

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of
LEWIS SECURITIES COMPANY, INC.
Hanover, New Hampshire
(24B-1665)

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INITIAL DECISION

Washington, D. C.
July 31, 1970

Sidney L. Feiler
Hearing Examiner

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APPEARANCES: Willis Riccio, Esq., of the Boston Regional
Office of the Commission, for the Division
of Corporation Finance

William M. Kaplan, Esq., 469 Fifth Avenue,
New York, New York 10017 and Douglas S.
Hatfield, Jr., Esq., Central Square
Hillsborough, New Hampshire 03244,
for Lewis Securities Company, Inc.

Richard E. Floor, Esq., 28 State Street,
Boston, Massachusetts, for R. P. Durkin &
Company, Inc.

BEFORE: Sidney L. Feiler, Hearing Examiner

I. THE PROCEEDINGS

Lewis Securities Company, Inc. ("Issuer"), a New Hampshire corporation with its principal office at Hanover, New Hampshire, filed with the Commission on October 17, 1969, a notification on Form 1-A and an offering circular relating to its proposed offering of 60,000 shares of its no par value common stock at \$5 per share for the purpose of obtaining an exemption from the registration requirements of the Securities Act of 1933 ("Securities Act"), as amended, pursuant to the provisions of Section 3(b) and Regulation A, promulgated thereunder.^{1/}

R. P. Durkin & Company, Inc., Lowell, Massachusetts, a registered broker-dealer, was named as the underwriter of the issue.

Thereafter, the Commission, pursuant to Rule 261 of the General Rules and Regulations under the Securities Act, issued an order temporarily suspending the exemption.^{2/} It is stated in the

^{1/} The Commission, pursuant to the provisions of Section 3(b) of the Act is empowered to exempt an issue of securities from the provisions of the Act where the aggregate amount at which such issue is offered to the public does not exceed \$300,000. Pursuant to this provision the Commission has adopted Regulation A governing the terms and conditions under which exemption may be available to an issuer from the full registration provisions normally required under the Act for public offerings of securities.

^{2/} It is provided in Rule 261(a), so far as is material herein, that the Commission may, at any time after the filing of a notification, enter an order temporarily suspending the exemption, if it has reason to believe that the notification and offering circular contain untrue statements of material facts or omissions of material facts necessary to make the statements made, in the light of the circumstances under which they were made, not misleading; or, that the terms and conditions of Regulation A have not been complied with; or that the offering is being made or would be made in violation of Section 17 of the Act (the so-called anti-fraud provision of the Act).

order of temporary suspension that the Commission has reasonable cause to believe from information reported to it by the staff that the terms and conditions of Regulation A have not been complied with in that the offering circular filed by the Issuer as an exhibit to the Form 1-A notification failed to disclose material unrealized loss in the current assets of the Issuer and over-stated profits, stockholders' equity and retained earnings, so that the use of said offering circular would operate as a fraud and deceit upon prospective purchasers of the securities offered by the Issuer pursuant to Regulation A in violation of Section 17(a) of the Securities Act.

The Issuer filed an answer denying that the offering circular would operate as a fraud and deceit upon prospective purchasers of the securities proposed to be offered by it and further alleged that it had no intent to commit a fraud and deceit and that the offering circular had not been distributed to any prospective purchasers. Both the Issuer and the Underwriter requested a hearing, for which provision had been made in the Commission's order, to determine whether the order of temporary suspension should be vacated or made permanent. A hearing was held at which the Issuer, the Underwriter, and the Division were represented by counsel. At the conclusion of the hearing the parties waived oral argument, but requested and were given an opportunity to file proposed findings and briefs in support thereof. On the basis of the record, including the proposed findings and briefs submitted by the parties, the undersigned makes the following:

II. FINDINGS OF FACT AND LAW

The Issuer was organized on February 19, 1964 and since May 20, 1964 has been and is a registered broker-dealer deriving its income from commissions and trading activity normally conducted by broker-dealers. It maintains its principal place of business at Hanover, New Hampshire. During the time here relevant it employed approximately 70 employees, of whom approximately one-third were full-time employees. It conducted business in Vermont, New Hampshire and Maine and maintained five branch offices. Henry E. Lewis, during the relevant period was, and still is, president, treasurer, a director and the controlling stockholder of the Issuer. He has had 15 years' experience in the securities business. William V. Williams was vice president, general manager and a director of the Issuer during the relevant period. He was in charge of the trading account of the Issuer. He participated in the drafting of the narrative portion of the offering circular. Lewis reviewed the entire filing.

The Issuer attached to the offering circular certain financial statements. These included Comparative Balance Sheets for the years ending November 30, 1966, 1967 and 1968; a Comparative Statement of Income and Retained Earnings for those years; a listing of Assets as of August 31, 1969; a Statement of Income and Retained Earnings for nine months ending August 31, 1969; and a statement of Liabilities and Capital, dated August 31, 1969. In the statements for the years prior to 1969 among the Current Assets itemization there was an item

"Securities Owned by Firm at Book Value (Note 1)." In Note 1 attached to the statements the market value for the marketable securities at year end for each of the three years was noted. In the statement of Assets as of August 31, 1969 there is an item "Securities owned by firm at book value" of \$127,581.80. However, the market value of those securities as of that date was \$69,697.52 or an unrealized loss of \$57,884.28 (Div. Ex. 1). Total assets were noted as \$835,430.95. In the statement of "Income and Retained Earnings for nine months ending August 31, 1969" the income item of "Gains and Losses -- firm trading -- net" is listed at \$26,910.53. No mention is made on this statement of unrealized losses in the firm trading account.

The Issuer had retained a firm of certified public accountants to perform certain work for it beginning in 1966. According to a member of that firm, who testified in the proceedings, the accountants prepared answers to the SEC financial questionnaire for the years 1966, 1967 and 1968. Tax returns were prepared for the years 1967 and 1968. Also, for the year ending November 30, 1968 an audited financial statement was prepared and at that time figures were recast to provide statements for the years 1966 and 1967.^{3/} This work was completed in February 1969. These statements with the appropriate footnotes previously ~~conferred~~ ^{referred} to are part of the financial statements attached to the offering circular. Continuing his testimony,

^{3/} The income statements were unaudited and were not covered by the opinion rendered on the comparative balance sheets (Issuer's Ex. 9).

the accountant witness stated that after the above work had been completed, the accountants withdrew from their engagement as auditors for the Issuer but agreed to remain available for routine book-keeping inquiries and assistance on tax questions. There had been discussions whether the accountants would be retained as experts to certify the financial statements to be used in the offering circular and to permit their names to be used in the offering circular. In October, it was finally decided that there would be no such engagement because of the size of the fees that would be involved. Instead, the accountants agreed to review the 9-month financial statements which had been prepared by the Issuer's bookkeeper and convert them to the format of a conventional financial statement. According to the testimony this was done as a matter of accommodation and not under any retainer, nor was any independent review made of the books and records of the Issuer. However, it was known at that time by the accountants that the Issuer was preparing a Regulation A filing.

In accordance with the above arrangement the balance sheets and an income statement as of August 31, 1969, prepared by an employee of the Issuer, were delivered to the accountant witness (Issuer's Exhibit 11). In the preparation of this material a form had been used which the accountant had prepared sometime previously and given to the Issuer. The accountant made some changes in the balance sheet presentation. Thus, an item of \$10,000 in "Subordinated Loans" listed under STOCKHOLDERS' EQUITY was moved up to Current

Liabilities. "Firm inventory" which was broken down into three subaccounts was consolidated into a single item of "Securities Owned by Firm at Book Value." Two other minor changes were also made. The statements as revised were sent back to the Issuer with a covering letter dated September 19, 1969, stating:

"We are enclosing your financial statements as of August 31, 1969 prepared by your bookkeeper. We have taken these figures and converted their presentation to a more commonly accepted accounting form. We have done nothing except accept these figures and rearrange their presentation. Also enclosed is a copy of your draft copy of the Offering Circular which we understand has been revised quite a bit. We will need to review the final draft if we are to be named at all in the final which is submitted to SEC." (Issuer's Ex. 13).

As previously noted there were no footnotes attached to these statements when they were submitted to the accountant nor were any added. The accounting firm understood that it was explicit in their arrangement that nothing was going to be done by them except to take the statements and convert them to proper form. There would be no auditing or checking of any accounts and there was an assumption that the Issuer had taken the proper amounts from its books and put them in the appropriate slots on the form used (Tr. 71).

Prior to the filing of any material with the Commission, counsel for the Issuer on August 14, 1969 visited the Boston Regional Office and conferred with a staff attorney with reference to the formal requirements of Regulation A and related procedures. He asked for a sample offering circular filed on behalf of other broker-dealers and was given two of them (Issuer's Exs. 7 and 8). On October 17, 1969

counsel for the Issuer appeared at the Boston Regional Office and filed the notification and offering circular on behalf of the Issuer. At that time the material was examined to see whether filing formalities had been complied with and whether required signatures had been properly affixed (Tr. 10-11).

Contention of the Parties; Conclusions

It is contended by the Division that the failure of the Issuer to reveal its unrealized loss in its trading account of over \$57,000 was a material omission which prevented a true valuation of the Issuer's financial situation as of August 31, 1969 so that stockholders equity was overstated by over 30% and retained earnings, by over 60%. It urges that listing the value of securities owned by the firm in its trading account as of August 31, 1969 at "book value" with no further explanation, was misleading in the circumstances, particularly since the statements for the prior years carried an appropriate note indicating market value so that any unrealized loss would be readily apparent. Instead of the net income of almost \$27,000 in the trading account as shown in the interim statement, there was actually, it is asserted, a very substantial net loss. It is also pointed out that the offering circular makes reference to the Issuer's trading activities as being a profitable part of its business, again without reference to the current trading losses. With reference to the underwriter, it is maintained that if it had made an adequate investigation of the material filed by the Issuer it

would have discovered the omission of current trading losses.^{4/}

Finally, it is contended that the use of the material filed by the Issuer would have operated as a fraud and deceit upon the investing public.

It is contended on behalf of the Issuer herein that the offering circular clearly indicated that securities of the Issuer were listed at their book value or cost and that it was readily apparent that current value was not included in the valuation. It is further urged that the sole accounting witness who testified stated that it was proper accounting treatment to list securities owned at cost rather than at market and that this had been done in the statements prepared by his firm for the Issuer. It also maintained that its presentation conformed with that used in the offering circulars made available to it at the Boston Regional Office and other financial statements which were offered in evidence. While it concedes that the accountant witness testified that if his firm had been retained to prepare the interim statements it would have included a footnote with respect to market value (Tr. 87), it also points to his further testimony that he did not advise the Issuer to add footnotes to those statements. (Tr. 69). It further notes that the net capital ratio set forth in the offering circular was computed on the basis of current market value of its securities. Finally, it

^{4/} Roger P. Durkin, president of the underwriter, testified that while he did confer with representatives of the Issuer and examined its books and records, he did not receive a copy of the final draft of the offering circular, including the interim financial statements, until the day of the filing and took no further action with reference to them except to forward the documents to his attorney.

relies on its statements in the offering circular that the offering price of its stock had been arbitrarily established, was not based on earnings, was a speculative issue, and that losses could be incurred in its trading activities.

On behalf of the Underwriter, it is asserted that it carefully examined the preliminary draft of the offering circular and the financial statements for 1966, 1967, and 1968 and reviewed the operations of the Issuer. While the underwriter did not review the final filing with the stub period financials prior to their filing with the Boston Regional Office, it is noted that the underwriting agreement, a necessary document, had not been filed and thus the underwriter could prevent final action until it satisfied itself on all aspects of the offering.

The burden of proving an exemption from the full registration requirements of the Securities Act rests on the person claiming the exemption.^{5/} Requirements prerequisite for an exemption must be strictly complied with. Intent to violate the Act, knowledge of a violation, or good faith efforts to comply with applicable requirements are not relevant to a determination of a violation of the registration provisions of the Act.^{6/} The preparation of an offering circular is not

5/ S.E.C. v. Ralston Purina Co., 346 U. S. 119 (1953); Advanced Research Associates, Inc., Sec. Act Rel. No. 4630 (August 16, 1963).

6/ Herman Hanson Oil Syndicate, 2 S.E.C. 743, 746 (1937); Del Consolidated Industries, Inc., Sec. Act Rel. No. 4795, p. 3 (1965); Gold Dust Mining & Milling Company, 3 S.E.C. 55, 56 (1938); Franchard Corporation, Sec. Act Rel. No. 4710, pp. 16-17 (1964).

an academic exercise. It is designed to aid investors in arriving at an informed opinion on the merits of an issue in which they are interested. Since it is planned for the use of ordinary investors without any special expertise, it must be couched in language they can understand, be clear, contain no half-truths, nor set forth information in such a form that recourse must be had to additional outside sources for further information. A reader is not required to grasp at clues which might alert him that further inquiry is required.

Judged by this standard, the offering circular filed by the Issuer was seriously deficient in its presentation of the financial situation of the Issuer for the latest period reported - the interim or stub period ending August 31, 1969. The securities owned by the firm were an important part of the Issuer's assets. Of total assets of \$866,277.96, securities owned by the firm were listed at \$127,581.80. The firm trading account showed a net gain of \$26,910.53. This figure almost matched the net income for the period of \$27,093.11. The latter figure was in turn added to "Retained Earnings" which then was used to increase "Total Stockholders Equity."

It cannot be successfully argued that in view of the apparent substantial value of the Issuer's securities inventory and the apparent successful trading activity, the very large unrealized loss of \$57,884.28 in the trading account would be of no interest to a reasonably prudent investor.

Although the accountant witness testified that the general structure of the presentation of the financial data from 1966, including the interim period, was in accord with generally accepted accounting principles, it is also clear from his testimony that a note as to the current market value of the securities inventory should have been included in the current statements, as it was in prior years. The fact that it was noted in the "Assets" statement that securities owned by the firm were listed at book value did not remedy the defect. At best it was a half-truth leaving a reader to guess that perhaps market value, if he could find it somewhere, might be worth checking. An ordinary investor would ~~have to~~ assume that all material information was set forth in the financial statements.

The offering circulars furnished counsel for the Issuer at the Boston Regional Office of the Commission were not furnished as approved forms. They were simply examples of filings on behalf of broker-dealer firms which were not then effective. Even these clearly indicated the current market value of securities inventory at the place where securities inventory was listed at cost. Other offering circulars offered in evidence by the Issuer also reveal market value of securities inventory by an appropriate entry.

The undersigned concludes that the failure to disclose the very substantial unrealized loss in the Issuer's current inventory of securities was a material omission necessary for an investor to make an informed judgment of the value of the current assets of the

Issuer and its profits, stockholders' equity, and retained earnings and that the use of said offering circular would operate as a fraud and deceit upon prospective purchasers in violation of Section 17(a) of the Securities Act.

III. CONCLUDING FINDINGS

It has been found that as alleged in the Order of Temporary Suspension the Issuer has failed to comply with the terms and conditions of Regulation A by failing to disclose certain information in the offering circular so that the use of the offering would operate as a fraud and deceit upon prospective purchasers in violation of Section 17(a) of the Securities Act.

The Division argues that misrepresentations and omissions in the offering circular warrant the entry of an order of permanent suspension. The Issuer seeks to withdraw its filing and asserts that it acted in good faith. The Underwriter adopts a similar position urging that there was no deliberate attempt to conceal information or mislead the public or to ~~carelessly~~ disregard applicable statutes and rules.

The Commission has recently restated the general rule applicable here, as follows:

"The exemption afforded by Regulation A is a conditional one based on compliance with express provisions and standards, and Rule 261 specifically provides that we may suspend an exemption in the event of noncompliance. The opportunity to amend or withdraw a deficient filing cannot be permitted to impair the required standards

of careful and honest filings or to encourage a practice of irresponsible or deliberate submission of inadequate material to be followed by withdrawal or correction when deficiencies are found by our staff."7/

It has further said,

"We are of the opinion that in an appropriate case we may consider amendments filed after the issuance of a temporary suspension order. We have exercised our discretion to consider amendments filed to registration statements after the institution of stop order proceedings under Section 8(d) of the Act, although the Act does not specifically provide for amendments at that time. However, in the case of a Regulation A offering, where suspension of the conditional exemption obtained under the Regulation does not bar the issuer from effecting a public offering if it complies with the registration requirements, we consider the opportunity to amend which should be accorded an issuer which has not properly met the simplified requirements provided by Regulation A to be more limited than the opportunity to amend in the case of a registration statement. The opportunity to amend cannot in any event be permitted to impair the required standards of careful and honest filings under the Regulation and encourage a practice of irresponsible or deliberate submission of inadequate or false material followed by correction by amendment of the deficiencies found by the staff in its examination." (Footnote omitted) 8/

The Commission has permitted withdrawal in certain limited cases where there has been a sufficient showing of good faith and other mitigating factors. 9/

7/ Jackpot Exploration Corp., Sec. Act Rel. No. 5061 (April 22, 1970), p. 5 and cases cited in footnote 8 therein.

8/ Illowata Oil Company, 38 S.E.C. 720, 723-724 (Dec. 4, 1958).

9/ National Land Company of Arizona, 39 S.E.C. 792 (1960); Guardian Consultants and Management, Inc., Sec. Act Rel. No. 4722 (Sept. 10, 1964)

The evidence indicates that the Issuer did make sincere effort to comply with applicable requirements. The efforts of its counsel to review the filings of other companies and the request of the Issuer to accountants familiar with its operations to look at its financial statements are all indicative of its good faith.^{10/} The Issuer had elected to prepare its current financial statements for the period and must bear the responsibility for the violations found and cannot rely on the limited function performed by the accountants, of which it was aware. However, in view of the good faith of the Issuer, which the undersigned finds was established from the evidence and his observation of the witnesses, and the fact that none of the shares of this issue were offered to the public, it is concluded that it is not necessary in the public interest or for the protection of investors that the temporary suspension of the Issuer's Regulation A exemption be made permanent. Accordingly,

IT IS ORDERED, pursuant to Rule 261(b) of the General Rules and Regulations under the Securities Act that the Order of Temporary Suspension entered in these proceedings against Lewis Securities Company, Inc., be, and it hereby is, vacated.

^{10/} The Division has placed reliance on net capital difficulties which the Issuer had had some months previous to the filing here as reflecting on its motives. This deficiency had been met and was not a current problem.

The application of the Issuer to withdraw its notification and offering circular is granted:

Pursuant to Rule 17(b) of the Commission's Rules of Practice a party may file a petition for Commission review of this initial decision within fifteen days after service thereof on him. This initial decision, pursuant to Rule 17(f) shall become the final decision of the Commission as to each party unless he files a petition for review pursuant to Rule 17(b) or 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 to review or the Commission takes action to review as to a party, ^{11/} this initial decision shall not become final as to that party.

Sidney L. Feiler
Hearing Examiner

Washington, D. C.
July 31, 1970

11/ All contentions and proposed findings have been carefully considered. This initial decision incorporates those which have been found necessary for incorporation therein.