 1960). The Commission has held in Charles C. Carlson, 46 S.E.C. 1125, 1129 (1977), that an offer and sale of unregistered securities was a willfull violation of Section 5.

It has also been said that responsibility for compliance with Section 5 cannot be shifted entirely to a salesman's superior. Willard G. Berge, et al., 46 S.E.C. 690, wherein the Commission at page 695, reaffirmed a statement in a prior decision that:

> "Salesmen also have some measure of responsibility in these matters. This is not to say that they must be finished scholars in the metaphysics of the Securities Act. But familiarity with the rudiments is essential."

20/ A finding of willfullness in the context of the securities laws requires merely proof that the person charged acted intentionally in the sense that he was aware of what he was doing. There is no requirement that the actor also be aware that he is violating one of the provisions of the Act so long as he consciously performed the acts constituting the violation. See Tager v. SEC, 344 F. 2d 5, 8 (CA. 2, 1965) and Arthur Lipper and Co. v. SEC, 547 F.2d 171, 180 (CA. 2, 1976).

With respect to Kilpatrick and Hodge who, as seen above, were the prime movers (along with Weeks) in the activities of GWS and its salesmen, they were bound to have investigated affirmatively the registration requirements of these securities. 21/ SEC v. Feeney, 564 F.2d 260 (CA. 8, 1977), cert. denied, 98 S. Ct. 1608 (1978), wherein the Court said at page 262, " . . . ignoring the obvious need for further inquiry and reckless indifference to suspicious facts will support a finding of violation of Sections 5(a) and 5(c)". 22/

Respondents argue that they relied upon the advice of "house counsel", Mr. A.V. McDowell, that standby with pair-off transactions were lawful to sell. However, the record fails to show that they ever asked McDowell for an opinion, nor did he ever express an opinion, as to whether the transactions involved a security required to be registered under Section 5. Respondents assumed from his

---

21/ It is noted that both Kilpatrick and Hodge declined to testify as to these or any matters under claims of Fifth Amendment privilege. Consequently, an adverse inference may be drawn from their failure to testify. Baxter v. Palmigiano, 425 U.S. 308 (1978).

22/ In an analogous situation under Section 12(1) of the Securities Act creating a civil liability in favor of the purchaser of an unregistered security against the seller thereof, liability is absolute. Liability is established merely by proof that the securities were not registered, that the defendant sold the securities to the plaintiff, and that the mails were used in making the sales. See Wolff v. Banco National de Mexico, supra, at page 853.

failure to advise them not to sell that it was all right to do so. This claimed reliance is insufficient as a defense to the charges. 23/

Under all of the circumstances, it is concluded that the standby with pair-off transaction was a security, that it was not registered, and that all of the respondents had willfully violated the registration provisions of Section 5(a) and (c).

Fraudulent Conduct Allegation

The Order charges that respondents, in connection with the purchase and sale of the standby with pair-off agreements, violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and the Commission's Rule 10b-5 promulgated thereunder (the so-called "anti-fraud"

23/ To establish good faith reliance on counsel, a person must demonstrate that he (1) relied on the advice of disinterested counsel; (2) made a complete disclosure of all relevant facts to counsel; (3) requested counsel's advice as to the legality of the proposed conduct; (4) received advice that such conduct was lawful; and (5) acted in accordance with the advice after it was rendered. See, e.g., SEC v. Savoy Indus., Inc., 665 F.2d 1310, 1314 n.28 (D.C. Cir. 1981); Arthur Lipper Corp. v. SEC, 547 F.2d 171, 181-82 (2d Cir. 1976), cert. denied, 434 U.S. 1009 (1978); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1101-02 (2d Cir. 1972). "[E]ach element [must be] proved to the satisfaction of the court." D. Hawes & T. Sherrard, Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases, 62 Va. L. Rev. 1, 6 (1976).

provisions) [24/] by misrepresenting that GWS was depositing GNMA securities with banks or savings and loan associations to secure the monies paid by investors; that GWS was a member of the Securities Investors Protection Corporation ("SIPC"); that GWS was a member of the National Association of Securities Dealers, Inc., (NASD); the nature of the transaction; that the investment was guaranteed; and the suitability of the investment for credit unions and trust funds. It is further

---

24/ Section 17(a) of the Securities Act makes it unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce, or by the use of the mails, directly or indirectly -- to do any of the following:

"(1) to employ any device, scheme or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

Section 10(b) of the Exchange Act makes it unlawful, in connection with the purchase or sale of any security to use or employ "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5 promulgated thereunder, extends, in effect and with a few language changes, the provisions of 17(a) relating to the sales of securities to both the purchase or sale thereof.

charged that respondents failed to disclose the use of the proceeds of the investments; the financial condition of GWS; and that about 30 percent to 45 percent of the funds were being paid as commissions. 25/

Financial Conditions

Given the nature of the transaction, whereby GWS promised that at some definite time in the future, whether it was six months or two years later, the investor would receive from GWS a guaranteed return of the original investment plus a fixed and stated profit (or "interest", as it was frequently referred to in the documents representing the transaction), the financial condition of GWS and the representations (or omissions) made in connection therewith becomes critical and material. Although in many instances investors were informed that GWS was looking to engage through Cantor and others in a hedging transaction, in reality the obligation to them was in no way the responsibility of any third party. Ultimately, the resources of GWS were the sole source of the funds needed to make good the absolute undertaking to investors.

25/ It should be noted that although GNMA certificates are exempt securities and a GNMA forward contract is not a security in and of itself, a purchase or sale of a GNMA forward (and a standby contract is also a form of a forward) is "in connection with" the purchase and sale of the underlying GNMA securities and therefore the anti-fraud provisions of the securities laws apply. See Abrams v. Oppenheimer Government Securities, Inc., supra.

The problem of furnishing adequate financial information concerning GWS was exacerbated by the failure of GWS management to make it available, and by the preparation by management of a joint GWS-GWC statement that was grossly misleading as it involved GWS.

I

The accountant retained to perform audits of registrant GWC in order to file requisite financial statements with this Commission for the fiscal years ending June 30, 1977 and 1978, also had prepared similar financial statements for GWS. However, although copies of the GWC statements had been prepared and sent to its customers, the ones for GWS had not even been printed.

Instead, Hodge, as the chief financial officer, directed the accountant to prepare a combined financial statement for the two corporations for the year ending June 30, 1978. This combined statement was printed and was sent to customers of GWS when financial information was requested. However, this combined statement, by merging the respective assets and liabilities of GWS and GWC, had the effect of covering up unfavorable information concerning GWS. It also misled those who read it as to the status of GWS.

To illustrate: The cover sheet of this report showed the names of both corporations, the address that both shared, and the statement: "Member: National Association of Security Dealers, Inc. Securities Investor Protection Corporation."

The impression thus given upon a reader was that GWS as well as GWC was a member of these organizations, with the concomitant effect of suggesting that GWS was subject to the regulatory supervision of NASD and that its customer accounts were insured under SIPC. This was not true with respect to GWS - only to GWC. 26/

As stated, the combined financial statement covered up and distorted the financial condition of GWS. Thus, the statement shows an asset entitled "Receivables from Customers" in the amount of $1,200,00. Yet, only $48,000 of this amount represented an asset of GWS. Again, "Goodwill", valued on the joint return at $41,562 was the asset of GWC only. The same is true of the stated assets "refundable federal income taxes" ($79,171) and "furniture, equipment and leasehold improvements" ($42,389).

On the liability side, of "Bank Loans" outstanding in the sum of $545,000, about $505,000 was the obligation of GWS only, and the obligation for "Commitment Fees Received", reported on the joint statement of condition as amounting to $745,466, was the obligation solely of GWS.

Finally, since the combined statement of condition excluded all intercompany transactions and balances, it

---

26/ In fact, respondent Smith admits that he believed from this document that GWS was a member of both NASD and SIPC and would have so told any customer who would have asked him.

fails to show the large sums of money that GWS was paying GWC under a "management agreement" wherein the overhead expenses at the joint company headquarters was shared in accordance with the gross profits of each company. It also did not show that as of June 30, 1978 GWS had paid $742,190 in fees to GWC which does not appear on the joint statement, and that GWS had advanced to Gerald Dean Weeks the sum of $270,511 for his personal account.

Further, the combined balance sheet shows a combined net capital as of June 30, 1978 of $1,063,145, but does not disclose that of this amount the net capital for GWS was only $221,297.

II

The actual financial condition of GWS during the relevant period is found in audits and financial statements compiled by the accountants for the trustee in bankruptcy and by the company bookkeeper acting under Hodge. They show the net capital position of GWS at various times, as follows, (with a deficit amount shown in parenthesis):

DATE	NET CAPITAL
June 30, 1978	$221,297
May 31, 1979	$555,119
June 30, 1979	($463,241)
July 31, 1979	($144,115)
August 31, 1979	($288,285)

DATE	NET CAPITAL
September 17, 1979	$337,568
November 6, 1979 (bankruptcy date)	($1,047,383) 27/

As a registered securities dealer with the State of Tennessee, GWS was required to maintain a net capital position of $100,000. In August of 1979, when it claims to have first learned it was in a net deficit position, GWS discontinued any further transactions until September 17, 1979 when it again showed a positive net worth. 28/

27/ As of this date, GWS was obligated to make good commitment fees to its standby with pair-off customers which, with interest, amounted to $12,781,673.

28/ GWS, as seen from the preceding table, replaced a deficit of $144,115 on July 31 and $288,285 on August 31st with a positive net capital position as of September 17 in the amount of $338,000. This abrupt change was based on an alleged accrued profit realized as a result of Cantor selling out its positions leaving GWS in a short position followed by a drop in the government securities market. Based upon the then market value of the securities freed by the action of Cantor, GWS credited its account "accrued income on unsettled transaction" with an alleged windfall profit in the amount of $796,250 as of September 17, 1979. The Tennessee Department of Insurance (which at that time had jurisdiction over government securities dealers) sent an investigator in order to verify this bookkeeping transaction. When GWS was unable to produce any work papers or schedules showing how they arrived at the figure stated, the Tennessee Commissioner of Insurance issued an order based on a preliminary finding of fraudulent practices which ordered respondent to cease and desist from committing further fraud violations until a hearing was held at the request of the respondent, GWS. Since GWS has never requested such a hearing the order of the Tennessee authorities would appear to be still in effect.

The salesmen-respondents knew and understood that the return of investment plus profit ("interest") to their standby with pair-off customers was solely dependent, in the last analysis, upon the financial condition of GWS and its ability alone to meet these commitments. They knew that in most cases, "guarantee letters" were being sent to their clients. They agree that they had no specific knowledge of the financial situation of GWS. Nevertheless, they made no efforts to determine the financial condition and net worth of GWS at any time. Instead, they assumed that GWS was financially stable. They also knew that GWS had not prepared or sent to its customers any statement of its own financial condition. [29/] They were aware that GWS was sending out a combined statement with GWC which not only failed to adequately inform a reader thereof of the financial condition of GWS itself, but also contained a misleading cover sheet which would indicate that GWS was a member of NASD and of SIPC. Despite the warning arising from the insolvency of GWS for two months in 1979, they never conveyed this information to their customers. As a matter of fact, they resumed selling standby with pair-offs after the September 17, 1979 date when GWS made the bookkeeping transaction which ostensibly changed its condition from one of insolvency to one of apparent solvency (except

---

29/ In fact, a Quarles customer and a Shelton customer specifically asked for such a statement, without success.

for Shelton who had left the employ of GWS in August, 1979).

Even though the salesmen were relying to a large extent upon what was told them by Kilpatrick and by Hodge, and despite the fact that they were relatively new at the business, "red flags" were raised sufficient to put them on notice that there was something amiss with the financial condition of GWS or at least to stimulate an inquiry concerning it.

The position of Hodge and Kilpatrick with respect to the financial situation is far more serious than that of the salesmen. Hodge was responsible for the books and records kept by GWS. He knew or should have known of the advances and loans made to Mr. Weeks personally out of the GWS funds. He knew or should have known of the "management agreement" whereby much of the funds of GWS were channeled to GWC. It was he who directed his bookkeeper to draw up the deceptive and misleading (at least with respect to GWS) joint statement of financial condition with GWC. And it was he who was reponsible to have prepared and disseminated to GWS customers a separate GWS statement of financial condition, which he failed to do. Finally, both Hodge and Kilpatrick knew that almost half of the outstanding standby with pair-off commitment fees were not hedged, and that GWS had itself taken the hedging positions in many instances that were formerly taken by Cantor and a few others, thereby leaving the investors exposed to the severe financial losses they ultimately suffered.

Kilpatrick shares much of the same blame as Hodge, as the one who brought the standby with pair-off transactions to the attention of GWS and its salesmen, and as the government bond trader who knew of the risks involved in the unhedged positions held by GWS. He also knew how vital was the GWS financial solvency in meeting the standby with pair-off commitments taken by GWS.

With respect to Hodge and Kilpatrick, their refusal to come forth and explain, under their assertion of Fifth Amendment rights, the failure to advise investors of the true financial situation of GWS, and the promulgation of misleading financial information, warrants an inference adverse to them. Baxter v. Palmigiano, supra.

Accordingly, it is concluded that all respondents have wilfully misrepresented the financial condition of GWS, and have failed to disclose other significant aspects thereof. In addition they have caused to be misrepresented that GWS was a member of NASD and SIPC.

It is further concluded that the omissions and misrepresentations found were material. Under the circumstances herein where GWS was guaranteeing the fulfillment of the transaction, there is a substantial likelihood that a reasonable investor would consider these misrepresentations and omissions important in making their investment decisions. TSC Industries, Inc. v. Northway, Inc. 426 U.S. 837 (1976).

Other Representations and Omissions

In addition to the misleading aspects surrounding the GWS financial situation, as discussed above, there remain the other specifications of fraudulent conduct which the Division in its brief seeks to ascribe in a blanket fashion to all respondents. However, their respective sales pitches differed somewhat and, for the purposes of this proceeding, will be considered separately.

I

Robert Quarles sold standby with pair-off transactions to some 10 or 12 customers, 3 of whom, representing credit unions, testified at the hearing. In soliciting a credit union in Grove City, Pennsylvania, he described the standby with pair-off as an investment in which there was a holder of GNMA certificates in need of cash who was willing to pledge the certificates to GWS as security for a loan from GWS; that the credit union's investment would form part of the loan; and that when the loan was repaid, GWS would repay the credit union its investment plus interest. With this understanding, the credit union invested monies with GWS. Although the credit union's representative received the usual paper work from GWS, (i.e. confirmations showing the pairing of a purchase and sale of a standby with a forward contract, etc.), he never felt that these represented anything other than what he was told by Quarles nor any

obligation either to take delivery of or to deliver GNMA certificates, especially since the papers included the standard GWS "guarantee letter" for the repayment of the investment plus interest. 30/

Quarles solicited an official of the Equitable Gas Company credit union, of Pittsburgh, Pa., and made the same description of the transaction as above. On this basis, Equitable invested in a total of four standby with pair-off transactions. When the first one came to maturity it was rolled over by Quarles, without authority, 31/ into another similar transaction. Equitable had asked Quarles for financial information concerning GWS on several occasions but only received some brochures describing GNMA certificates wherein Quarles had highlighted language indicating that these securities were backed by the full faith and credit of the United States Government. In total, Equitable invested and lost some $290,000.

An officer of the credit union at Aluminum Corporation of America (which already had an account at GWS) was influenced to invest in standby with pair-off transactions as a result of solicitation by Quarles from which he

---

30/ The credit union lost no money on this investment because of an offsetting independent transaction involving a standby contract on certain GNMA certificates for which the credit union was able to settle with the trustee in bankruptcy.

31/ Quarles claimed that due to a misunderstanding he thought he had such authority.

understood that the investment would, on settlement date, be returned with interest. When he received the documentation from GWS showing confirmations of a standby and a forward contract involving GNMA certificates in amounts varying from $1 million to $3 million dollars, which were beyond the ability of the credit union to buy, he was not concerned because he understood that under the arrangement there never would be a need to deliver or take delivery of any bonds. The credit union never asked for nor received any financial statements pertaining to GWS. Quarles told the credit union official he had checked with the National Credit Union Administration (NCUA) and was advised that it was legal for credit unions to invest in standby with pair-offs. [32/] The credit union invested between $500,000

32/ Federal Credit Unions (FCUs) are authorized pursuant to Section 1757(7)(B) of the Federal Credit Union Act [(12 U.S.C. 1757(7)(B)], to invest in, among other things, "obligations of the United States Government, or securities fully guaranteed as to principal and interest thereby". Section 1757(1) of the Act authorizes FCUs to make contracts, and Section 1757(7)(E) authorizes them to purchase GNMAs. The decision in <u>LTV Federal Credit Union</u> v. <u>USMIC Government Securities, Inc.</u>, (D.C., Tex. 1981) 523 F.Supp. 819, aff'd. 704 F.2d 149 (5th Cir. 1983). <u>cert</u>. <u>den</u>. 104 S. Ct. 163 (1983) tells us (at P. 826) that standby commitments to purchase GNMAs had been authorized (at least until July 20, 1979) for FCUs by the NCUA under an interpretation of the Act. In 1979, the NCUA promulgated a regulation prohibiting FCUs from entering into standby commitments to purchase or sell securities. 12 C.F.R. Sec. 703.3(b)(2). NCUA specifically cautioned that the regulation was not to be retroactive. The regulation was first published in the Federal Register on June 20, 1979 (44 Fed. Reg. 42676).
(FOOTNOTE CONTINUED)

and $600,000 in these transactions, and suffered a net loss of some $200,000 as a result of the bankruptcy.

Quarles, testifying on his own behalf, stated that he never knew nor inquired about the financial condition of GWS. He admits that although he became aware in August of 1979 that GWS was in financial difficulty, nevertheless, he later entered into a further standby with pair-off transaction with a customer. Quarles denies ever telling his customers that the transactions were approved by NCUA. He claims that he advised his customers of the exact nature of these transactions and denies telling them that their investments were to be loaned to an individual in financial

---

32/ (FOOTNOTE CONTINUED)

It is noted that the only proof of Quarles's representations as to the legality of these investments was from the official of the Alcoa Credit Union. The documents of record show that the trade dates for the 3 transactions with this FCU were all prior to the date of publication and of promulgation of the NCUA regulation.

Given the fact that as of the date of these investments the separate transactions comprising the standby and the forward contracts were arguably legal for FCUs, it cannot be concluded that the representation by Quarles as to the legality of the pairing off of these two transactions was fraudulent. In the last analysis it is not unreasonable to expect the officer of the FCU involved to have known his statutory authority and under the rulings of the NCUA Administrator with respect thereto. In any event, Quarles had no reason to believe the standby with pair-off transactions were not authorized for FCUs at the time they were entered into, at least with respect to charging him with fraudulent conduct. (Compare _LTV_, _supra_ at page 827).

trouble pledging GNMA certificates with GWS for the loan. 33/

II.

Carlos A. Smith waited a month or two after he first learned of the standby with pair-off transactions at the sales meetings conducted by Kilpatrick to see how other salesmen were handling these transactions, and then he solicited two credit unions, the British Airways Credit Union and the Oneida Limited Employees Credit Union. He explained to the representatives of both organizations the concept of pairing of a GNMA forward contract with a GNMA standby, so that despite the form of the transaction, there would be no need to take delivery of any security on settlement date. He further explained that the commitment fees paid by the customer would be forwarded to Cantor who would hedge the transaction.

Smith also told these two customers that he had checked with the Atlanta office of the National Credit Union Administration and was advised that these types of investments were legal for credit unions. 34/ Smith also

---

33/ These denials and assertions were taken into account in arriving at the conclusions of fact stated.

34/ See footnote 30, ante. The transactions with these customers all preceded June 20, 1979 when the NCUA regulation forbidding them was first published. The same conclusions with respect to Quarles's conduct apply to Smith's.

stated that the investments were secured by SIPC insurance coverage for up to $1 million, and told the Oneida representative that there would be securities backing these contracts. The credit union representatives made inquiry of NCUA to verify Smith's representation as to legality but could get no definite answer.

Smith furnished the Oneida Credit Union, in response to a request for a GWS financial report, the combined financial statement of GWS and GWC. He also advised that GWS was a very profitable firm with a net worth of over $1 million. (As stated, the combined balance sheet showed such a balance. Separately, GWS would have showed far less.)

As a result of these solicitations and representations British Airways Credit Union entered into five standby with pair-off transactions, two of which were settled profitably one year beyond the sale date, and the remaining three, having settlement dates 18 months later which brought them beyond the bankruptcy, were never settled. Its officer would not have invested in these transactions had he known that they were not being hedged. The Oneida Credit Union entered into one transaction paying a commitment fee of $42,812.50, but its officer does not remember whether it was completed

or the money repaid. [35/]

Although Smith denies that he ever represented the transactions to have been approved by NCUA, he did write a letter dated June 27, 1978 to the Boston office of NCUA replying to a "criticism" of the Oneida Credit Union investments in the standby with pair-offs in which he attempted to explain the hedging opportunities in these transactions. In the letter he recognizes that NCUA was considering putting limitations on the use of the pair-off transactions.

Smith asserts that following the criticism by NCUA of these transactions he sold no more of them even though the GWS staff continued to do so. (The exhibits show he only made transactions in April and May, 1978). He is aware that as a result of these investments both of his clients lost money. He claims to have been misled by the combined GWS-GWC financial condition statement into believing that GWS was a member of NASD and SIPC and relied upon his superiors and the GWS compliance officer in believing the standby with pair-offs were legal to sell.

35/ The exhibits of record show that on April 21, 1978, the described transaction was made for settlement on May 18, 1979 (prior to the GWS bankruptcy); that in May, 1978, 2 more transactions involving commitment fees of $127,500, to settle November 15, 1979 (after bankrutpcy) were entered into.

III

After attending the training session given by Kilpatrick and Hodge, Bobby Bruce, sold standby with pair-off arrangements to some 3 or 4 individuals, two of whom testified at the hearing.

Roy Whitehead was told orally by Bruce that he would be participating, along with other individuals, in owning a GNMA certificate backed by mortgages which would return a good interest rate. Bruce sent him a letter outlining the typical standby with pair-off transaction and asserting that it could only result in a profit to investors because of the spread existing between GNMA forward contracts and standby contracts. His letter pointed out that GWS would guarantee the return of the investment plus the promised yield and even included a sample of the "guarantee letter".

Thereafter, Bruce advised orally that there was not any safer investment than the one proposed, that they were guaranteed by a federal agency, and that the GNMA bonds involved would be held in a bank to secure the investment. Whitehead was also told many times that by his investment he was part of a pool in GNMA standby transactions.

Whitehead asked Bruce for financial data concerning GWS and was sent the combined GWS-GWC financial statement heretofore referred to. Bruce advised that a financial statement relating to GWS alone was being made up, but the witness never received one.

As a result of these solicitations and coversations, Whitehead entered into a transaction in January of 1979 with a settlement date six months later in which he paid a commitment fee of $106,250. He received the usual confirmations as well as the "guarantee letter" signed by Hodge. This transaction was closed out by Whitehead prior to its settlement date at a profit. Later he entered into a second 3-month transaction in August of 1979 in which he paid a settlement fee of $129,375. It does not appear whether he was ever repaid any part of this money; the settlement date was after the bankruptcy of GWS.

Bruce solicited Joseph B. Vickery for investments in the standby with pair-offs and told him that there was no way he could lose money on the transaction since they involved GNMA certificates which were backed by the U.S. Government, that he was investing, along with others, in a portion of a GNMA certificate, and that the certificates representing the investment would be held by GWS until maturity. Bruce also gave Vickery a financial statement for GWC.

As a result of these solicitations Vickery, invested in several standby with pair-offs approximately $31,000, of which he received back about $15,000 from the trustee in bankruptcy.

Bruce denies representing that the transaction was backed by GNMA certificates and by the federal government,

but that he told his customers the only guarantee was by GWS itself.

IV

William E. Shelton undertook the selling of the standby with pair-off transactions both to his own customers as well as to those obtained through an arrangement with an insurance agency, Sipe & Company, as hereinafter described.

One of his own customers, a bank, invested $500,000 in such a transaction based upon Shelton's oral assurance that the investment would yield a 12% return on an 18-month basis. The bank officer did not realize until after receiving the confirmation documents that they dealt with a transaction involving $8 million dollars worth of GNMA certificates. However, Shelton then assured him that under the pair-off arrangement there would be no need to take delivery of any certificates and that there was no risk involved. As the record shows, the usual "guarantee letter" accompanied the documentation received from GWS. 36/

At the request of the bank, Shelton sent a letter explaining that the price spread between a forward and a standby contract determines the "interest rate", and stating that GWS will guarantee the payment of the interest.

The bank officer had asked Shelton for financial information concerning GWS and received the combined GWS-GWC statement

---

36/ Although Shelton denies ever having such guarantee letters sent to his customers.

heretofore referred to.[37/] The transaction settled prior to the GWS bankruptcy, and this investor received the return of its investment plus the agreed-upon profit.

Shelton entered into an arrangement with Glenn Sipe and Gerald Lum (both associated with Sipe & Company), in which GWS joined, whereby Sipe and Lum were to refer their clients to GWS to invest in standby with pair-off transactions, with Shelton getting credit for and commissions from the sales. Sipe and Lum were to receive a "finders fee" amounting to one half of Shelton's commission. Preliminarily, Shelton explained to Sipe that under the transaction GWS would purchase GNMA bonds in blocks of one million dollars and would simultaneously sell those bonds in a forward position to someone else. GWS would then splinter the million dollar block of bonds into fractions for sale to smaller investors who would pay a commitment fee which GWS would, in turn, pay as a commitment fee to the party taking forward delivery of the larger block of bonds. Shelton further explained that these transactions would produce a yield based upon a spread between the purchase and selling price of the bonds, and that ultimately, the investor would get back his investment plus interest. This explanation was repeated to Sipe at a later meeting with Hodge who also made available to Sipe a brochure

---

37/ However, Shelton denies providing his customers with financial information concerning GWS.

explaining the nature of investments in GNMA certificates. Both Hodge and Shelton told Sipe that the only security for the investments were the physical ownership by GWS of the GNMA bonds which, in turn, were backed by the full faith and credit of the United States Government. No other guarantee was mentioned to him. 38/

When Sipe had his first investor he asked Shelton and Hodge for a written explanation as to how the GNMA standbys with pair-offs worked. As a result of this request, A.V. MacDowell, the GWS house counsel, sent Sipe a letter explaining how the basic standby with pair-off arrangement worked, including the profit based upon the difference in the price spread, and the passing on of the commitment fee to a large national dealer to hedge the GWS position. The letter further stated that the arrangement could only lose money for the investor if the U.S. Government would fail in its guarantee as to principal and interest on GNMA securities and if the market should fall to such a level as to put large and small broker dealers out of business. It further states that anything short of "economic disaster" would likely ensure the soundness of the investment. Shelton received a copy of this letter and expressed no disagreement with it.

38/ Shelton admits telling Sipe and Lum that standbys with pair-offs had GNMAs behind them, but asserts he only meant to imply that there were actual GNMA certificates involved.

Sipe had also requested of Shelton a GWS financial statement after his first client made an investment, but received one instead for Cantor. Subsequently, he did receive the joint financial statement of GWS and GWC. Sipe also asked Hodge for a prospectus but was told that a prospectus was not necessary since the investment was in GNMA bonds backed by the Government.

Sipe was paid finders fees for recommending customers directly from GWS. He estimates the total amount of fees thus received to have been about $28,000. Presumably, Shelton received the same amount from Sipe-solicited transactions.

Ennis J. Hurdle, Jr. made an investment in a standby with pair-off upon the solicitation of Gerald Lum who advised him that the securities involved were government guaranteed and hence risk-free. Hurdle invested some $20,000 and received the usual confirmation documents including a purchase and sale in a pair-off of a certificate worth $250,000. He negotiated the return of his investment prior to the settlement date directly with Shelton who personally delivered the repayment check to him. The connection between Shelton with Sipe and Lum is clearly established.

Shelton denies having made any arrangements directly with Sipe or Lum, that he had anything to do with the arrangement for splitting commissions (although he was content to receive his share thereof), or that he ever told Sipe that GWS was holding GNMA bonds for the standby with pair-off customers.

Shelton left GWS prior to its bankruptcy in 1979.

Since John Kilpatrick was the firm trader, he would normally not be acting as a salesman in a position to make representations to customers. However, Alvin Saucier, a customer of Patrick Michael (a respondent salesman who is no longer a party to this proceeding), claims to have met with Kilpatrick and Michael and was told by both that the standby with pair-off involved an individual owner of GNMA certificates who, because of a need for ready money, would pledge these securities for a loan at a high rate of interest and that Saucier would be buying a percentage of a one million dollar block of these certificates which would be put up as security for the loan and held by GWS. He was further told by Kilpatrick, at the meeting, that the investment would be guaranteed by GWS, and that GNMA bonds would be guaranteed by the Federal government. At that meeting, Kilpatrick gave him a pamphlet explaining GNMA pass-through certificates in which Kilpatrick highlighted portions thereof describing these securities as government insured.

Kilpatrick attacks the credibility of Saucier and the reliability of this testimony because during the investigatory phase of this proceeding, Saucier had named Michael but not Kilpatrick as the source of these representations. His credibility is further attacked on the basis of a final decree in the Tennessee Chancery Court

dated March 22, 1982 which found that Saucier was the "mastermind and driving force" behind a civil fraud. However, at the hearing herein, Saucier was most definite in identifying Kilpatrick as the one who made these representations. In view of the fact that Kilpatrick declined to testify concerning this matter, and there is nothing else to contradict him, the inference is drawn that Saucier is entitled to be believed.

VI

Cletus Marion Hodge, who was mainly concerned with the books, records, back-office operations and financial affairs of GWS, and who also served as a trader, like Kilpatrick would not be in a position normally to be making representations to customers. Other than his responsibility for misrepresentations as to the financial condition of GWS, he did make representations to Glenn Sipe that the security for the investments in standby with pair-off transactions was the ownership by GWS of GNMA bonds guaranteed by the full faith and credit of the United States Government. The refusal of Hodge to testify with respect thereto will be construed adversely.

Summary

From the record herein concerning the specifications of fraud, in addition to those heretofore found with respect to financial matters, it is concluded that:

1. Bruce misrepresented that there would be actual GNMA certificates to be held in a bank

as security for the standby with pair-off transactions; that the investments were guaranteed by a Federal agency; that the investors would be owning a portion of an actual GNMA certificate; and that there was no safer investment to be had.

2. Shelton misrepresented that GWS would be holding as security for the investments in standby with pair-offs, actual GNMA certificates backed by the Federal government; that there would be no risk to investors, particularly as so vividly described in the McDowell letter and concurred in by Shelton; and that investors would be buying into a portion of a GWS forward contract embracing million-dollar blocks of GNMA certificates.
3. Smith misrepresented that there would be actual GNMA securities backing the transactions, and that investments were insured up to $1,000,000 by SIPC.
4. Quarles misrepresented that the monies invested with GWS would be loaned to a third party who had a cash flow problem and would pledge actual GNMAs to secure the loan;
5. Kilpatrick misrepresented that the standby with pair-off transactions involved an individual who needed ready cash and would pledge government-backed GNMAs to secure the loan; and that the investor would be buying a percentage of a $1,000,000 block of the GNMAs so pledged.

6. Hodge misrepresented that there would be physical ownership of GNMA certificates guaranteed by the full faith and credit of the U.S. Government, and hence, no prospectus was necessary.

All of the foregoing representations were untrue and were material and wilfull as those terms have hereinabove been defined. (See footnote 20 and page 38, above).

As to the remaining specifications in the Order, while it is true that all of the respondents failed to disclose the use of proceeds of the investments or that the salesmen were receiving commissions of between 35 and 40 percent of the "profits" earned on the transactions, [39/] these facts were not material. Moreover, it is unlikely that the salesmen would have been informed as to the disposition made of the proceeds of investments. Finally, as stated before in footnote 32, there is insufficient proof to sustain the allegation that respondents misrepresented the investments to be lawful for credit unions.

Scienter

A further aspect of the anti-fraud violations is that one of the elements required to be established to show a

---

39/ It is noted that the Order alleges that the commissions were to have amounted to these percentages of the funds invested. This was not the measure of compensation.

violation of Rule 10(b)-5 and the first subsection of Section 17(a) is that respondents acted with "scienter", defined as "a mental state embracing intent to deceive, manipulate, or defraud". Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193, n.12 (1976). Scienter is established by knowing or intentional conduct. Aaron v. SEC, 446 U.S. 680, 690 (1980). It may also be established by reckless conduct. Nelson v. Serwold, 576 F.2d 1332, 1337-8, (9th Cir.), cert. den., 439, U.S. 970 (1978). Courts recognize that absent an admission by defendant, scienter may be inferred from circumstantial evidence which "can be more than sufficient". Herman & McLean v. Huddleston, 103 S. Ct. 683, 692 n.30 (1983).

It is clear from the findings heretofore made that each of the respondents acted with the requisite scienter in one or more aspects. Thus, with respect to the misrepresentations and omissions concerning the GWS financial condition and its bearing upon the sale of the standby with pair-off transactions Hodge and Kilpatrick clearly acted with knowledge of the inability of GWS to fulfill its obligations to the investors without hedging the transactions and of the firm's failure to hedge, or delayed in hedging, almost half of them. At the very least, these individuals acted recklessly in this regard. On the other hand, it is quite likely that the individual salesmen did not possess the requisite scienter as to these matters.

On the other hand, when these salesmen told their clients their investments would be loaned to persons in need of cash who would pledge GNMAs to secure the loans, that the investments were insured by SIPC, that the transactions were backed by a Federal agency, that there would be GNMA certificates held as security, that the customers were buying a portion of a GNMA or participating in a pool of such securities, etc., they were going off on an adventure of their own, making representations that were clearly not part of what they were told at their training sessions and beyond the confines of the transactions as offered. Hence, it must be concluded that each of them acted with knowing and intentional conduct, i.e., with "scienter".

In any event, all of the respondents have violated Sections 17(a)(2) and (3) of the Securities Act for which it is not necessary to show scienter. Aaron v. S.E.C, supra, at pp. 694, 696-7.

Respondents Hodge and Kilpatrick argue as they did with respect to their Section 5 liability that they never sold any standby with pair-offs to customers, were not responsible for the representations made by the GWS salesmen, made no representations of their own, had no knowledge of the GWS financial condition, and were not "control persons". Each urges that he cannot be held responsible either as a principal or as an aider and abettor for any misrepresentations that might have been made.

As stated previously herein with respect to the registration violations (at pages 24-26) both Hodge and Kilpatrick were responsible at least _indirectly_ and hence as principals for the activities of GWS through the salesmen and otherwise which resulted in these violations. The same reasons (including the doctrine of "participant liability") apply to hold them responsible as principals for the violations of the fraud sections. As with the Section 5 language, the proscriptions of Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act apply to those who violate "directly or indirectly". Consequently, there is no reason to probe the question of secondary (i.e., aider and abetter) liability.

Injunctions

On January 29, 1980 respondents Kilpatrick and Hodge were preliminarily enjoined from future violations of the registration provisions, Sections 5(a) and 5(c) of the Securities Act, by the United States District Court for the Western District of Tennessee. On May 5, 1980, the same Court enjoined respondents Bruce, Quarles, Shelton and Smith from further violations of the same sections of the Act. These injunctions were affirmed on appeal. See _SEC_ v. _G. Weeks Securities, Inc._, _supra_.

Having been thus enjoined, the respondents are subject to the sanctions provided in Sections 15(b)(4) of the Exchange Act.

Miscellaneous Matters

In his brief, respondent Kilpatrick challenges the jurisdiction of the Commission to sanction him in this administrative proceeding pursuant to Section 15(b) of the Exchange Act on the ground that he has not been shown to be a "broker" or "dealer" as named in Section 15(b)(4) of the Act, nor "any person associated, or seeking to become associated with a broker or dealer", as stated in Section 15(b)(6) of the Act.

Specifically, Kilpatrick asserts that there is no proof that he is associated with any registered broker-dealer, and, in particular, the registrant GWC. He asserts that the only dealer with whom he was associated was GWS, a government securities dealer exempt from registration, and therefore beyond the Commission's reach in Section 15. 40/

The record herein shows that on February 11, 1980, registrant GWC filed an amendment 41/ to its broker-dealer registration deleting, as of November 1979, a number of

---

40/ It is not clear whether the basis for Kilpatrick's contentions is that he is not now employed by a registered broker-dealer, or that he was not so employed during the relevant period. If he means the former, then his position is untenable. Otherwise, as pointed out in the Division's reply brief, one could always escape an administrative proceeding by quitting his association. Hence, the issue will be considered as one concerning his associations during the relevant period.

41/ Exhibit 44 in Evidence.

individuals including "John Taylor Kilpatrick" and respondents Shelton, Quarles, Smith and Hodge (plus a number of others) from those previously reported to have been an officer, director, or a person with similar status or functions, or a stockholder. Because of the closeness of GWS (Kilpatrick admits having been associated with the latter corporation) and the identity of names it will be presumed that the amendment refers to respondent Kilpatrick and that prior to the filing, he had, in fact, held one of the positions described from which he was being deleted. Further, Kilpatrick failed to offer testimony or proof to contradict this presumption. It is concluded that during the relevant period, he was associated with GWC, a registered broker-dealer and subject to the Commission's sanctioning jurisdiction.

Moreover, Kilpatrick admits to an association with GWS, a broker and a dealer as defined in Section 2 of the Act, but exempt from the registration requirements of the Act. 42/ Section 15(b) is not limited in it scope to imposing sanctions against registered brokers or dealers, and against those who are associated only with

---

42/ "The term 'broker' means any person engaged in the business of effecting transactions in securities for the account of others . . ."

"The term 'dealer' means any person engaged in the business of buying and selling securities for his own account . . ."

them. If that is what Congress intended, it could readily have said so. During the relevant period GWS was a "broker" and "dealer" as defined in the Act, and it is concluded that Kilpatrick's association with GWS during that period subjects him to the Commissions sanctioning power under Section 15(b). His defense based on jurisdictional grounds must fail. 43/

II

Respondents Shelton and Smith each charge, in their respective briefs, unfairness as to them because out of some 30 salesmen employed by GWS and selling standby with pair-offs only 6 including themselves have been charged in this proceeding.

Since this issue of "selective enforcement" had not been raised previously, no proof was offered by the Division to show the basis of this selection, or by the respondents to show that the Commission engaged in some invidious type of discrimination in proceeding against these 6 individuals.

In Oyler v. Boles, 368 U.S. 448, 456 (1962), the Supreme Court observed that a "consious exercise of some selectivity in enforcement is not in itself a federal constitutional violation". There must be presented a claim that the selection was deliberately based upon an

---

43/ Similarly, the anti-fraud provisions, as seen previously, have been held to apply to transactions in securities exempt from the registration requirements.

"unjustifiable standard such as race, religion, or other arbitary classification". No such claim was alleged or demonstrated herein.

In Arthur Lipper Corp. v. S.E.C., 547 F.2d 171, 182 (1976), the Court of Appeals for the Second Circuit observed that Oyler v. Boles, supra, would be "a formidable obstacle" to a claim of improper selective enforcement on the part of the Commission.

The contentions of Smith and Shelton must be rejected.

Public Interest

The respondents have been found to have wilfully violated the registration provisions and the anti-fraud sections of the securities laws. They also have been temporarily enjoined from further violation of the registration provisions. Any one of these findings supports the impositon of the sanctions set forth in Section 15 of the Exchange Act.

In assessing a sanction, due regard must be given to the facts and circumstances of each particular case, since sanctions are not intended to punish a respondent but to protect the public interest from future harm. See Berko v. S.E.C., 316 F.2d, 137, 141 (2d Cir. 1963) and Leo Glassman, 46 SEC 209, 211 (1975). Sanctions should also serve as a deterrent to others. Richard C. Spangler, Inc., 46 SEC, 238, 254 n.67 (1976).

Insofar as violations of the registration requirements are concerned, they are not merely technical. The purpose of

the registration provisions is to provide adequate disclosure to members of the investing public. S.E.C. v. Continental Com. Corp., 497 F.2d 516, 528 (5th Cir. 1974). The registration provisions have been characterized as "a keystone of the entire system of securities regulations, and set forth basic requirements for the protection of investors", Sirianni v. S.E.C. 677 F.2d 1284, 1288-9 (9th Cir. 1982), since they provide investors with the information neccesary to make informed investment decisions. S.E.C. v. Ralston Purina Co., 346 U.S. 119, 124 (1953).

The responsibility of respondents Kilpatrick and Hodge for the registration violations have hereinbefore been stated. As the prime movers and the source of all information concerning the standby with pair-off transactions their participation in and contributions to the violations are of utmost seriousness. On the other hand, and for reasons also stated previously (See pages 26-7), the four salesmen-respondents had reason to follow the lead of Hodge and Kilpatrick to a large extent under the circumstances of their participation in the sale of the unregistered standby with pair-off transactions. If their violation of the registration requirements were their only violation the record would justify only the imposition of the lightest sanction (a censure, perhaps). However, they have also been found to have violated the anti-fraud sections of the law in a significant way.

In order to appreciate the seriousness of the fraud violations herein, one must look at the realities of the transactions, not at what they purported to be. What was basically an investment or advance of a sum of money to GWS, under the promise of a fixed and guaranteed profit for the investor at some stated time in the future (and an immediately declared profit for GWS and its salesmen) became immersed in documentation giving the appearance of a forward contract in government-backed GNMAs (which it was not), paired with a standby contract in GNMAs (which it was not).[44/] The transactions were embraced within the attractive aura surrounding GMNA certificates, i.e., securities that are guaranteed as to principal and interest by the full faith and credit of the United States Government. And if the latter concept was not made clear, then pamphlets highlighting the government-guarantee feature were supplied. And if that were not sufficient, then the salesmen embellished the sales pitch with such representations as there being an investment in a portion of GNMA certificates, that such certificates were to be deposited with a bank or with GWS as security for the investment, that there was an individual "out there" who needed money

---

44/ The true forward or standby contract includes the basic element missing from the pair-off arrangement as sold to the investors - the possibility of losing part or all of the investment in an unfavorable market.

and would pledge his GNMA certificate for the loan being made to him, etc. There should be added against this background of a no-lose investment, the GWS letter guaranteeing the return of investment plus s stated profit and a "stated rate of return".

Despite the GNMA paperwork from GWS, the investors understood that there was not going to be any actual exercise of the standby or forward contracts, that they would not be obligated to buy or deliver GNMAs, and had no intention of exercising an election to take delivery if the market price rose high enough and sell to the market for an even greater profit rather than to GWS under the standby portion of the transaction. 45/ The respondents also knew this. They knew that only the resources and trading success of GWS would be able to ensure the return

---

45/ Respondents in their briefs and during the hearing have emphasized that the investors could, under the documentation issued by GWS, have taken delivery of GNMAs on settlement day under the forward contract, but, if the market price on settlement day were high enough, elect not to deliver under the standby to GWS, and to sell to market at a greater profit. They ascribe the fact that this never occurred to a declining market, although they offered no proof as to what the market did during the relevant period. The more likely reason is found in the testimony of the investors who said the exercise of such an option just never entered their minds, and was not a consideration in making their investments. Some of them admitted that they probably could and perhaps would have done so based upon what they learned afterwards and as part of these proceedings, but did not consider this at the time they made their investments. See discussions on page 14 herein.

of the investments with "interest" (or "profit", a term which they seem to prefer). It is in this aspect that their omissions and misrepresentations concerning the GWS financial condition become so significant. The salesmen were told by Kilpatrick and Hodge, and believed, that the taking of positions by GWS with Cantor and others would be the mechanism by which everyone, including themselves, would profit. [46/] It is in this aspect, also, that the failure of Kilpatrick, the trader, and Hodge, the keeper of the books and records and also trader to advise that GWS was not promptly hedging the transactions, or was taking for its own account positions on the other side of the standby with pair-off transactions (and even crediting itself with the presumed "profit" earned from itself), likewise becomes significant.

In the last analysis, Kilpatrick and Hodge were principally responsible for introducing the standby with pair-offs to GWS, for setting up the procedures under which they were sold, for promoting the sales thereof through the salesmen, for the false and/or misleading financial statements, and for the ultimate losses to investors amounting to millions of dollars.

46/ GWS was so sure of this profit, Kilpatrick already assumed it when the investment was first made long before settlement date, and paid the salesmen their commissions on the imputed profit in the transaction immediately.

However, this does not mean that the salesmen-respondents do not also share in the responsiblity, although to a lesser degree. By their acts as heretofore outlined, they had failed to observe the special relationship which a salesman or broker occupies with respect to his customers, in that, by his position, he implicitly represents that he has an adequate basis for the opinion he renders. Thus, a salesman cannot deliberately ignore that which he has a duty to know and recklessly state facts about matters of which he is ignorant. By his recommendation, he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based upon such investigation. Where he lacks essential information he should disclose this, as well as the risks which arise from his lack of information. Hanly v. S.E.C., 415 F.2d 589, 597 (2d Cir. 1969). Here, respondents made no adequate investigation as to the GWS financial condition, and there was no basis for their representations concerning the role of GNMA certificates as guarantees or security for the moneys invested.

Based upon the foregoing, it is concluded that the following sanctions be imposed upon the respondents herein:

Respondents Kilpatrick and Hodge, as the principal architects of and being fully responsible, both directly and indirectly, for the violations herein found to have occurred, should be barred from association with any

broker or dealer. Because of their Fifth Amendment stance, the record contains no assurances against their future violations of the securities laws, or that they have recognized the wrongful nature of their conduct. See Steadman v. S.E.C., 603 F.2d 1126, 1140 (5th Cir. 1979); aff'd on other grounds, 450 U.S. 91 (1981). However, in recognition of there being no proof in the record of any prior misconduct on their part, the public interest would not be adversely affected should they be allowed to reapply after two years to again become associated with a broker or dealer but only in a non-supervisory and non-proprietary capacity.

With respect to the salesmen respondents, consideration has been given in mitigation that much of their responsibility for the violations committed can be attributed to their relative lack of prior securities experience, that they had become accustomed to deal in the usual exempt transactions, and that they were misled to a large extent by the acts and representations of Kilpatrick, Hodge and Weeks. That having been said, they nevertheless should be barred from association with any broker or dealer in a supervisory and proprietary capacity, and, in addition, each should be suspended from any association with any broker or dealer, for the following periods:

Six months for respondents Bruce and Shelton, who freely conveyed to their customers, without justification, and beyond

what they were told about standby with pair-offs, that the investments were being made in actual government guaranteed GMNAs which were going to be held as security for the investments. Six months also for respondent Quarles who recklessly represented to his customers that they would be lending money to an individual having cash flow problems.

Two months for respondent Smith, who waited for several months before embarking upon the sale of the standby with pair-offs, who only sold to 2 customers during April and May of 1978 and then, long prior to the GWS bankruptcy, ceased further solicitation upon learning that some officials of the NCUA were questioning the legality of the transactions as investments for credit unions, thereby exhibiting a willingness to cease further violatative conduct. 47/

ORDER

Under all of the circumstances herein, IT IS ORDERED:

1. That Cletus Marion Hodge and John Kilpatrick, each be barred from association with any broker or dealer, provided, that after two years following the effective date of this order, each of them may apply to again become associated with

---

47/ In their briefs and arguments, the parties have requested the Administrative Law Judge to make findings of fact and have advanced arguments in support of their respective positions others than those heretofore set forth. All such arguments herein have been fully considered and the Judge concludes that they are without merit, or that further discussion is unnecessary in view of the findings herein.

any broker or dealer in a non-supervisory and non-proprietary capacity only.

2. That Bobby Bruce, William Edward Shelton, IV, and Robert Hardee Quarles each be suspended from association with any broker or dealer for a period of six months following the effective date of this order and that each be barred from association with any broker or dealer in a supervisory or proprietary capacity.

3. That Carlos Arturo Smith, Jr., be suspended from association with any broker or dealer for a period of 2 months following the effective date of this order and that he be barred from association with any broker or dealer in a supervisory or proprietary capacity. 48/

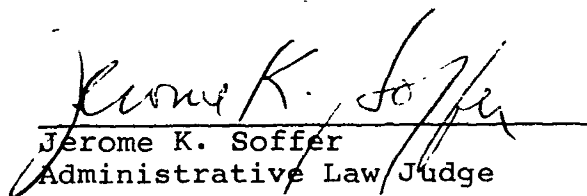
This order shall become effective in accordance with and subject to the provisions of Rule 17(f) of the Commission's Rules of Practice.

Pursuant to Rule 17(f), 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),

---

48/ A permanent bar order is not necessarily an irrevocable sanction; upon application the Commission, if it finds that the public interest no longer requires applicant's exclusion from the securities business, may permit his return. Hanly v. S.E.C., supra, at p. 598.

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.



Jerome K. Soffer
Administrative Law Judge

December 20, 1984
Washington, D.C.