ADMINISTRATIVE PROCEEDING
FILE NO. 3-5788

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of :

DON A. LONG :

INITIAL DECISION

Washington, D.C.
June 30, 1980

Jerome K. Soffer
Administrative Law Judge

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APPEARANCES:

Thomas H. Monahan, Steven M. Steingard and Dennis R. Surprenant, of the Philadelphia Branch Office, for the Division of Enforcement of the Securities and Exchange Commission.

John H. Saling and Wayne M. Whitaker, for respondent. Don A. Long, respondent, pro se.1/

BEFORE: Jerome K. Soffer, Administrative Law Judge

1/ John H. Saling, Esq., represented respondent for the duration of and only at the hearing. Wayne M. Whitaker, Esq. represented him during all pre-hearing and post-hearing procedures prior to the submission of his proposed findings of fact and conclusions of law and supporting brief. These post-hearing pleadings have been filed by respondent himself, having elected to appear pro se from that point on. Neither Mr. Saling nor Mr. Whitaker currently represent respondent.

On July 5, 1979, the Commission issued an Order for Public Proceedings (Order) and Notice of Hearing pursuant to Section 203(f) of the Investment Advisers Act of 1940 (Advisers Act) naming Don A. Long as respondent.

The Order is based upon allegations of the Division of Enforcement (Division) that respondent wilfully violated and wilfully aided and abetted violations of the registration procedures of the Securities Act of 1933 (Securities Act), the anti-fraud sections and rules thereunder of the Securities Act, the Securities Exchange Act of 1934 (Exchange Act) and the Advisers Act, and the record-keeping provisions of the Advisers Act. The Order further alleges that respondent has been permanently enjoined by a United States District Court from violating various provisions of the securities laws and rules.

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. Hearings were held before me on December 17, 18, and 20, 1979, on January 14, 15, 16, and 17, 1980.[2/] After the close of the hearings, proposed findings of fact and conclusions of law and supporting briefs were filed by the Division. Respondent filed his pro se brief (see footnote 1)

2/ Upon motion by counsel for the Division, the Order was amended to conform to the proof adduced at the hearing.

to which the Division replied.[3/]

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 standard of proof applied with respect to the charges of violations of the anti-fraud provisions of the securities laws is that the allegations with respect thereto be proven by a clear and convincing evidence. The standard of proof regarding the other charges in the Order is that the allegations be established by a preponderance of the evidence.[4/]

3/ Prior to filing his brief, respondent had moved this administrative law judge for an indefinite stay of his time to serve his post-hearing pleadings in order to allow the Commission to inquire into his charges made at about the same time that a member of the Commission's staff had engaged in improper conduct with respect to respondent's affairs. The substance of these charges are discussed hereinafter. Respondent's motion was denied by me, and he filed his brief pro se some 9 days after the time previously fixed for him to do so.

The Division has objected to the receipt of his pro se brief as being out of time and improperly filed by him since he was still represented by two counsel of record, neither of whom has withdrawn. These objections are overruled and the pleading received. The late filing did not prejudice the Division in any way, and counsel had previously advised orally that they no longer represented respondent.

4/ In Collins Securities Corporation v. S.E.C., 562 F.2d 820 (1977) the Court of Appeals for the District of Columbia Circuit held that although the traditional standard of proof in an administrative proceeding is the preponderance of evidence standard, where in such proceeding fraud is charged and there may be involved a heavy sanction resulting in the deprivation of respondent's livelihood, the "clear and convincing" standard of proof should be applied. The application of the "clear and convincing" standard in administrative proceedings charging violations of the anti-fraud Sections has recently been re-affirmed in Whitney v. S.E.C., No. 78-1326, D.C. Circuit, June 28, 1979. In other proceedings, the "preponderance" standard continues to be applied. Thus, the Commission has rejected the "clear and convincing" standard of proof with respect to charges of record-keeping violations in Hinkle Northwest, Inc., SEA Release No. 15338 (November 16, 1978), 16 SEC Docket 173. However, application of the "clear and convincing" standard of proof to all of the charges would not change my findings herein.

The events leading up to the circumstances involved in this proceeding have their beginning in 1972 at the University of Texas where a group of some ten students, including respondent and one Kenneth Cherry, as part of a practical demonstration business project in connection with their business courses, embarked upon the operation of an investment advisory service. On November 13, 1972, these students organized Galaxy Investment Advisory Service, Inc. (Galaxy), a corporation in which they were the stockholders. They adopted by-laws, elected directors, and appointed officers from among the ten of them. Respondent was elected secretary and chairman of the board of directors. The corporation registered as an investment adviser pursuant to Section 203 of the Advisers Act on May 9, 1973. In connection with its activities, the students formed their own investment club for which Galaxy was to serve as investment adviser. From the very beginning, respondent took an active interest in Galaxy.[5/]

Upon graduation, the students went their separate ways (respondent went into the United States Navy) and Galaxy became a dormant corporation. As time went on, some of the class members sold their shares to other individuals. Respondent Long owned no more than 22% of the outstanding capital stock at any time.[6/]

5/ The registration of Galaxy as an investment advisor has been revoked on consent in the Commission's Order adopted simultaneously with the Order for Proceedings herein and bears the same administrative proceeding file number of 3-5788.

6/ The records on file with the Commission show that among the stockholders of Galaxy are Jerry Glen Swor and Ace Freeman Trask each owning between 25-50% of the stock, and that there are seven remaining stockholders, including one Kenneth Cherry, each of whom is listed as owning less than 10% of the stock. Over the years there have been other stockholders owning varying amounts of stock who have since sold out their interests.

After his tour of duty in the Navy, respondent moved to Pennsylvania for a brief association with an investment adviser. In June of 1975, with the apparent consent of some of his former college associates, he proceeded to reactivate Galaxy by entering into an arrangement with a firm known as Main Line Consulting (ML Consulting) in the joint promotion of an investment advisory service under the name of Main Line Investments (ML Investments). He assumed the role of "Chief Executive Officer" of Galaxy while still continuing as its secretary and board chairman.

The written agreement dated September 12, 1975, between Galaxy and ML Consulting, initially described the business of the resulting partnership, ML Investments, as "financial consultation and investment" but by later amendment was changed to read, "to promote and sell the services of Galaxy". There was no investment by either party. The exclusive management of the partnership affairs was the responsibility of respondent. All income (i.e., fees) generated by the partnership was to be paid to him for his services until some indefinite future time when some other disposition of the earnings would be agreed upon by the partners. ML Consulting was to pay all the expenses (including Long's salary) of the partnership, and provide office space and employee services.

ML Consulting had been engaged primarily in selling insurance. It also offered individual and corporate financial planning advice for a fee. It intended through the formation of the partnership to offer an investment advisory service to existing and potential customers

as part of an entire package and thereby enhance its sales efforts for its insurance business. ML Consulting had no other role to play but to pay expenses, and provide needed office services and facilities, although its salesmen, numbering generally between 4 and 6, were to solicit among their customers and prospects for the advisory services offered by ML Investments.

As a result of this arrangement, respondent had found a vehicle for functioning as an investment adviser and employ his market techniques, under the umbrella of Galaxy's investment adviser registration, 7/ without having to invest any equity or operating capital of his own, or to register himself as an investment adviser, and to enjoy, at least for the first few years, all of the fees generated as a result of his advisory activites.

The Investment Clubs

The principle activity of ML Investments was that of an investment adviser for three investments "clubs" organized by respondent in late 1975, and for a number of individual clients. These clubs were designated as Main Line Growth Investment Club (ML Growth Club), Main Line Municipal Bond Club (ML Bond Club) and Main Line Savings Club (ML Savings Club), having investment objectives conforming to their names and as expressed in membership agreements and oral representations hereinafter described. Their initial membership was drawn from ML Consulting employees and their friends and neighbors. From among them respondent selected officers for each club whose sole function was to sign checks for the respective club. They performed

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7/ Galaxy also registered as such with the Pennsylvania Securities Commission.

this function when and as directed by respondent, never questioning what the checks were for or participating in any decisions concerning their issuance. The officers made no investment decisions. Each of the clubs had its own bank account. The books and records for each of them were kept on the premises of ML Investments and maintained by the employees borrowed from ML Consulting who were also made club officers.

After respondent's initial organization of the clubs, solicitation for additional members was done by letters mailed by ML Consulting to its customers and prospects, and also used by its salesmen. At least one of the salesmen, Park Messikomer, employed a letter of his own creation which he sent to prospects describing each of the 3 investment clubs, and their current yields or rate of gain. The statistical information varied from time to time but the contents of the letter had been submitted to and approved by respondent. 8/ Long described Messikomer as the most productive of all ML Consulting salesmen.

It was the practice of the salesmen to recommend prospects who had more than $10,000 to invest directly to Mr. Long for an individual account. Those prospects who had less than this sum (the great majority) were invited by the salesmen to join one of the investment

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8/ Respondent denies that he had ever approved this letter. However, the testimony of Messikomer and of the secretary who prepared the letter to the effect that both of them had submitted this to respondent for approval is deemed to be the more reliable interpretation. In fact, respondent insists he was not aware of the solicitation letters being sent. The record shows otherwise.

clubs and these individuals also were referred to Mr. Long for further consultation.[9/] The salesmen were provided with copies of semi-annual reports prepared by ML Investments, and they were instructed concerning the investment objectives of the respective clubs by respondent to whom they looked for supervision in this respect. There were no limitations and guidelines as to who could be a club member.

The investment purposes of the respective clubs were set forth in a memorandum of agreement which every club member was given to sign and were consistent with the oral representations made to them either by the ML Consulting salesmen or by Long personally as "managing partner" of ML Investments.[10/] Specifically, the agreement with the ML Growth Club stated as its purpose "to invest in the stock market for growth", of the ML Bond Club "to invest in tax-free municipal bonds", and of the ML Savings Club "to invest in interest-earning securities and high-dividend yielding securities within the utilities industry".[11/]

9/ The ML Consulting salesmen's compensation for their activities generally was on a commission basis. At first, they received no additional compensation for soliciting either club members or individual investor accounts. However, in 1977 a form of compensation was provided for them taken from a 1% levy on new accounts.

10/ In actual practice, the members of the clubs as well as the individual clients believed themselves to be represented by ML Investments in the person of respondent and did not even know of the existence of Galaxy.

11/ Respondent prepared the agreement memoranda for the clubs, drawing upon model charters offered by the National Association of Investment Clubs, an organization which he caused the Clubs to join.

ML Growth Club initially invested in common stocks but later changed to no-load mutual funds under a technique used by respondent involving the switching of monies from one fund to another as market conditions varied. ML Bond Club invested in medium-grade municipal bonds purchased at a discount because of their quality, but which would be insured with Mortgage Guarantee Insurance Corporation (MGIC) against loss due to default. ML Savings Club purchased discounted corporate bonds and held them until maturity, in the meantime enjoying their income. All of these techniques were explained by respondent to prospects and club members, and they understood that respondent was to have complete investment discretion in meeting these objectives.[12/]

The three Clubs continued to grow both in the number of members and the assets under their control. Thus, ML Growth Club expanded to about 170 members and had about $2.5 million assets, ML Bond Club had about 68 members and some $1.5 million in assets, and ML Savings Club had some 40 members with some $200,000 in assets. By December 1977, ML Investments also had under management about $600,000 for individual clients. In late 1977, respondent organized the Main Line Resource Development Club (ML Development Club) with the avowed purpose of investing in "tax shelters", such as geo-thermal energy, oil and gas ventures, and housing projects.

Respondent came to believe that, because of the large numbers of members, particularly in ML Growth Club, there may have developed a need to register one or more of them as a "mutual fund" (i.e.) as

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12/ The individual accounts executed powers of attorney to respondent and to ML Investments to manage their accounts.

investment companies.[13] Consequently, he divided ML Growth Club into two parts, "I" and "II", on an alphabetical basis. Despite the split, both parts of the Club retained common officers and common bank accounts. The ML Bond Club was split into four entities for the same reasons and on the same basis.

The various clubs had periodic meetings, generally every three or six months, where respondent would explain his investment objectives and relate the previous successes in his trading practices. At least at one of these meetings, he discussed the possible effect resulting from the large number of members being acquired and explained the advantages and disadvantages of becoming a "mutual fund" or of continuing as an investment club by splitting into smaller groups.[14]

13/ It was respondent's understanding that bona fide investment clubs could start with no more than 35 members, add no more than 15 per year, and could reach a maximum of no more than 100 members.

14/ One of the confusing aspects of this case is in determining the lines of demarcation establishing who or what was the adviser and who or what were the clients. The only registered investment adviser, Galaxy, which was theretofore dormant, joined with ML Consulting, an insurance selling firm, in forming ML Investments in order to promote the investment advisory activities of respondent. He held himself out as the "managing partner" of ML Investments, although he had no personal partnership interest therein. Solicitation of clients was in the name of ML Investments rather than Galaxy, whose existence was not disclosed to prospects and who received none of the advisory fees. Neither respondent nor ML Investments was ever registered as an investment adviser (although both would seem to meet the definition thereof in Section 202(a)(11) of the Act).

The identity of the clients of the investment advisory service is similarly fudged. Were they the three (later four) clubs, who were created by and actually under the control of respondent - or were they the members thereof? The members were solicited by salesmen of ML Consulting with a follow-through by respondent, who reported to them directly by letter through ML Investments and at club meetings, rather than to their club officers.

This fuzziness is apparently the result of the efforts on the part of respondent and his associates to bring their investment adviser activities under the cloak of Galaxy's registration, and to deal with groups of investors in a common fund as if they belonged to bona fide investment clubs exempt from the registration provisions of the Investment Company Act.

In the summer of 1977, respondent invited Kenneth Cherry, one of the students at the University of Texas who participated in the Galaxy project, to leave his employment with a stock broker and join him in his activities at ML Investments and eventually to take over many of Long's duties. It was respondent's intent to free himself from his activities there in order to have more time to devote to his oil well activities in which he was very interested. He also wanted Cherry to bring the books and records into compliance with regulatory rules and statutes.

An agreement dated August 29, 1977, was entered into in which respondent granted Cherry a portion of his interest in certain oil drilling joint ventures known as "NFL I" and NFL II",[15/] together with an interest in whatever future oil, gas or mineral activities respondent would become engaged. Earlier, in July of 1977, Cherry and respondent had already become associated in NFL II with three other individuals, including a Mr. Chester Franecke. These other individuals supplied all of the capital for the venture, and in return for their advice and expertise, respondent and Cherry each received a 3 percent interest in the venture, to be apportioned after return of investment capital.

The Specifications of Fraudulent Impropriety

The Order specified a number of acts which are embraced within the allegations therein charging fraudulent conduct. A discussion of these actions follows.

15/ The "NFL" letters stand for three individuals, Niebler, Franecke and Long (respondent).

The Chester Franecke Loan

Between August 25 and September 16, 1977, respondent caused ML Growth Club to lend a total of $150,000 to Chester Franecke, who had expressed to him an urgent need for funds to pay for the drilling of wells for the NFL II venture. Respondent instructed the appropriate ML Growth Club officers to make the transfers from the Club bank account to Franecke's account in a Texas bank, without advising them of the use to be made of the funds. The loan was unsecured, not even by a promise by Franecke to repay, and respondent was reluctant to ask him for one since he believed Franecke to be too substantial financially to be embarrassed by such a request. Later on, at the insistence of Mr. Cherry and the threat of legal action, Franecke did execute a series of promissory notes payable to ML Investments and ultimately repaid the loans plus interest.

Respondent felt justified in making the loan as being made out of idle funds at an attractive rate of interest, "approved" by ML Growth Club officers, and made within his claimed "inherent authority" over any account he managed. Although his testimony is contradictory as to whether he knew that the funds loaned to Franecke were to be used in drilling wells of NFL II in which he had a 3% interest,[16/] it is clear that he did so know.

16/ Page 103 of Exhibit 107, Transcript pages 995, 1000, and 1001.

The Mitchton Loan

On or about August 15, 1977, Long directed ML Growth Club to lend $75,000 to Mitchton, Ltd., a land developing company in which Charles A. Mitchell, president of ML Consulting had a one-half interest. A check was drawn on that date and signed by an officer of the Club. On August 17, Mitchton, Ltd. and ML Growth Club entered into an agreement and Mitchton signed a promissory note for the repayment of the loan, plus interest and a loan placement fee at the then prevailing market rates. Mitchton needed the money to complete a real estate purchase, and did have a commitment from a purchaser of other of its property out of which it expected to meet the payment. The loan was repaid within 60 days, with interest. Respondent explains that the loan was secure and was made out of idle funds not then earning sufficient interest.

The Manoogian Loan

Mr. and Mrs. Robert Manoogian operated a restaurant in the same shopping center where ML Investments and ML Consulting maintained their offices. In August of 1977, the Manoogians advised respondent, who was a regular customer, that they were in serious debt amounting to about $15,000 and he agreed to arrange for a loan to them. On August 30, 1977 he caused ML Growth Club to transfer $15,000 from its account to that of ML Investments, over whose checks respondent had signatory power. On the same day, he prepared and signed three checks totalling that amount drawn on ML Investments' account, payable to the respective

creditors and to Manoogian personally. He prepared a short memorandum signed by the Manoogians in which they agreed to repay the loan personally to respondent at the rate of $190 a month over a 10-year period. Respondent also prepared a "guarantee agreement" which was signed by Mrs. Manoogian's mother. Subsequently, commencing in October 1977 and for each of the next three months, the Manoogians paid Mr. Long personally $190 in cash. After December 1977, when he did not appear to collect the monthly payments, the Manoogians deposited the amount due in a separate escrow account in respondent's name until they ran out of money.

The Manoogian's did not know where the loan funds were coming from, but they understood they owed the money to respondent personally. The responsible ML Growth Club officer did not know what the money represented nor for what purpose they were to be used, merely following respondent's instructions. Finally, on September 8, 1977, as reimbursement to ML Growth Club, respondent directed Sylvia Clark, an officer of ML Bond Club (and an employee of ML Consulting), to transfer $15,000 of its funds to ML Growth Club. She did not know what the money was for. Respondent later explained to Cherry that the Bond Club funds represented "excess income" to that club derived from the payment by the insurer of a defaulted municipal bond of an amount greater by $15,000 than the original cost of the bond. He considered this an unexpected "windfall profit". He also told Cherry that he arranged for the repayment of the loan to himself personally

as representing commissions and fees owed to him by ML Bond Club for his advisory services, but that in any event he intended to repay ML Bond Club out of anticipated oil and gas venture profits. 17/

As a result of these transactions, respondent was able to divert "excess funds" of ML Bond Club derived from its MGIC insurance, and actually belonging to that Club's members, into a $190 monthly repayment to himself for 10 years. He justified the transaction because the Manooginas were "religious" people, that ML Bond Club had funds which were lying idle anyway, that this was really a personal loan by him since he had intended to reimburse ML Bond Club which allegedly did not sustain any losses, and that the funds were initially drawn on ML Growth Club in error. None of these explanations is substantiated by the record herein.

The $20,000 Loan

On March 23, 1977, a respondent directed ML Bond Club to advance $20,000 to ML Investments which, together with $10,000 of other funds, was forthwith used to purchase an interest in "Republic Geo-Thermal Energy Program" on behalf of the ML Resource Club. The records do not show that the $20,000 was ever repaid to the Bond Club by Investments or the Resource Club. The ML Bond Club officer who drew the

17/ At the hearing, he testified that the ML Bond Club was reimbursed with money loaned to him by a friend in Texas. This claim is not corroborated in the record.

check from Growth to Investments did not know what it was for. Respondent explained that the transaction was done to correct an inadvertent deposit into the Growth Club account of funds invested by an individual intended for the ML Resource Club.[18/]

The Messikomer/Sanders Real Estate Deal

In late 1975, Mrs. Margaret Messikomer, a widow and the mother of Park Messikomer, retained respondent individually as an investment adviser with full discretionary authority over her finances with the understanding that she was interested in income. At respondent's behest, she opened accounts with three different brokerage companies and gave him power of attorney with respect thereto.[19/] He promised to keep her apprised of all investments made on her behalf.

Thereafter, respondent made a number of investments for Mrs. Messikomer in margin accounts, and opened accounts for her in ML Bond Club and ML Growth Club, in neither of which did she sign the usual membership agreement nor was she advised of the investment policies of the clubs. Respondent also used her funds in a real estate transaction involving the private home of one of his neighbors, Theodore Sanders, under the following circumstances:

18/ However, this testimony is in sharp contradiction to his testimony given in his deposition in the civil injunction action that the $20,000 was "excess"funds of ML Bond Club which he intended to repay if the Resource Club got more members, which it did not.

19/ The record contains a power of attorney from her to respondent over one of the brokerage accounts which was signed in her name by her son who did so at the suggestion of respondent. The signature was witnesses by Sylvia Clark and acknowledged before a notary, neither one of whom saw Park Messikomer sign it for his mother.

On July 15, 1977, respondent, knowing that Cherry would need a place to live when he arrived to join the management of ML Investments and that Sanders was looking to sell his house, entered into a written agreement with Sanders whereby respondent personally advanced him the sum of $10,000 by his own check, which he was to be repaid out of an ultimate sale of the property. The agreement provided that when such sale took place, respondent would also receive all proceeds exceeding $43,500 as his profit. Respondent undertook to keep up the mortgage payments on the property and to be responsible for insurance and all other expenses in connection with the maintenance of the home. On its face, this agreement was personal between Sanders and respondent, individually and not as representing any one else. On July 18, 1977, respondent caused ML Growth Club to draw $10,000 from the account of Mrs. Messikomer, which he then deposited in his own checking account to cover his check to Sanders.[20/] At that time, Respondent intended that this house be occupied by Mr. Cherry as his residence while working for ML Investments and that Cherry would pay the mortgage payments and all upkeep expenses that respondent had promised Sanders he would take care of. In fact, Cherry did just that.

More than seven weeks later, on September 7, 1977, respondent wrote to Mrs. Messikomer advising her for the first time that he had invested $10,000 of her money in the home bought from Sanders, that

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20/ Interestingly, the check transferring $10,000 from Mrs. Messikomer's account at ML Growth Club to the personal account of respondent was signed by her son as an officer of the Club. He did not know what the check was for.

ML Investments had agreed to make the mortgage payments as well as other maintenance expenses[21/] and that upon the sale of the home she would receive 1/2 of any profit derived. The letter further advised that during the interim ML Investments would credit her account in ML Growth Club with 8 per cent return on the money advanced. The letter professed to "confirm" an agreement whereby her profits from the sale of certain bonds and "additional dollars" making a total of $10,000 were the source of her investments in the Sanders' real estate. However, neither at that or any other time did respondent ever give her a copy of his agreement with Sanders.

Some four days later, on September 11, 1977, Mrs. Messikomer wrote respondent seeking to terminate the financial agreement between them because of his failure to keep her apprised of the investments he was making for her. Specifically, she asserted that the undertaking with respect to the Sanders' property, as appeared in the letter to her, was not in accord with their verbal commitments. She also questioned the source of the "additional dollars" used to make the investment in the property.

It should be noted that the agreement between Sanders and respondent on July 15 was a private one between them concerning a prospective sale of the house by respondent for Sanders and made no reference to Mrs. Messikomer, the fact that her monies were the

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21/ In direct disagreement with the terms of the Sanders/Long contract which did not involve ML Investments.

source of the $10,000 advance to Sanders, or any other reference to her having any possible interest in the profits or otherwise in the house. Respondent for his part, asserts that he entered into this transaction to satisfy repeated requests by her for a real estate investment, and that he had, in fact, discussed the Sanders deal with her. She, on the other hand, expressed surprise upon receiving the letter of September 7, 1977, insisted that she never authorized an investment of this size in real estate and was not interested in doing so, and that her principal interest was in income. Her testimony is believable.[22/]

Subsequently, when Sanders entered into a sale of the property unaware of Messikomer's interest in the transaction, she brought suit against him to impress an equitable trust on the proceeds to protect her investment. The suit was settled upon payment to her by Sanders of $9,000 out of which she had to pay counsel fees. Respondent comments that (transcript p. 1034): "I believe Mr. Sanders went the extra mile to give Mrs. Messikomer the $10,000 because he didn't in fact know that she was the party that had put the $10,000 up; he was really giving Coleman (the attorney) and Mrs. Messikomer quite a bit of faith; I mean he could have been giving the wrong party the $10,000".

22/ Respondent insists that Mrs. Messikomer was after him to invest in real estate, and that she was "a little bit scatter brained". (Transcript, p. 1026). However, based upon her demeanor and her testimony, as observed by me at the hearing, such a characterization of her was totally unjustified.

Although respondent denies personally profiting from the transaction, he, by using Mrs. Messikomer's $10,000, with maintenance expenses paid by Sanders, and interest on her money paid by ML Investments, put himself in the position of obtaining one-half of the profits to have been derived from the ultimate sale of the house by Sanders. It would further appear that other than respondent's promise that Mrs. Messikomer would get one-half the profits of the sale there was no record of her $10,000 interest in the property and surely none that made Sanders or any one else aware thereof.

Commingling and Taking Control of Client Funds

As seen, respondent caused to be transferred $10,000 from Mrs. Messikomer's Growth Club account into his personal checking account to cover his check to Sanders given to acquire his interest in the profits from the sale of Sanders' home. He caused $15,000 to be transferred from ML Bond Club's account to ML Investments so that he could personally draw the checks to the Manoogians to be converted into a personal transaction for his benefit. He used the bank accounts of ML Investments as conduits for transferring funds of the respective clubs to other clubs or investments, such as the investment by ML Bond Club on behalf of ML Resources Club in the Republic Geo-Thermal deal. In fact, the respective bank records showed constant transfers of funds from one Club account to another.

The records show numerous examples of monies issued by ML Investments to respondent personally and deposited in his own account. During the year 1977, these deposits amounted to about $200,000.

Respondent urges that in all of these instances these monies were put into his account to reimburse him for funds that he had laid out in connection with various oil well investments on behalf of club members or individuals who were investing therein.

This taking control of client funds extended to the individual investors as well as club members. Thus, on September 14, 1977, one Michael Squyres, having some $55,000 to invest on a short-term basis, agreed with respondent to invest $8,000 in an oil venture and to lend ML Investments the balance of $47,000 which could be used for investments in oil drilling projects and to be returned to him on demand. Respondent thereafter caused the $47,000 to be transferred from ML Investments to the credit of his personal account in ML Growth Club, from whence they were invested in two oil ventures in Squyres' name.

The Keeping of Books and Records

When Mr. Cherry joined respondent in Philadelphia in September of 1977 to assume operations of the advisory service, he was also to straighten out the books and records and to effect compliance with the Commission's regulations. He found that the only records of Galaxy consisted of a financial statement approximately 9 months old and a cash receipts and disbursements book that had not been posted in approximately 9 months. The records of ML Investments consisted only of a check-book and bank statements. The books and records of the investment clubs consisted merely of a checking account for each club and ledger sheets for individual members showing the amounts of their respective deposits and withdrawals, and the number of shares held by each at any given time. He could not determine

from the books whether the clients of the advisory service were the investment clubs or the individual members thereof.

The ledger sheets maintained for club members were not posted on a daily basis nor were checks issued to the members promptly. The value of the individual shares of the members was not computed daily. Rather, this was done about 2 or 3 times a month.

An investigation in November of 1977 of Galaxy's books and record by a securities compliance examiner of the Commission disclosed the existence only of cash receipts and disbursement ledgers which had not been posted for 6 months. The only other records discovered were the ledger accounts for the individual club members, and the respective checking accounts for Galaxy, ML Investments, and the individual clubs, plus a cash receipts and disbursements journal for ML Investments.

In January of 1978, pursuant to an Order of the District Court hearing the injunction action, a firm of certified public accountants was engaged by Mr. Cherry to perform certain accounting functions including the setting up of basic accounting records, which did not then exist, such as cash receipts journals, cash disbursements journals general journals and general ledgers, and bring all accounting records up to date on behalf of Galaxy, ML Investments, the three investment clubs and the individually managed accounts. They prepared for each of the clubs cash receipts and disbursement journals and a general ledger, based upon the bank recrods and brokers' confirmations and statements.

None of the investigations disclosed that any verification of funds and transactions in the club accounts and members' accounts had ever been conducted by an independent accountant.

ML Investments did not make financial reports to the respective club officers on a club basis. When requested by club members, monthly statements showing only the total value of their shares were sent. Additionally, ML Investments sent club members every six months a statement of activities, which usually consisted of a covering letter in narrative form by respondent describing generally his investment activity during the previous period; a list of each individual account by social security number and the value of each; a statement of trades made, identified as either a buy and sell transaction, the amount thereof, and the profit or loss derived, without naming the particular security traded; a balance sheet for the particular club, and a graph comparing the increase in value of the club's shares as compared to other indexes. No other written report was sent to the individual club members as to the transactions engaged in on their behalf. The individual accounts being managed by respondent did receive from the involved stock brokers monthly statements of transactions on their behalf, as well as confirmations of sales and purchases executed on their behalf under respondent's direction.

Discussion and Conclusions

The Injunction

By virtue of the fact that the United States District Court for the Eastern District of Pennsylvania had entered an order on

October 20, 1978, as amended on January 11, 1979, permanently enjoining respondent from violations of the anti-fraud provisions of the Advisers Act and the Exchange Act, and Rules promulgated thereunder, and of the record-keeping of requirements of the Advisers Act, the Commission's jurisdiction to impose sanctions has been established under Section 15(b)(4)(C) of the Exchange Act.

The Section 5 Violations

The Order for Proceedings charges that from September 1975 through December 1977 (the relevant period) respondent, directly and indirectly, wilfully violated and wilfully aided and abetted violations of Section 5(a)and 5(c) of the Securities Act[23/] in the offer and sale of securities in the form of interests in ML Growth Club, ML Bond Club, and ML Savings Club at a time when no registration statements were filed or were in effect with the Commission with respect to these securities.

The threshold question is whether memberships in these clubs constitute "securities", defined in Section 2(1) of the Securities Act as "a note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any

23/ These Sections provide, in part, that unless a registration statement is in effect as to a security, it is unlawful for any person to sell or offer to sell such security through the means and instrumentality of interstate commerce and the mails.

profit-sharing agreement . . . investment contract . . . or in general, any interest or instrument commonly known as a 'security', . . . or right to subscribe to or purchase, any of the foregoing.[24/] (underlining added).

Whether the interests acquired by the individual club members were securities would depend upon whether these interests constituted "investment contracts" within the meaning of the statute. A number of decisions of the Supreme Court, including S.E.C. v. Howey Company, 328 U.S. 293 (1946) and United Housing Foundation v. Forman, 421 U.S. 837 (1975), have set forth four elements which must be found to be present in any economic relationship to give rise to the existence of an investment contract. These elements are: (1) an investment of money or tender of initial value, (2) in a common enterprise or venture, (3) with a reasonable expectation of profits, (4) to be derived from the undeniably significant or essential managerial or entreprenurial efforts of others which affect the failure or success of the enterprise.

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 security laws, and, in searching for the meaning of that term, form should be disregarded for substance with the emphasis place upon "economic reality". See S.E.C. v. C.M. Joiner Leasing Corp., 320 U.S 344, 351, (1953);

24/ The same language is found in Section 3(a)(10) of the Exchange Act.

S.E.C. v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963); and Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

Under the foregoing criteria, it is clear that the membership interests in the respective investment clubs constitute "investment contracts", and hence, "securities", within the meaning of the Act. Specifically, each member invested money in the common enterprise (i.e., the "Club"), in order to earn profits derived exclusively from the investment efforts of respondent.

From the record herein, it is found that respondent was offering and selling securities in the form of interests in the respective clubs and was using the mails and other means and instrumentalities of interstate commerce in so doing. He organized these "clubs" to be clients of Galaxy and, more specifically, of himself as adviser, in much the same way that the student-organized club was the client of student-organized Galaxy back in his college days. Respondent personally advised the salesmen of ML Consulting as to the investment aims and objectives of the clubs and directed their solicitation of potential members. He approved the form of and the use by them of letters of solicitation which were mailed to prospects. He personally consulted with these and other prospects, informed them of the respective clubs' investment objectives and recommended in which of the respective clubs they should invest their monies. He acted directly on his own behalf and indirectly for ML Investments in whose name he conducted these activities.

There is no claim that the involved securities were ever registered, nor were they exempt under Sections 3 and 4 from the registration

requirements of the Securities Act. Moreover, no claim for exemption has been raised herein by respondent.[25/]

It is concluded that under the circumstances disclosed respondent not only engaged directly in the unlawful sale of the securities described herein, but actively aided and assisted others in their solicitation and sale, all in wilfull[26/] violation of the registration provisions of Section 5 of the Securities Act. Public policy strongly supports registration as a protection to investors by promoting full disclosure of information thought necessary to informed investment decisions (S.E.C. v. Ralston-Purina, supra, page 124), and respondent's violations herein justify the imposition of sanctions.

The Books and Records Violations

The respondent is charged with having, during the relevant period, directly and indirectly, wilfully violated and aided and abetted the violation of the record-keeping provisions of the Advisers Act and pertinent Rules thereunder, in causing Galaxy to fail to

25/ It is well settled that the burden of proving the availability of an exemption from the registration requirements of the Securities Act rests with the person claiming the exemption (S.E.C. v. Ralston-Purina Company, 346 U.S., 119, 126 (1953); and Herbert L. Wittow, 44 S.E.C. 661, 671 (1971). Even where the exemption is relied upon, it must be strictly construed against those claiming it. Quinn & Co. v. S.E.C., (10th Cir. 1971) 452 F.2d 943, 946.

26/ It is well established that a finding of wilfulness does not require an intent to violate the law; it is sufficient that the person charged with the duty consciously performs the acts constituting the violation. See Billings Associates, Inc., 43 S.E.C. 641, 649 (1967); and Hughes v. S.E.C., 174, F.2d 969, 977 (C.A.D.C., 1949).

make, keep and preserve certain books, records and documents, as required, including the maintenance of an accurate form ADV, its application for registration as an investment adviser.

Section 204 of the Advisers Act requires every investment adviser to make and keep such records and make and disseminate such reports "as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors". Rule 204-2 promulgated thereunder requires every investment adviser to make and keep true, accurate and current a number of books and records embracing, among others, a journal or journals including cash receipts and disbursements records; general and auxilliary ledgers reflecting assets, liability, reserve, capital, income and expense accounts; specified memoranda of each order given; check books, bank statements, canceled checks, all bills or statements paid or unpaid, and numerous others. During the relevant period, the only financial records kept by Galaxy, the registrant, were a checkbook and a cash receipts and disbursements journal which, at the time of their examination, had not been posted for six months. The records maintained by ML Investments, the partnership through which Galaxy ostensibly functioned, consisted only of its checking account transactions. The individual clubs had check account records, and individual ledger sheets for each club member as maintained by the employees of ML Consulting.

It is clear that neither the records maintained by Galaxy nor by any of its affiliated entities were in compliance with the requirements of Rule 204-2. Respondent recognized that it was his

ultimate responsibility, as the "chief executive officer" of Galaxy and the "managing partner" of ML Investments, for the maintenance of proper books and records. By his own statement, he turned this responsibility over to a bookkeeper who did not have experience in maintaining the books and records of an investment adviser with very little supervision on his part. He made no inquiry to find out what books and records should be maintained, although he was aware that the books were not up to date. One of his professed reasons for engaging the services of Mr. Cherry was to straighten out the books and records and to get them in compliance.

With respect to the charges relating to Galaxy's form ADV, Rule 204-1 of the General Rules and Regulations to the Advisers Act requires that an amendment to form ADV is to be filed whenever the information therein becomes inaccurate.

Galaxy's ADV was originally filed January 28, 1973, and thereafter amended from time to time. It is the contention of the Division that the information therein, as found in late 1977 by a Commission examiner, contained serious inaccuracies which respondent, as Galaxy's chief executive officer, failed to amend by the required filing. The alleged inaccuracies are found on an amended page 3 of the form, as filed by respondent on Galaxy's behalf on March 23, 1976.

Specifically, the Division challenges the statements in the DMV form in which Galaxy, the registrant, states that it is furnishing "investment supervisory services" (defined as the giving of continuous advice to clients as to the investments of funds on the basis of individual needs of each client), and, further, that it does not manage securities accounts for clients under circumstances

not involving "investment supervisory services". Assuming that the activities of ML Investments are those of Galaxy, it is not at all clear that these statements are incorrect with respect to the services provided to the Clubs as a group or to the individual accounts of customers who were not club members. The testimony of those witnesses who also had individual accounts, i.e. Mrs. Messikomer and Mr. Squyres, would seem to indicate that they were getting advice which appears to be based to some extent on their individual needs. The Division's brief is lacking in any specificity to sustain its contentions; it cannot be concluded that the challenged statements are incorrect.

The Division further contends the statements in the form ADV that Galaxy does not engage in any business or profession other than acting as an investment advisor is incorrect, since respondent using Galaxy as a base was involved with oil well drilling and similar ventures, and advising individuals to transfer their funds into these ventures. The money for the oil drilling ventures flowed through the bank accounts of ML Investments in which Galaxy was a partner. Nevertheless, it is not at all clear that in this respect the actions of respondent, even through the bank accounts of ML Investments, put the registrant, Galaxy, in the oil and gas exploration business.

The DMV form states that neither Galaxy nor any person connected with Registrant, had discretionary authority to determine where securities were bought or sold and the total amount thereof. This statement is incorrect and in sharp contradiction with the repeated testimony of respondent (a person connected with registrant) that he had absolute and total discretion about where and to what extent

clients' funds were to be invested. Since this inaccurate statement is found on the portion of the form amended by respondent himself, he is directly chargeable therewith.

Finally, the Division contends that the "most egregious" misstatement in the form ADV as filed was a denial that Registrant or any person connected with Registrant had authority to obtain custody or possession of securities or the funds of any client, or did regularly or periodically have such custody or possession. The fact is that respondent, as a connected person, did, from time to time, take custody of the funds of the clients, whether the private ones or the various Clubs and their members, for investing in the oil drilling ventures. Some of these funds found their way into ML Investments, in which Galaxy was a partner and over which respondent had control.[27/] These ADV statements found in the amendment filed by respondent are totally incorrect.

It is found that respondent directly and indirectly did cause Galaxy, the registrant, to fail to make, keep and preserve the accounts, journals, correspondence, memorandums, papers, books and other records

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27/ Once there exists a situation where a registered investment adviser, or any person connected with Registrant, does have authority for or actual custody or possession of funds of clients, the provisions of Rule 206(4)-2 come into play. This Rule contains requirements as to the proper manner of handling the funds or securities of the client in the possession or custody of the Registrant. That respondent violated this Rule will be seen hereinafter.

as required by Rule 204-2; that he further caused Galaxy to fail to maintain accurate information in its form ADV as filed with the Commission and to appropriately correct the same by amendment, as required by Rule 204-1; and that these violations were "wilfull" as that term is understood in securities proceedings (see footnote 26).

The fact that, as asserted by respondent, information concerning the business activities and transactions of Galaxy or of ML Investments could be found in other documents in the office, such as bank statements, brokers confirmations and receipts and the records maintained for the various clubs, does not alter the affect to be accorded the violations so found nor does not it obviate the need for full compliance with the Commission's requirements. See Eugene N. Owens, 42 S.E.C. 149, 151 (1964).

The Commission has repeatedly stressed the importance in the regulatory scheme that books and records be kept current and in proper form. Pennaluna & Company, Inc, 43 S.E.C. 298, 312, 313 (1967); and Olds & Company, 37 S.E.C. 23, 26 (1956). The requirement that records be kept constitutes "an unqualified statutory mandate" (Billings Associates, Inc., 43 S.E.C. 641, 649 (1967)), and embodies the requirement that such records be true and correct. Lowell Neibhur & Co., Inc., 18 S.E.C. 471, 475 (1945). Respondent's violations in this regard are deemed quite serious under the circumstances.

The Anti-Fraud Violations

It is the contention of the Division that the activities of respondent heretofore described in "Specifications of Fraudulent

Impropriety" in the management of the investor funds under his discretionary control, and in the offer and sale of membership interests in investment clubs, constitute material misrepresentations and omissions of material facts in violation of the anti-fraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Section 206, subdivisions (1) (2) and (4) of the Advisers Act. 28/

28/ Section 17a makes it unlawful for any person "in the offer and 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) 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.

Section 206 of the Advisers Act, while containing similar proscriptions, is not limited to sales or purchases of securities, and is directed to conduct with respect to clients or prospects. It provides, in pertinent part:

> It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly -
>
> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
>
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
>
> * * *
>
> (4) to engage in any act, practice, or course of business which is fraudulent deceptive, or manipulative. * * *

On the basis of the record herein, it is found that the proof fails to bring the conduct within the proscriptions of either Section 10(b) or Section 17(a). Specifically, Section 10(b) is directed against fraudulent activities "in connection with the purchase or sale" of a security. Section 17(a) is directed against fraudulent activities "in the offer or sale of any securities". The problem in finding a violation of these Sections is that the acts complained of all occurred after the sale of or offer to sell membership interests were made to the complaining witnesses. From their testimony, and from the records of the various clubs, it appears that they all became members at various times commencing in September of 1975 through March of 1977. The acts complained of, however, all began many months after the sale to these witnesses of their memberships. Since the gist of the alleged frauds involves the failure to disclose the misuse and diversion by respondent of funds under his management, it is apparent that no disclosure of these occurrences could have been made prior to the time in which they took place, unless it can be shown that respondent had intended to divert the funds in this way at the time of the sale or offer of sale to the customer-witnesses. No such intent can be spelled out from "clear and convincing" evidence.[29/]

29/ It is likely that the ML Consulting salesmen were offering to sell the memberships as well as the individual adviser services throughout the entire relevant period. However, there is no proof that specific offers were made to any individual subsequent to the occurrence of the described events.

However, under Section 206 of the Advisers Act there is no requirement that a fraud be committed in connection with a purchase or sale of securities, i.e., the club memberships. This statute is intended to protect investors against frauds committed by investment advisers who manage their clients' funds, as well as fraud committed by advisers who did not make purchases and sales for their clients. See Abrahamson v. Fleschner, 568 F.2d 862, 877 (2nd Cir., 1977), cert. denied, 436 U.S. 905 (1978).[30/] Compare, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731-734 (1975).

Whether respondent's acts as outlined were fraudulent under Section 206 must be considered in the context of his relationship, based upon his wearing of many hats as self-professed chief executive officer of Galaxy, managing partner of ML Investments, and acting on his own behalf, on the one hand, and the situation of the investment clubs, their members and the individual accounts managed by respondent, on the other.

In principal part, the investment clubs were created by respondent so that they and their members were to be subservient to his managerial wishes. He caused their investment objectives to be clearly spelled out in the membership agreements, in the presentations to prospects and members by sales personnel, in his representations to members individually and at club meetings, and

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30/ In the Division's posthearing brief, the thrust of the discussion relates to alleged anti-fraud violations under Section 206. Discussion of the involvement of Section 17a and Section 10-b is relatively brief and makes no connection of the fraudulent acts to the sale or purchase of or offer to sell, securities.

in the occasional written reports sent to members. Those club members testifying at the hearing made it perfectly clear what they understood these objectives to be. ML Growth Club was to invest in stocks and mutual funds using a "switching" technique, the Bond Club in medium-grade municipal bonds, and the Savings Club in income-producing bonds. None of the objectives encompassed the transactions heretofore described and which at no time were disclosed by respondent either to the clubs themselves, to their members or to his individual accounts.[31/] The witnesses expressed surprise at learning of these transactions and were in agreement that they were not of the type contemplated by them when they made their investments into the clubs to be managed by respondent or when they engaged him on an individual basis.

The transactions themselves operated as a fraud or deceit upon the clients, be they the clubs and their members, or the individual accounts. Respondent not only subjected their money to considerable risk, but he placed himself in a position to personally profit thereby. These facts constituted material considerations which should have been disclosed to the clients because they departed from the investment objectives under which all of them invested their money.

31/ These acts include the lending of $150,000 of Growth Club funds without security to a wildcat oil drilling operation in which Long had an interest; the loan of $75,000 secured only by a written promise to repay, to a corporation in which Mr. Mitchell, president of ML Consulting was part owner; the loan to the Manoogians of Bond Club funds of $15,000 with repayment to be made not to the club but to respondent individually; and the transfer of $20,000 of Bond Club funds for the purchase of an interest on behalf of ML Resource Club. With respect to individual clients these acts include the diversion of Mrs. Messikomer's money to Sanders, and the placing of Mr. Squyres money in Long's account rather than in ML Investments to whom the client thought he was advancing the money.

The Advisers Act reflect a congressional recognition of the delicate fiduciary nature of an investment advisory relationship. Courts have imposed on a fiduciary an affirmative duty of utmost good faith and full and fair disclosure of all material facts. The practice of suppressing relevant information, with its potential for abuse, operates as a fraud or deceit within the meaning of the Act. Securities and Exchange Commission v. Capital Gains Bureau, Inc., 375 U.S. 180, 191, 194 and 200-201 (1963).

In this case, the information withheld from the clients was material. An omitted fact is material if there is a substantial likelihood that a reasonable person would consider it important in making his investment decision or that the omitted fact would have assumed actual significance in the deliberations of a reasonable investor. Compare TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). Each individual case must be judged on its own unique facts. S.E.C. v. Geon Industries, Inc., 531 F.2d 39, 47-48 (2nd Cir. 1976).

Respondent cannot hide behind the claim that he was given total discretion as to where funds were to be invested. Such discretion was still limited by investment objectives expressed to clients by respondent, by the salesmen, and as found in the membership agreements. Some of the clients would not have invested had they known that their funds were to be loaned to oil wildcatters and friends of respondent, or the risks to which they were being subjected, or the fact that respondent was in a position to personally gain as a result of these advances.

Respondent's acts in the placing of clients'(the Clubs' as well as individuals') funds in his own bank account and the mingling of clients' funds in the accounts of ML Investments as well as in each other's accounts were in clear violation of Rule 206(4)-2 promulgated pursuant to Section 206(4) of the Advisers Act.[32/] This way of handling funds should have been disclosed.

The respondent has raised the question of "scienter", or the intent to defraud, as being a necessary ingredient of the charges made against him. In Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), it was held that it was necessary to prove scienter in a private action under Section 10(b). In the recent Supreme Court case of Aaron v. Securities & Exchange Commission, No. 79-66, decided June 2, 1980, it was held that scienter is an element of a civil enforcement action to enjoin violations of Section 10(b) and Rule 10b-5 thereunder, and Section 17(a)(1) of the Securities Act, but need not be established in actions to enjoin violations of Section 17(a)(2) and 17(a)(3) of that Act.

32/ These requirements are imposed where, as found here, the adviser had custody or possession of the funds or securities in which any client has any beneficial interest. They include: that client funds be deposited in one or more bank accounts containing only client's funds in the name of the adviser maintaining a separate record for each such account; the written notification to the client of the place and manner in which such funds will be maintained and of any changes thereof; the sending to each client no less than once every three months of an itemized statement showing the funds and securities in the custody or possession of the adviser and all debits credits and transactions in such client's account during such period; and the verification of the funds and securities of clients by actual examination at least once a year by an independent public accountant on a "surprise" basis. The record indicates that none of these requirements was ever instituted or performed by respondent or any company over which he had management or operational control.

The language of Section 206(1) of the Advisers Act similar to that found in Section 10(b) and 17(a)(1) and hence, in order to establish a violation of that Section, scienter must be shown. However, since the language of Sections 206(2) and 206(4), is similar to Section 17(a)(2) and 17(a)(3), it follows that no scienter need be shown under those paragraphs of the Act. To put it another way, Section 206(1) making it unlawful for any investment advisor to employ any device, scheme, or artifice to defraud plainly shows an intent to prohibit only knowing or intentional misconduct. On the other hand, the language of 206(2) and 206(4) plainly focuses upon the effect of particular conduct on members of the investing public, rather than upon the culpability of the person responsible. See Securities & Exchange Commission v. Capital Gains Research Bureau, supra, p. 200.

All of the acts charged and found to have been committed by respondent as well as his failure to comply with the record-keeping requirements of Rule 206(4)-2 constituted transactions, practices and courses of business which operated as frauds, deceits and manipulative practices upon the clients of respondent and his affiliated entities. With respect to the Franecke loans, the Manoogian loan and the Sanders/Messikomer deal, there is found to have been a deliberate diversion of clients' investment funds in a manner calculated to benefit respondent personally. Hence, they constitute the intentional and knowing employment of a device and scheme to defraud. And with respect to all of these acts, respondent's conduct has been "wilfull" as that term has heretofore been defined.

Under all of these circumstances, it is concluded that, the record has established by clear and convincing evidence that respondent wilfully violated Section 206(1),(2) and (4) of the Advisers Act, but fails to establish his violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder or of Section 17(a) of the Securities Act.

The Contentions of Respondent

In addition to respondent's contention that his actions were justified by the discretionary investment authority granted to him, he has asserted as one of the principal grounds of his defense that he has been the victim of a conspiracy designed to deprive him of his company, Galaxy, and to take over his investment advisory business. The gist of this argument is set forth in his response to the Division's post-hearing pleadings wherein he states:

> I began in the same spring (i.e. of 1977) an effort to solve a few problems and improve our bookkeeping. In the fall of 77 several partners saw these problems as an opportunity to sieze control of my business. They hired the assistance of Robert Shields Esq. who in turn elicited and obtained the help of SEC Attorney Steve Delaney. Mr. Delaney colored thc attitude and opinions of his co-workers and his boss. Had it not been for Mr. Delaney and the conspiracy I am certain that I would not be enjoined.

At the hearing respondent was permitted to testify at great length about his version of the alleged conspiracy including considerable testimony as to events occurring subsequent to and beyond the time frame of those alleged in the Order for Proceedings, events which culminated in the dissolution of the business of ML Investments, the return of the money to the investors in the clubs,

the issuance of the injunction against Galaxy and respondent, and the revocation of the investment adviser registration of Galaxy.[33/]

Respondent's testimony with respect to a "conspiracy" was admitted over objection by the Division, not because it was relevant to the issues involved under the Order, but because the existence of such a conspiracy could, if established, have some bearing upon the credibility of Mr. Cherry and Mr. Mitchell, who were principal witnesses for the Division. It was made very clear at the hearing that this was the only purpose for which respondent was permitted to expand upon his belief of the existence of a conspiracy to take over his business. This was reiterated in my Order of April 24, 1980, denying respondent an extension of time to file his brief in order to permit the Commission to consider investigating his belated complaint of misconduct on the part of Commission personnel (see footnote 3). Not only is his testimony of alleged conspiracy irrelevant to the issues involved, but respondent offered no other evidence to sustain such charges, although he had ample opportunity during the course of the hearing to do so.

33/ During this later period, there also occurred maneuvers on the part of the principals concerning the Galaxy corporate affairs, such as the removal of record books in the middle of the night and their return thereafter, the resignation by respondent from his positions with Galaxy and his subsequent withdrawal of such resignations, the investigations conducted by the Commission of the affairs of Galaxy, respondent, ML Investments and the Clubs, and the bringing of criminal charges in the state of Pennsylvania against respondent which were dismissed or resulted in acquittal.

However, in the last analysis even if there were such a conspiracy it would not in any way effect the findings of violations as hereinbefore set forth. Very simply, these charges have been sustained by documentary evidence and by the testimony of other witnesses apart from those of Mr. Cherry and Mr. Mitchell. Moreover, having observed the demeanor of these two men and having weighed their testimony in the light of all the other proof, the administrative law judge finds that there is no reason, even one based on a "conspiracy", to justify a conclusion that their testimony was not credible. Whatever motives may have impelled Mr. Cherry and Mr. Mitchell to have respondent called to account for his activities does not alter the conclusion that his actions did occur and were in violation of the pertinent provisions of the securities laws.

Public Interest

Respondent having been found to have violated the registration provisions of the securities laws and the antifraud provisions and the recordkeeping requirements of the Advisers Act, and having been permanently enjoined in a securities related matter, it becomes necessary to determine what sanction, if any, should be imposed upon him.

The Division has asked that respondent be permanently barred from association with any investment adviser. Respondent, for his part, calls for the dismissal of the proceeding and, while not addressing himself to the subject of sanctions, suggests that for "true justice" to be served, "several people on the SEC side would

be imprisoned and massive damages would be awarded to my company and myself".

It has long been held that in imposing sanctions due regard must be given to the facts and circumstances of each particular case, since sanctions are not intended to punish respondent but to protect the public interest from future harm. See Burko v. SEC, 316 F.2d 137, 141 (2nd Circuit, 1963): and Leo Glassman, SEA Release No. 11929 (December 26, 1975), 8 SEC Docket 735, 737. Additionally, consideration may be given to the likely deterrent effect the sanction will have on others in the industry. Arthur Lipper Corp. v. S.E.C., 547 F.2d 171 (2d Cir 1976), cert denied, 434 U.S. 1009.

It has recently been held that when the Commission imposes the sanction recommended herein by the Division barring someone from the securities industry, described as the most drastic sanction at its disposal, there is a duty to articulate carefully the grounds for such a sanction including an explanation of why a lesser sanction will not suffice.[34/] Steadman v. Securities and Exchange Commission, 603 F.2d 1126, 1143 (5th circuit, 1979).

The seriousness of the violations found to have been committed by respondent has heretofore been stated. Of striking significance

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34/ A "permanent" exclusion from the industry really means "indefinite" since the Commission retains the power to modify its Orders, and one who has been barred is not precluded from applying for admission at some future time to reenter the securities business upon appropriate showing. See Steadman Securities Corp., SEA Rel. No. 13695, 12 SEC Docket 1041, 1064, Note 100.

in connection therewith is the respondent's attitude concerning them, characterized by a total disregard of the obligations owed to his clients' as an investment adviser, his failure to recognize the wrongful nature of his conduct, his failure to provide any assurances against future violations, and his willingness to attempt pseudo-compliance with pertinent statutory and regulatory requirements.

This attitude is evidenced by the manner in which he used the investment adviser registration of a dormant corporation, Galaxy, as a cloak for the investment advisory services furnished by himself and by ML Investments; by his creation of investment "clubs" whose officers and activities were under his domination and control and which were hardly the spontaneous type of associations normally associated with such clubs; by the splitting of clubs into sham divisions when they threatened to become large enough to require registration as investment companies; by the setting up of situations, such as the Sanders/Messikomer real estate transactions, the Manoogian loan and the Franecke loan in which funds were used improperly and in such a way as to conceal the fact that he would be deriving personal benefits therefrom.

Respondent's attitude is further evidenced by his strongly felt believe that under the discretionary authority given to him to make investments, he could place the funds of his clients wherever he in his wisdom saw fit without conforming to express investment objectives or the necessity of reporting any of his investments to his clients. He expressed his state of mind a number of times throughout the hearing and aptly, at transcript page 1155; "the policy was one of my having absolute and total discretion about

where the funds were to be invested; this policy was reiterated at every club meeting; it was reiterated to every potential customer that I ever met; it was a continual notice made to them. If they wished a more formal, hand-holding type investment advisory services, they needed to go elsewhere".

The failure of respondent to recognize the seriousness of his violations is demonstrated by his willingness to make unsubstantiated accusations of illegality and conspiracy against those who looked into his affairs, as if this justified the wrongdoing. And one looks in vain throughout the record for any recognition on respondent's part of the fiduciary duty owed to clients and and for any undertaking or commitment to avoid any future violations of law or rule. For all that appears in this record, he would continue to act the same way in the future as he has been found to have done in the past.

For his part, respondent asserts that he and his family have been crushed and destroyed financially as a result of his association with the situation described hereinabove. He claims that he is one of the most competent investment managers in the nation who would provide a means for profitable investments to all members of the general public, large and small.[35/]

Also to be taken into consideration is the fact that, although

35/ Since December of 1977 he has been doing "odd jobs" around oil and gas deals. He had been giving advice to friends and relatives with respect to some of these deals as suitable investments. In early 1978, he entered into a transaction with a registered investment adviser for the sale of his "timing" investment system for the sum of $10,000 plus "royalties" for the use thereof. He had notified "a few" individuals that the investment adviser was using this system as an alternative to Galaxy. For royalties, he has received a portion of the fees earned by the investment adviser, amounting to several hundred dollars at a time. He has obtained employment in a bank in Texas in 1979.

respondent has had as much as $4 million under his control, the total amount of the transactions which were the basis of the charges herein do not total more than several hundred thousands of dollars. It would appear from the witnesses that they all made money from his investment advice and did not suffer any losses except for Mrs. Messikomer who lost $1,000 in the Sanders real estate deal plus whatever counsel fees she expended to recover the balance. There is also a question of whether ML Bond Club was ever repaid for the $15,000 Manoogian loan. All of the public witnesses admitted that they made money with respondent's services and one or two said they would continue to invest with him. However, the fact that no investors were injured is not a necessary element in Commission enforcement proceedings. O'Leary v. S.E.C., 424 F.2d908, 912 (D.C. Cir. 1965); Hughes v. S.E.C., 174 F.2d 969, 974 (D.C. Cir. 1949); and Berko v. S.E.C., 316 F.2d 137, 143 (2d Cir. 1963). This fact is not given much weight under the circumstances herein.

An investment adviser is a fiduciary whose actions must be governed by the highest standards of conduct and in whom clients must be able to put their trust. S.E.C. v. Capital Gains Research Bureau, Inc., supra, at pages 191-192; and Joseph P. D'Angelo, Investment Advisers Act Release No. 562, (December 16, 1976) 11 SEC Docket 1263-1264, affirmed without opinion, 559 F.2d 1202 (2d Cir. 1977). It is "an occupation which can cause havoc unless engaged in by those with appropriate backgrounds and standards". Marketlines, Inc. v. S.E.C., 384 F.2d 264, 267 (2d Cir. 1967), cert. denied, 390 U.S. 947 (1968).

In the last analysis, the circumstances herein, particularly respondent's state of mind[36/] concerning his activities, and the failure of the record to demonstrate that he would cease such activities in the future, justify the conclusions that respondent should be barred from association with an investment adviser.

However, in the expectation that during the passage of time respondent will come to recognize and accept the duties owed by an adviser to his clients, it is recommended that after one year he be permitted to apply to become employed by an investment adviser upon making a satisfactory showing to the Commission that he will be adequately supervised.[37/]

ORDER

Under all of the circumstances herein, IT IS ORDERED:

(1) that respondent Don A. Long be barred from association with any investment adviser, and

(2) that after 12 months following the effective date of this Order, Don A. Long may apply to the Commission for leave to become associated with an investment advisor upon making a satisfactory showing that he will be adequately supervised.

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

36/ The respondent's state of mind is highly relevant in determining a remedy to impose. See Steadman v. S.E.C., supra, page 1140.

37/ 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 other than those heretofore set forth. All such arguments and expressions of position not specifically discussed 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.

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), 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

Washington, D.C.
June 30, 1980