FILE COPY

UNITED STATES OF AMERICA

before the

SECURITIES AND EXCHANGE COMMISSION

In the Matter of	:
Diotron, Incorporated 3650 Richmond Street Philadelphia, Pennsylvania	:
File No. 24W-2492	:

RECOMMENDED DECISION

Sidney Ullman
Hearing Examiner

Washington, D. C.
July 31, 1963

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BEFORE: Sidney Ullman, Hearing Examiner.

APPEARANCES: Paul E. Leonard, Assistant Regional Administrator, Washington Regional Office, and John J. Sharp, Esq., for the Division of Corporation Finance.

Sigmund H. Steinberg and Morton S. Gorelick, Esqs., of Steinberg, Steinbrook, Lavine & Gorelick, 1528 Walnut Street, Philadelphia 2, Pennsylvania, for the issuer, Diotron Incorporated.

Martin A. Forman, Esq., of Forman, Rosenberg and Resnick, 12 South 12th Street, Philadelphia 7, Pennsylvania, for Royer Securities Company.

Robert H. Richards, Jr., and William E. Wiggin, Esqs., of Richards, Layton & Finger, DuPont Building, Wilmington 1, Delaware, for Laird, Bissell & Meeds.

I. NATURE OF PROCEEDINGS

On July 26, 1962, the Commission issued an order pursuant to Rule 261 of the General Rules and Regulations under the Securities Act of 1933, as amended, ("Act") temporarily suspending the exemption under Regulation A of these General Rules and Regulations, of the public offering of common stock of Diotron, Incorporated ("Diotron").[1/] The order provided an opportunity to any person having an interest therein to request a hearing. Following a request by Diotron the Commission ordered a hearing to determine whether to vacate its order of temporary suspension or enter an order permanently suspending the exemption. That is the

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1/ Regulation A, adopted under section 3(b) of the Act, provides for exemption from registration when an issuer offers securities with an aggregate public offering price not exceeding $300,000 provided, among other things, that the issuer files with the Commission a notification and an offering circular containing certain minimum information.

Rule 261, as applicable here, provides for the issuance of an order temporarily suspending an exemption if the Commission, among other things, has reason to believe that the terms and conditions of Regulation A have not been complied with, that the offering circular contains any untrue statements of a material fact or omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or that the offering is being made or would be made in violation of section 17 of the Act. The Rule further provides that where a hearing is requested the Commission will, after notice and opportunity for such hearing, either vacate the order or enter an order permanently suspending the exemption.

ultimate issue in this proceeding, which was originally predicated upon allegedly untrue statements and omissions of material facts in the offering circular, and an offering allegedly in violation of section 17 of the Act. 2/

By an amending order of December 28, 1962, issued on motion of the Division of Corporation Finance ("Division"), the Commission added to the proceedings the subordinate issue whether, in connection with the offering and sale of Diotron stock, the broker-dealer firm of Laird, Bissell & Meeds ("Laird") had engaged in specified fraudulent activities in violation of section 17(a) of the Act.

The matter came on to be heard before the undersigned Hearing Examiner at Philadelphia, Pennsylvania, on January 7, 1963. The hearing was continued from time to time and was concluded on February 5, 1963.

2/ Section 17(a) of the Act, as amended applicable to this case, provides that it shall be unlawful in the offer or sale of any securities by use of means of communication or transportation in interstate commerce or the mails, directly or indirectly:

"(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 under 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."

Under the order of the Commission, as amended, the specific matters placed in issue for hearing were:

A. Whether the offering circular contains untrue statements of material facts and omits to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, concerning:

1. The true position of Diotron with respect to debt, and the accuracy of the financial statements of the Company contained in the offering circular at the time the offering began.

2. The status of Laird as an underwriter and the membership on the board of directors of Diotron by a member of that firm.

3. The failure to disclose accurately and adequately the intended disposition of the proceeds from the issue.

4. The obligation to pay the sum of $12,374.34 to salesmen as commission.

5. The obligation to pay immediately the sum of $79,435.13 to The Broad Street Trust Bank of Philadelphia.

6. That officers' salaries were to be paid from the proceeds of the offering.

B. Whether in the offering and sale of Diotron stock Laird directly or indirectly employed a scheme and artifice to defraud, obtained money and property by means of untrue statements of material facts and omissions to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, and engaged in transactions, practices and a course of business which operated as a fraud and deceit upon the purchasers of stock of the issuer in violation of section 17(a) of the Act, particularly with respect to:

1. Statements that the price of the issuer's stock would double in six months;

2. Statements that the price of the issuer's stock would increase from $3.00 per share to $12.00 per share within one month;

3. Statements that because of the issuer's increased business, the price per share would double within a short time;

4. Statements concerning the favorable prospects of the issuer by reason of substantial contracts, present and future, for the sales of its products to nationally known firms;

5. Statements that the issuer would be another "Texas Instruments";

6. Statements of similar purport or object.

C. Whether the offering was made in violation of section 17 of the Act.

Both the Division and Diotron were represented by counsel at the hearing. In addition, during the course of the proceeding the Hearing Examiner, pursuant to Rule 9(c) of the Rules of Practice of the Commission, granted leave to be heard to Royer Securities Company ("Royer"), the named underwriter of the Regulation A issue, and to Laird, whom the Division contends was an undisclosed underwriter. Both of these participants were represented by counsel throughout the hearing.

A recommended decision by the Examiner was requested by the Division, and proposed findings of fact, conclusions of law and briefs in support thereof were submitted by all parties and by the above participants.

During the course of the proceedings counsel for Diotron, Royer and Laird joined in a motion for an order by the Examiner amending the Commission's order for the proceedings by deleting the issues of alleged fraud and improper activity by Laird in the sale of the Diotron stock, as added by the aforementioned order of the Commission of December 28, 1962 and as set forth in paragraph B on pages 4 and 5 hereof, and deleting the issue of the alleged violation of section 17 of the Act. As indicated in detail, infra, the motion was denied by the Examiner. In their respective proposed findings, conclusions and briefs, Diotron, Royer and Laird renew the motion, and this is discussed below in connection with the Examiner's findings.

Based upon the entire record in these proceedings and the Hearing Examiner's observation of the witnesses, he makes the following findings of fact and conclusions of law.

II. FINDINGS OF FACT

A. The Offering

1. Diotron, a Pennsylvania corporation, filed with the Commission on March 29, 1961, a notification on Form 1-A and an offering circular relating to a proposed public offering of 100,000 shares of no par value common stock at $3.00 per share for an aggregate amount of $300,000 for the purpose of obtaining

an exemption from the registration requirements of the Act, pursuant to the provisions of Section 3(b) and Regulation A promulgated thereunder.

2. Royer is a sole proprietorship owned by Sidney L. Neff, with offices in Philadelphia, Pennsylvania, engaged in the securities business since 1957.

3. Laird is a general partnership engaged in the securities business since 1888. It is a member of the New York Stock Exchange and of other principal stock and commodity exchanges. It has a main office in New York City, a home office and an accounting office in Wilmington, Delaware, and an office in Philadelphia, Pennsylvania, among others. The firm has enjoyed an excellent reputation in the securities business.

4. Laird maintained a branch office in South Philadelphia under the management of Sydney R. Shermann. The office was opened in October 1960. Although Shermann had an extensive background as a trader in commodities, he had no prior experience in the sale of securities. Following his employment by Laird he participated in the standard six-month training program in securities required by the New York Stock Exchange. He continued to be employed by Laird as a registered representative at the time of the hearing, although Laird had closed its South Philadelphia office on December 1, 1962.

5. The South Philadelphia office was under the general supervision of Laird's resident Philadelphia partner, George B. Rebbman, and of Louis J. Sneed, Jr., the managing partner at the home office in Wilmington. During the period from October 1960 through at least May or June 1961, because of Mr. Rebbman's illness and absence from the Philadelphia office, Shermann reported to and was under the direct supervision of Sneed, who remained at Wilmington. As managing partner, Sneed's duties included supervision of all accounting matters and of all operations, including those of the branch offices of Laird.

6. Jack Shusterman became an employee of Laird's South Philadelphia office in October 1960. His experience as a salesman of securities had extended over a period of approximately ten years, as employee of member houses and over-the-counter houses. He was employed by Laird to aid Shermann in the South Philadelphia office because of the latter's inexperience in the securities field. Shusterman's association with Laird terminated in December 1961.

7. In the summer of 1960, Shusterman spoke with Shermann about the possibility of Shusterman's employment at the South Philadelphia office, which was to open in October, and at a meeting of Shusterman, Shermann and George B. Rebbman, the latter agreed to Shusterman's employment at the South Philadelphia office.

8. In anticipation of this employment but without the knowledge of any partner of the Laird firm, Shermann and Shusterman

entered into a strange "working arrangement and joint venture" by written agreement prepared in August 1960, which provided, in brief, that they would share the net profits to be made by buying and selling securities in the South Philadelphia office to be opened by Laird. The agreement also provided that if Shermann should purchase or receive a partnership in Laird, Shusterman would have the right to purchase up to a one-half interest in such partnership. Under certain conditions the purchase price to be paid by Shusterman was to be valued by Laird's determination of the fair market valuation of Shermann's partnership interest. This agreement first came to the knowledge of a partner in the Laird firm in December 1961, when Shusterman produced it at the Rebbman residence.

9. At or about the time of Shusterman's employment at Laird, he discussed with Shermann the possibility of Laird's acting as underwriter of a securities offering by Diotron. Shermann thereafter communicated with Mr. Sneed at Wilmington by telephone, and on the basis of the information then known, Mr. Sneed advised that Laird would not be interested in underwriting the offering.

10. Thereafter Mr. Shusterman called Mr. Sneed, requesting further consideration of the proposed underwriting on the basis of the information he had acquired in investigating the company and the enthusiasm of Messrs. Shermann and Shusterman for an underwriting. At Mr. Sneed's suggestion, the information was sent by

Mr. Shermann to Laird's syndication department in New York City, but following a discussion between Mr. Sneed and Middleton Rose, a Laird partner in charge of its syndication department, Sneed advised Shusterman that Laird was not interested in underwriting a Diotron offering. He also advised, in response to Shusterman's inquiry, that he had no objection to efforts by Shusterman to place the underwriting with another brokerage house.

11. Following this, Mr. Shusterman contacted other brokers or representatives with regard to the offering, including a firm in New York City which refused the underwriting.

12. Late in 1960, Shusterman contacted Sidney L. Neff, of Royer, with regard to the Diotron public offering, and introduced Neff to counsel for Diotron and to some of its officers. Neff became interested and undertook an investigation of the company. Eventually an agreement was executed under which Royer was to act as underwriter of the Diotron offering on a best-efforts basis.

13. The underwriting agreement was executed on January 31, 1961. It provided in part that Diotron engaged Royer as its exclusive agent to sell to the public 100,000 shares of its common stock at $3 a share; that Royer would receive $.45 of the per share sale price as commission for each share sold and paid for; that Diotron would pay Royer's expenses at the rate of $.15 for each share sold (any excess over its actual expenses to be retained by Royer as additional compensation); that Diotron would issue to Royer 16,667 warrants for common stock, on a pro rata basis of one warrant for each six shares sold,

each warrant authorizing the purchase of a share of stock at the exercise price of $.10; that Royer would issue to the finder, David Steinberg, 4,500 of these warrants; and that Diotron would perform all acts necessary to elect to its board of directors two persons to be designated by Royer.

14. After discussions between Shusterman and Shermann, the latter obtained authorization from Sneed to engage in negotiations for Laird's becoming a member of the selling group to be formed by Royer.

15. Royer formed a selling group of approximately 35 brokers for the purpose of distributing the 100,000 shares of Diotron common stock. Laird was a prominent member of the group. The negotiations with respect to its membership in the group were carried out with Royer principally by Shermann in April 1961 at Laird's South Philadelphia office.

16. As a result of Shermann's negotiations, his assurances to Sidney L. Neff of a substantial indication of interest in the offering among Laird's customers,and his suggestion or representation that Laird would be helpful to the issue in making an after-market, Royer agreed to pay Laird a commission of $.30 for each share it sold, and to turn over up to 4,000 of the 16,667 warrants which Royer would receive under

its underwriting agreement, on a pro rata basis of one for each 12 shares sold. Each of the other members of the selling group was to receive a commission of $.225 per share sold, and no other member of the group was to receive any warrants from Royer. Although Shermann testified that he did not know the amount of the commission Royer had agreed to pay the members of the selling group other than Laird, the Examiner does not credit this testimony. It taxes credulity to suggest that in the give and take negotiations which took place between Shermann and Neff the latter did not disclose that a commission of $.225 was to be paid those members of the group.

17. In these negotiations, Neff was dealing with Shermann as a representative of Laird and he contemplated that the warrants would belong to the Laird firm. It appears, however, that Shermann expected that the warrants would be shared equally by Shusterman and himself in accordance with their joint venture agreement. However, Shermann was thereafter advised by Sneed that in accordance with the firm's policy 50% of the warrants would belong to the firm and 50% would belong to the South Philadelphia office which had generated the business for which the warrants were being received, and when the warrants were received by Laird in July 1961, 2,000 were retained by Laird and 2,000 were credited to Shermann's account with the firm. He, in turn, had agreed to deliver 1,000 warrants to Shusterman.

18. Prior to the offering date of June 26, 1961, Shermann met with Sneed to discuss the extent of the firm's participation in the offering. Shermann asked permission to request 65,000 shares from Royer because of the substantial indication of interest, but Sneed suggested the amount be kept at about 55,000 shares. Ultimately, Laird received from Royer and offered and sold to the public approximately 56,660 shares out of the 100,000 share offering. The sales were made in approximately seven states to approximately 357 customers. Of the total 56,660 shares, Jack Shusterman sold approximately 31,975 shares and Sidney Shermann sold approximately 12,550 shares. One reason for the large volume of sales by Laird is that Diotron's counsel and its officers referred persons who expressed interest in the forthcoming issue to Laird rather than to Royer.

19. Prior to May 16, 1961, Shermann spoke with Neff about the latter's right to designate two persons to be elected to Diotron's Board of Directors and asked that he be designated as one of these persons. Thereafter, on May 16, 1961, at the request of Shermann, Sneed addressed a letter to Diotron's counsel, asking that Shermann be elected to the Board of Directors in view of Laird's large selling group position and its sense of responsibility to its customers. Laird's wishes were communicated to Neff and shortly after the termination of the public offering, Neff and Shermann were elected. The Examiner discredits

Shermann's testimony regarding the background of his election to the Board. He finds that as a result of Shermann's conversations with Neff, Laird, through Shermann, had a reasonable expectation on May 16, 1961, that Shermann would be elected to the Board, even though Neff may not have firmly promised such election.

20. The public offering of the stock commenced on June 26, 1961. The order for this proceeding, apparently based upon the Form 2-A report filed by the issuer, states that the offering was completed on June 27, 1961, with the sale to the public of the entire offering of 100,000 shares.[3/] The issuer received from the offering the sum of $237,100, which was deposited in its account in The Broad Street Trust Company.

21. Laird participated in the after-market. From June 26, 1961 to June 29, 1962 the price range for the common stock of Diotron was a high bid of 3-3/4 on July 20, 1961 to a bid wanted on February 20, 1962 and the highest offering price was 4-1/8 on July 20, 1961 to an offer wanted on February 20, 1962.

22. Diotron's principal business was the developing and manufacturing of semi-conductor metallurgical materials and devices and certain

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3/ Actually, it is apparent from the evidence that the offering was not completed on June 27, 1961. Firstly, subsequent to the original allotment by Royer and because of an oversight of some kind an additional block of 1,450 shares of stock was alloted by Royer to Laird, and these shares were sold by Laird on July 5, 1961, as part of the offering under Regulation A. In addition, confirmations of other sales made by Laird as part of the original offering indicate a trade date of July 5, 1961.

electronic components and equipment. The firm never earned a profit. In June 1962 a petition for an arrangement under Chapter XI of the Bankruptcy Act was filed in the United States District Court for the Eastern District of Pennsylvania and the company was adjudicated a bankrupt on December 31, 1962.

23. In June 1961, Diotron had unfilled orders for its products in the amount of approximately $140,000, consisting largely of pilot orders under which the company had submitted samples of products to large firms with the hope of obtaining substantial contracts. At that time, however, it had no substantial and profitable contracts on its books.

24. The offering and the sale of the Diotron stock were accomplished to a large extent by means or instruments of communication in interstate commerce and the mails.

B. The Alleged Defects in the Offering Circular

25. The allegation to the effect that the offering circular fails to disclose the true position of Diotron with respect to debt and that the financial statements in the offering circular were false and misleading is supported by the undisputed fact that as of the "effective" date of the offering circular, June 26, 1961, the company owed to The Broad Street Trust Company ("Bank"), a sum in excess of

$79,435.13,[4/] whereas the offering circular reflected, in the financial statement of the company as of December 31, 1960, notes payable to the Bank in the amount of $32,513.24.

26. Collateral to the above are the allegations in the order that the offering circular failed to disclose that the $79,435.13 was due immediately to the Bank, and that it also failed to disclose the intended disposition of the proceeds of the issue being offered to the public.

27. That $79,435.13 was due immediately upon demand by the Bank is undisputed. The details and background of this obligation appear in findings below, some of which also treat with the issue of the intended disposition of the proceeds of the offering. However, the materiality of the failure to disclose the true debt position of Diotron, i.e., the amount of the debt owed the Bank and the fact that the debt was due immediately, is strenuously contested. This is treated infra under Discussion.

4/ The actual amount of the debt as of June 26, 1961, appears from the evidence to have been $84,963.56, of which $81,763.56 was secured by accounts receivable and $3,200 was unsecured. The figure $79,435.13 was the amount of the secured loan on July 13, 1961, at which time the unsecured loan obligation was $2,908.34.

28. As indicated above, Diotron deposited the proceeds of the offering in its account in The Broad Street Trust Company. The Bank had created a line of credit for Diotron in September 1960, and the company's indebtedness had grown as a result of frequent loans and relatively infrequent repayments or liquidations of accounts receivable, to the point where interest charges were a substantial burden on the income of this company which had sustained losses throughout its existence.

29. John M. Horan, Vice President of the Bank, had approved all of its loans to Diotron and was, from the Bank's standpoint, in complete charge of the Diotron account. He testified, regarding the Bank's general policy on loans, that:

> "If the company has the funds and the loan can be repaid, we prefer that at least an annual clean up of the obligation be made."

There is no dispute that on July 13, 1961, the proceeds of the offering were used, to the extent of the then-existing secured obligation of $79,435.13, to repay the obligation. There is sharp dispute, however, regarding the background of this repayment.

30. The Division contends, through the testimony of Mr. Horan, that shortly prior to the public offering Horan discussed with Basil Lawson, then President of Diotron, and with Ronald Warwick,

then its Vice President, the advisability that Diotron repay or substantially reduce its liability to the Bank. Horan testified that the officers agreed, and that the repayment was taken by the Bank from the offering proceeds in Diotron's bank account with the prior approval of these officers. The officers, however, deny prior discussion or approval of the repayment. They testified, also as witnesses for the Division, that following the deposit of the proceeds of the offering in Diotron's bank account, Mr. Horan telephone Mr. Warwick to inform him that the funds in the bank account were being used to repay the outstanding secured loan; that this clean-up of the obligation would be in the best interests of the company by saving substantial interest charges; and that if and when additional funds were required by the company the Bank would renew the line of credit as funds were required.

31. Lawson and Warwick testified that they were surprised by this action of the Bank; that Lawson telephoned the company's counsel, who was thereafter also assured by Mr. Horan that credit would be extended as required; and that no consideration was given by the company's officers to the fact that the use of the $79,435.13 in this manner would constitute a departure from the statement in the offering circular setting forth the intended use of the proceeds of the offering. No further action was taken by any of the company officers in an effort to reverse or rescind the action of the Bank.

32. The Bank's records show that commencing September 8, 1961, new credit was in fact extended to Diotron by way of unsecured loans. The indebtedness grew to the point that on April 18, 1962 the company owed an unsecured obligation of $123,127.16. As of May 14, 1962, the obligation had been reduced to $110,997.34. This amount was owing to the Bank at the time the company was adjudicated a bankrupt.

33. The Examiner credits the testimony of Lawson and Warwick that no prior approval of the July 13, 1961 repayment of the loan was given. Their respective recollections of the entire transaction appear to have become relatively indelible because of the importance of the matter to the company and their relatively few conversations with Mr. Horan. The latter, on the other hand, supervised the Diotron loan account among others, and his recollection of the transaction was understandably clouded in some respects. It might be added that there is no doubt he believed he was acting in the best interests of Diotron as well as the Bank in cleaning up the loan as he did.

34. The repayment of the loan reduced interest charges substantially and released to the company the accounts receivable which had been assigned to the Bank as collateral. Whether it had an adverse effect on Diotron's ability to conduct its business, as, for example, by precluding "purchase of piece parts and materials in advance of the actual awarding of contracts, so that the Company

[might] take advantage of the most favorable purchasing terms", as stated in the offering circular, or in any other way, is conjectural.

35. The officers of the company acquiesced in the repayment and took no further action in an effort to convince Mr. Horan or other officials of the Bank that the repayment was contrary to the provisions of the offering circular regarding the use of the proceeds. There is no evidence that either the officers or Mr. Horan considered, at the time of the repayment, that it might be in violation of statements in the offering circular.

36. As alleged in the order, the offering circular failed to disclose that Laird was to be an underwriter of the offering and that a member of that firm would be on Diotron's board of directors. The validity and materiality of these matters are contested, however, and these issues are also considered below, under Discussion.

37. As indicated above, the order also asserts that the offering circular failed to disclose that $12,374.34 was due as commissions to salesmen of Diotron and fails to disclose that officers' salaries were to be paid from the proceeds of the offering. The proposed findings and briefs of respondent and of both participants urge that the Division has offered no evidence in support of these two allegations, and that they must be presumed to have been abandoned. Actually, the Form 2-A filed by Diotron on December 26, 1961, as amended on March 6, 1962, discloses the payment to salesmen of commissions of

$12,374.34 and of salaries and fees to "officers, directors and affiliates", and no itemization of these payments appears in the offering circular's statement of the prospective use of the proceeds. However, the argument of abandonment is well-taken and is undoubtedly correct, for no findings were proposed by the Division in these areas and no response to the abandonment contention is made in the Division's reply brief. Accordingly, these charges are deemed abandoned.

C. Discussion:

I. The Bank Loan and its Repayment

38. It is urged on behalf of the issuer that the discrepancy between the obligation of $32,513.24 reflected in the offering circular as due the Bank as of December 31, 1960 and the obligation of $79,435.13 [5/] allegedly due as of the "effective" date of the offering circular was not a material misstatement. The Examiner rejects the several arguments urged in support of this position, i.e., that the net worth of Diotron actually had increased during this six month period because of capital contributions made to the company by its officers out of the proceeds of intrastate sales of Diotron stock and because of the sale of additional stock by the company; that no fraudulent intent was shown to exist in relation to the discrepancy; that no purchaser of Diotron stock testified that he would not have purchased had he known the true amount of the loan; and that the amount of the discrepancy was not in itself material.

5/ See footnote 4, supra, with regard to the actual amount of the obligation.

39. That capital contributions were made by the company's officers or net worth increased by sales of stock would not, of course, insure or suggest that the company could continue to operate effectively in the future by virtue of such activities. Nor were such factors relevant to the alleged defect, for they in no way disclosed the important fact that a large obligation of the company to the Bank had more than doubled in the six month period. Further, fraudulent intent, of course, is not an essential element of this aspect of the Division's case, predicated, as it is, on misstatements in or omissions from the offering circular. A permanent order of suspension need not be supported by a finding of willfulness. Cf. Rule 261, supra; Trail-Aire, Inc., Securities Act Release No. 4621 (1963), where the Commission stated:

> "At the least Trail-Aire's officers exhibited a lack of concern for the complete truth and accuracy of the material filed and used, which is incompatible with the responsibility of those who seek to avail themselves of the conditional exemption provided by Regulation A."

Cf. 1 Loss, Securities Regulation, 627 (2d ed., 1961). Nor is it a necessary element of the allegation that a purchaser of the securities be shown to have relied upon the misstatement in the offering circular upon which the Division's case is predicated. N. Sims Organ & Co., Inc., Securities Exchange Act Release No. 6495 (1961). The sole issue here relates to the alleged materiality of the misstatement of the loan amount.

40. Rule 405 of the General Rules and Regulations under the Act defines the term "material", when used to qualify a requirement for the furnishing of information as to any subject, as "those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security [registered]". The substantially increased amount of the Bank obligation as of the date of the offering was a matter as to which an average prudent investor ought reasonably to be informed. In the view of the Examiner the issuer's distribution and use of the offering circular dated June 26, 1961, without noting therein the substantial increase in the obligation to the Bank was improper, and the financial statement in the offering circular was materially false and misleading.

41. The obligation of $79,435.15 was payable on demand, as indicated above. To the extent, therefore, that the offering circular failed to disclose the correct amount of the obligation to the Bank, there was, of course, a failure to disclose, as charged in the order, that $79,435.13 "was due immediately to the [Bank]." The Examiner rejects any suggestion that might inhere in the charge, however, that the offering circular improperly failed to disclose that the obligation of Diotron to the Bank was due immediately. There is no suggestion that the offering circular stated or implied in any way that the notes payable to the Bank represented a deferred obligation. Conversely, the obligation was listed in the financial statement under "Current Liabilities". There is no indication of a failure to comply with the disclosure requirements as to the due date of the obligation, i.e., that it was payable on demand.

42. As indicated above, the evidence does not support the contention that Diotron's officers intended or anticipated that the proceeds of the offering would be used to repay the Bank loan which was secured by the company's accounts receivable. Nor does the failure of the company officers to take steps in an effort to have the Bank rescind the repayment action support the contention that the offering circular, as of its effective date, June 26, 1961, failed to disclose accurately and adequately the intended disposition of the proceeds of the issue. Cf. Loss, (op. cit., supra), 292-4. The Division relied on the repayment of the bank loan to support this charge, and the Examiner finds a failure of proof of the charge for reasons indicated.

II. Laird as an Underwriter: Membership on the Board of Directors

43. Rule 251 of Regulation A provides in part that:

> "The term 'underwriter' shall have the meaning given in section 2(11) of the Act."

Section 2(11) of the Act defines the term to include any person who participates in an underwriting but excludes or excepts:

> "a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission."

Rule 141 further provides that the term "usual and customary distributors'

or sellers' commission" in section 2(11)

> "shall mean a commission or remuneration, commonly known as a spread, paid to or received by any person selling securities either for his own account or for the account of others, which is not in excess of the amount usual and customary in the distribution and sale of issues of similar type and size, and not in excess of the amount allowed to other persons, if any, for comparable service in the distribution of the particular issue. . ."

44. The Division contends that the commission paid by Royer to Laird was in excess of the usual and customary distributors' or sellers' commission and that, as a consequence of Laird's participation in the underwriting, it became an underwriter which was not designated as such in the offering circular.

45. There are no precise lines which delimit the usual and customary distributors' or sellers' commission which may be paid a dealer who participates in an underwriting yet not convert his relationship to the issue to that of underwriter.[6/] As a dealer Laird had twice considered the expediency of serving as underwriter of the issue and had twice refused to act in that capacity because of the speculative nature of the offering. When Sneed agreed that the firm would

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6/ Cf. discussion in Loss, (op. cit., supra) 1493-7. While it appears permissable for a dealer to receive substantially more than the flexible 5% described therein as the "NASD Spread Philosophy" when he participates in the sale of securities at a specific public offering price stated in an offering circular, nevertheless the receipt of such sum substantially in excess of the flexible 5% would appear to convert him into an underwriter under Rule 141.

participate with Royer in disposing of the stock, he had no intention that Laird would take over the function of underwriter. Nor did Royer ever intend to abdicate to Laird its responsibilities as underwriter, even though Neff relied heavily on Laird's reputation as a member firm in disposing of the stock and in making a market in it. And although Royer had never previously acted as an underwriter, it did not in fact abdicate its functions or responsibilities as underwriter of this issue. This was not a situation where the true underwriter of a Regulation A issue was intentionally not disclosed. Cf. Condor Petroleum Co. Inc., Securities Act Release No. 4152 (1959). Although Laird sold over 56% of the offering, became the focal point to which prospective purchasers of the stock were referred by officers and counsel for the corporation, and was the important factor in maintaining the after-market in the stock following the offering,[7/] its designation as underwriter must depend on an evaluation of the commission it received, in the light of section 2(11) of the Act and the rules issued in implementation of the section.

46. It is the Examiner's view that Laird was an underwriter of the issue, firstly, because it received commissions "in excess of the amount allowed to other persons . . . for comparable service in the distribution of the particular issue." It is argued, on behalf of Laird, that no other dealer in the selling group performed comparable

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7/ This is apparent from the National Daily Quotation sheets for July 1961.

service. In a sense, this is true, for no other dealer sold more than approximately 2,000 shares. In a more basic sense, however, and in the sense in which the term "comparable service" is used in the rule, each of the dealers in the selling group performed a comparable service as a member of the group under the aegis and control of Royer. Neither Laird nor any other dealer was under commitment to Royer to take down a minimum number of shares, and none of the dealers in the group had a greater risk or responsibility for the offering's success than any other dealer (except to the extent of shares sold to their customers, for which, of course, compensation was received).[8/] Laird's extensive participation in the underwriting and sale of approximately 56,660 shares of the 100,000 share offering substantially increased its earnings but did not change the nature of its services, within the purpose and intent of the rule, in a way that would differentiate them from the services performed by the other members of the group. It is the Examiner's view that the services were comparable, even though the commission to Laird differed substantially. And if the

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8/ Although Royer bargained with Laird (through Shermann) with the hope that Laird would participate in the after-market, the evidence indicates that no promise of such participation was given.

increased commission was paid to Laird because of its incomparable service in performing functions normally performed by the underwriter of an issue, such commission would fall outside the permissive limits of Rule 141, as

> "amounts paid to any person whose function is the management of the distribution of all or a substantial part of the particular issue, or who performs the functions normally performed by an underwriter or underwriting syndicate."

Cf. Weiss, Regulation A Under the Securities Act of 1933 - Highways and Byways, New York Law Forum, March 1962, p. 22-3, to the effect that the exception does not apply to dealers who, by virtue of special concessions or especially large participation in a distribution, are not selling dealers.

47. In addition, as indicated above, the Examiner believes that within the meaning of Rule 141, Laird received commission or remuneration in excess of the authorized spread defined in the Rule. If nothing else did so, the receipt of 4,000 warrants took the commission or remuneration of Laird outside the limits of the Rule permitted to one who would retain the status of dealer only. The only evidence adduced on this issue is testimony of Shermann to the contrary, which the Examiner discredits.

48. It is urged on behalf of Laird that, assuming arguendo, Laird's status as an underwriter within the statutory definition, the failure to disclose that status in the offering circular did

not constitute the omission of a material fact. In support of this position Laird's brief urges that such disclosure in the offering circular would have had no effect on the issue other than the enhancement of interest in the stock. While it seems clear that such disclosure would have enhanced the interest of a part of the investing public, this is not an answer to the issue of materiality. For one thing, another portion of the investing public might have looked less credulously at the issue as represented by Laird's salesmen, if it were informed of Laird's status. More importantly, the definition of materiality, as indicated above, precludes an inquiry into subjective reactions of the investing public into "those matters as to which the average prudent investor ought reasonably to be informed before purchasing the security". There is little room for doubt that the average prudent investor ought reasonably to be informed of the underwriters of a public offering and of their interest in the security. This seems especially true with respect to any purchases that might be made from a dealer who is in fact an underwriter of the issue. Cf. Apache Uranium Company, 38 S.E.C. 34 (1957); Bald Eagle Gold Mining Company, 38 S.E.C. 891 (1959).

49. The order also charges a material omission in the offering circular in failing to disclose that a member of Laird would be on

Diotron's Board of Directors. Although Laird might reasonably have expected as of June 26, 1961, that Shermann would be elected to the Board, the Examiner does not believe that it was necessary, or indeed that it would have been proper under the circumstances, for the issuer to have disclosed in the offering circular the possibility that a member of the Laird firm might be elected to the Board. The underwriter had not committed himself to such election as of that date, and the conservative character required of an offering circular may well have been jeopardized no matter in what cautionery language such announcement might have been spelled out. 9/

50. No charge was made in the order that the offering circular was materially deficient in omitting to state that Laird might receive a substantial portion of Royer's warrants, based upon its sales of the stock, or that the warrants, despite the escrow agreement covering them, were allocated or disposed of by transfer to Laird within the escrow period.

9/ The Examiner rejects as specious any suggestion to the effect that Shermann, though an employee of the firm, was not a partner, and therefore not a "member" of the Laird firm.

D. The Sales Methods

51. The amendment of the order on December 28, 1962, introduced into this proceeding alleged violations of section 17(a) of the Act in the sales methods employed by some of Laird's representatives, particularly Shermann and Shusterman, in the offering and sale of the stock. Essentially, the alleged violations and improper methods attributed to Laird consisted of false and misleading oral representations concerning Diotron's operations, prospects, financial condition and contracts, and improper and unwarranted comparisons of the company or of the prospects for the price of its stock with the well-known Texas Instruments. The thrust of the charge and of the Division's argument in support of its contentions appears to be that the anti-fraud provisions of the Act were violated when statements were made in the offer and sale of the stock which were without adequate or reasonable basis or support.

52. Thus, the evidence indicated and the Examiner finds that Shusterman told Mrs. S. W. in February 1961, that Diotron was a young company with good potential, that its stock would come out at about $3 per share and had a good possibility of doubling within a year. When the customer indicated an interest in no more than 100 shares, Shusterman expressed a doubt that he could get 100 shares for her because of the great demand for the stock. Mrs. S. W. received and paid for 35 shares.[10/]

10/ Mrs. S. W. may also have been influenced to make the purchase by her son-in-law's favorable estimate of Diotron's products.

In April 1961, he told another customer who expressed interest in a securities purchase in the electronics field that something big was in the offing, and he advised Mr. J. G., the customer, to hold off and to contact him in May or June. When Mr. J. G. contacted him in June, Shusterman enthusiastically stated that Diotron would be another Texas Instruments and that the price of its stock would increase at least 12 points within the next two months, that the stock could be bought at $3 and probably would open at $5 or $6. He also spoke of pending contracts of the company with I.B.M. and Sperry Rand, on the basis of which the company had hired extra help. Mr. J. G. ordered 100 shares, was advised by Mr. Shusterman that the stock was in short supply, and ultimately received and paid for 75 shares. In March or April 1961, Shusterman told a women's investment group for which he served as broker that Diotron had a substantial backlog of orders with the Government and otherwise, which would provide constant work for about a year, and that the stock should double in price in six months to a year and could be another Texas Instruments. Mrs. A. R., one of the members of the group, testified that Shusterman indicated that he felt the price of the stock "would go straight up, but for us to hold it for at least six months." He spoke of its being in short supply but advised any prospective purchasers among the women to order exactly the amount they wanted rather than a greater amount. Mrs. A. R. ordered 100 shares and received and paid for 50, but after remonstrating with Shusterman she received another 50 shares. Just prior to

the public offering Shusterman telephoned Mr. H., another of his customers,and advised that the stock would go to $12 within a year and would help Mr. H. recover some of his prior losses. Again Shusterman advised of the short supply of the stock. Mr. H. bought and received 100 shares.

53. Shusterman admitted in his testimony that he told customers that Diotron had contracts with General Electric, Westinghouse and RCA, but did not discuss the size of these contracts. He testified that he compared Diotron with Texas Instruments only to illustrate an electronics company which manufactured a similar type of products and which became successful after its poor financial condition was improved by refinancing; that prior to the public offering his reference to Diotron stock to one or two investment clubs he represented was made in order to explain or exemplify a speculative issue; that if Diotron obtained what he considered to be potential contracts, based on his investigation of the company he projected earnings of 40 to 60 cents per share for the ensuing year, and that on the basis of a price times earnings ratio of 25, 30, or 40, he mentioned to his customers the possibility that the stock could sell at $10 to $12 per share. He also stated to his customers that if Diotron got contracts and had earnings its price could double in six months. He believed that he acted in ultra-conservative fashion when he passed on to customers information he received from the President of Diotron, realizing that

the latter would over-emphasize the favorable aspects of its operations, and he testified that in using his price times earnings ratio of 25, 30, or 40, he believed his conservativism was consistent with the proper attitude of a responsible broker, particularly because most electronics stocks were then selling at from 30 to 60 times earnings.

54. On May 19, 1961, Shermann informed Mr. E. R. that because of the great indications of interest in Diotron's forthcoming issue he doubted E. R.'s friends could purchase any stock. He stated that he would be on the Board of Directors of Diotron and that Mr. E. R. should disregard information he had received from Shusterman to the effect that the latter would be on the Board. During the conversation, E. R. ordered 200 shares, and on the same date he ordered 300 shares from Royer. (This witness previously had purchased Diotron stock in an intrastate offering of October 1960 and in a private sale.) Sometime between June 26 and July 7, 1961, E. R. spoke with Shermann by telephone and was advised that the stock was "red hot" and that it was "the kind of a stock which could go to 40 in a year or so." E. R. received and paid for the 500 shares which he ordered on May 19 from Laird and Royer. Another customer, Mr. W. I., who had never bought securities, was advised by Shermann in March or April 1961, that he had a new issue coming out that "looks good" and that the company was supposed to get contracts from General Electric. Based on Shermann's

judgment he bought 200 shares at the offering price (and 300 shares thereafter at 3-3/8ths per share).

55. Another Laird salesman, Fred Friedman, approached Mr. B. J. at his home in June 1961, and offered Diotron's forthcoming issue as an opportunity for B. G. to make up some of his prior losses, stating that this stock would eventually make some money. B. G. ordered 100 shares. When he received the offering circular for the issue together with the confirmation of his purchase, he called Mr. Friedman but was turned over to Mr. Shermann. He asked that his stock be sold, inasmuch as he was unimpressed with the offering circular, but he was advised by Shermann that the offering circular was poorly written, that his investment would be a good one in time because of the company's products, and was told that Laird had a position in the stock. (He understood this to mean that Laird would help maintain the price of the stock.) He testified that either Mr. Friedman or Mr. Shermann stated to him that the stock would go to $9 or $10. As a result of this conversation and Shermann's recommendation that he continue to hold the stock, B. G. was persuaded to withdraw his request to sell.

56. R. F. testified that another Laird salesman, Lee Preston, telephoned him in May or June 1961 and offered Diotron's forthcoming issue as an excellent investment opportunity. He represented the company as having secured contracts of "upwards of a million dollars," and estimated earnings at close to 50 cents per share. Preston stated that

the stock probably would go to $12 or $13 but suggested that R. F. could sell half of his stock at $8 within a year. He also represented that since a member of the Laird firm would be on the Board of Directors, Preston would be able to keep R. F. posted on the program of the company. R. F. ordered 300 shares and received 200.

57. The Examiner credits the above purchaser testimony and omits from these findings other testimony which does not seem to be sufficiently accurate to warrant credibility. He regards many of the statements by Laird salesmen as falsely and improvidently made without adequate foundation in fact. Many were undoubtedly generated by Shusterman's unfortunate and excessive enthusiasm for the issue and for the products of the company: they fall without the ambit of proper activity by sellers of securities and violate the standards that have been fixed under section 17(a) of the Act. Concomitant and totally related violations stem from the failure of the salesmen to supply to their customers adverse but clearly material information concerning the issuer and its operations.

58. The predictions of price rises in Diotron's stock were entirely unwarranted. Laird had twice refused to underwrite the speculative stock issue of this small and as yet unsuccessful company despite the fact that several persons, including some engineers, were firm in their belief that the company's products were "ahead of the field". But

Shusterman's enthusiasm was permitted free rein in Laird's participation in the underwriting. It seems natural that Shermann and other Laird representatives who knew substantially less than Shusterman about Diotron's business would share his unbridled enthusiasm and would seek a part in the fertile sales field which this enthusiasm had helped to develop. Price rises were predicated on possible contracts or orders which might result from interest which such companies as General Electric and Westinghouse had shown in taking samples furnished under what were essentially pilot orders. Any figures relating to potential sales furnished by Lawson, the President of Diotron, to Shusterman, were based on the growth of the diode and rectifier fields rather than on demonstrated success of Diotron's products in these fields. The record is devoid of any adequate basis for the projection of future earnings of the company during the ensuing year or in any year, and is barren of any justification for applying a price times earnings ratio to such estimate of future earnings as a predicate for evaluating the upward movement of the price of the stock. In Thomas Bond, Inc., 5 S.E.C. 60, 71 (1939), the Commission said of a projection of earnings in a prospectus: "It is our opinion that these statements lend an appearance of predictability of future profits which is improper for a corporation which has yet to start business. Although stated as an estimate of future profits, the use of definite figures is misleading". Cf. Alexander Reid & Co., Inc., Securities Exchange Act Release No.6727 (1962),where it was stated ". . . the predictions of very

substantial price rises to named figures with respect to a promotional and speculative security of an unseasoned company cannot possibly be justified. In our experience such predictions have been a hallmark of fraud."

Shusterman's estimates, while not always in definite or specific figures and while oral rather than written into a prospectus, were also misleading and unwarranted for this company which had operated only at a loss and which had hopes for contracts rather than existing orders.[11/] It should be noted, in this connection, that the company's losses were not described to the prospective purchasers of stock; and this, of course, was a material factor in a prospective purchaser's evaluation of the stock. Shusterman and Shermann knew of the company's losses and poor operations in the past.

59. The comparison of Diotron with Texas Instruments was also misleading and unwarranted. In The Whitehall Corporation, 38 S.E.C. 259, 266-7 (1958) and in American Republic Investors, Inc., 37 S.E.C. 287, 290-91 (1956), the Commission condemned comparisons of a new and promotional company with established companies in the same industry. Even if the comparison was for the limited purpose stated by Shusterman in his testimony, the presentation to customers was not sufficiently extensive in background nor adequately guarded to make this understood, and it is not credible that the comparison was intended only for the limited purpose of exemplifying a company whose success followed refinancing.

11/ As of the offering date apparently a substantial portion of Diotron's order backlog of $140,000 represented unprofitable pilot orders.

60. Other statements to customers were misleading and apparently false. There is nothing in the record to support statements that Diotron had contracts with I.B.M. and Sperry Rand, on the basis of which extra help was hired, or that it had a substantial backlog of orders which would provide work for about a year. The implications, if not the facts, were misleading, and absent disclosure of the currently unfavorable earnings position of the company such statements should not have been made in order to induce the purchase of the stock.[12/] Similarly, Shusterman's failure to disclose the relatively minuscule size of the contracts with General Electric, Westinghouse and RCA because he "was not asked", or the unprofitable nature of these contracts, made statements that such contracts existed misleading to the investing public.

61. Neither Shermann nor Shusterman related to their customers the fact that they or Laird were to receive warrants for the future purchase of the stock of $.10 per share in an amount proportionate to their sales of the stock. The omission was an especially material one in light of the fact that the offering circular made no reference to Laird's sharing the warrants with Royer. Nor did the other salesmen mention to their customers the fact that Laird would receive warrants.

12/ Cf. Loss (op. cit., supra)1701, concerning the Act's language "misrepresentation" of "fact": "There is even more reason, in view of the express reference to omissions, to expunge any lingering distinction between lies and half-truths."

62. Shermann's activity in urging B. J. to retain his stock because the offering circular was poorly written, and because the investment would be a good one, predicated in part on Laird's position in the stock, is further evidence of improper sales activity that took place in the disposition of the offering. It seems hardly necessary to characterize other representations, such as those of Preston, related above, or to recapitulate all of the representations which helped to create a somewhat pervasive pattern of improper activity in the sale of the stock.

63. The brief submitted on behalf of Laird urges that the salesmen's representations or statements, if made,"boiled down to their substance charge nothing more than mere permissible puffing". However, the following quotation by the Commission in Fennekohl & Company, Incorporated, Securities Exchange Act Release No. 6898 (1962) seems apposite:

> "The concept of 'puffing' is derived from the doctrine of caveat emptor and arises primarily in the sale of tangibles where it appears that examination by the purchaser may offset exaggerated statements and expressions of opinion by the salesman. It can have little application to the merchandising of securities. Particularly is this true under the anti-fraud provisions of the securities laws, which were designed to protect against sharp and inequitable practices whether or not they meet the requisites of common law fraud. [Citing Cady, Roberts & Co., Securities Exchange Act Release No. 6668 and cases cited at p. 8 (November 8, 1961).] Indeed, a basic purpose of this remedial legislation was to supplement the doctrine of caveat emptor with high standards of responsibility for sellers of securities. We have repeatedly emphasized that these standards are embodied in the concept of fair dealing which is inherent in the relationship between a broker or dealer in securities and his

> customers. [Citing Duker & Duker, 6 S.E.C. 386, 288-89 (1939); William J. Stellmack, 11 S.E.C. 601, 621 (1942); Carl J. Bliedung, 38 S.E.C. 518, 521 (1958)]".

Compare the recent statement in S.E.C. v. Johns, (Civil Action No. 509-62, U.S.D.C.N.J., 1962):

> "The standards of conduct prescribed for this type of business cannot be whittled away by the excuse that false statements made were inadvertently made without intent to deceive, or by reliance upon the literal truth of a statement which, in the light of other facts not disclosed, is nothing more than a half-truth. Nor may refuge be sought in the argument that representations made to induce sale of stock dealt merely with forecasts of future events relating to projected earnings and the value of the securities, except to the extent that there is a rational basis from existing facts upon which such forecast can be made, and a fair disclosure of the material facts. The element of speculation is inherent in stock investments, but the investor is entitled to have the opportunity to evaluate the risk of loss, as against the hope of a lucrative return, from true statements of the financial status of the corporate enterprise in which he is acquiring an interest."

Whatever the extent of Shusterman's investigation of the company, by discussion with officers or otherwise, it was certainly not such as could reasonably support the statements made by him and other Laird representatives or the failure to disclose or refer to adverse and uncertain aspects of the company's business activity. Cf. Leonard Burton Corporation, Securities Exchange Act Release No. 5978 (1959).

E. The Motion to Dismiss

64. As indicated above, during the course of the proceedings counsel for Diotron, Royer and Laird joined in a motion to amend the order for proceedings by deleting therefrom the charges of alleged fraud and improper activity by Laird in the sale of the stock. The motion was denied by the Examiner for two stated reasons: Firstly, although the motion was tailored under Rule 6(d) of the Rules of Practice, which permits the Examiner to rule on amendments to the matters of fact and law to be considered, the Examiner ruled that the motion was clearly designed to dispose of a part of the proceeding which the Commission had ordered to be heard. Rule 11(e) of the Rules of Practice provides that the Examiner may rule on all motions made during the course of the hearing, except that:

> "where his ruling would dispose of the proceeding in whole or in part, it shall be made in his recommended decision submitted after the conclusion of the hearing".

Secondly, the Examiner ruled that the substance or merits of the motion had been determined by the Commission in a prior proceeding adversely to the contention of movants.

65. The motion, which was renewed in the briefs of the movants and is submitted to the Examiner for consideration in this recommended decision, is grounded on the language of Rule 261(a)(3), which provides, in effect, that a Regulation A exemption may be suspended by the Commission

where "the offering is being made or would be made in violation of section 17 of the Act." Movants emphasize the present and future tense of this language and argue that a Regulation A exemption can be suspended for improper activities occurring in connection with the sale of the stock only while these activities are taking place or when it appears that they will occur in the future, but that once an offering has been completed the Commission is powerless to suspend under Rule 261(a)(3) for such violations of section 17 of the Act which have already occurred.

66. The Commission's order temporarily suspending the exemption was issued on July 26, 1962, based upon alleged deficiencies in the offering circular. The Division seeks to have the suspension made permanent on the basis, in part, of violations which took place during the offering but which were not alleged or asserted until long after the offering was completely sold, i.e., December 28, 1962. In Cemex of Arizona, Inc., Securities Act Release No. 4430 (1961), a similar question was considered by the Commission and disposed of in the following language:

> "The issuer has argued that we may not base any suspension order in this case upon a violation of Section 17 of the Act because its offering has been completed and Rule 261 (a)(3) provides for suspension only where an offering 'is being made or would be made' in violation of that Section. The Division opposes this contention, urging that to construe this provision narrowly as contended by the issuer so as to be applicable only to offerings which have not been completed would be inconsistent with the regulatory scheme of which Rule 261 is a part and which is designed to deny access to the simplified Regulation A procedures to all issuers and related persons who have misused such procedures, so as to restrict them to the fuller registration requirements in any further attempt by them to obtain funds from public investors. We agree with the Division

> that Rule 261(a)(3) should not be viewed as solely applicable to the situation where a false and misleading offering circular has not yet been used or has only partially achieved its purpose and as inapplicable to the even more serious situation where an offering has been completed through its full utilization. However, we note that in this case, as is true in nearly all cases where the offering circular is false or misleading, Rule 261(a)(2) is alone sufficient to require suspension of the exemption." 13/

Here, too, the deficiencies in the offering circular were the basis for and will support the suspension under Rule 261(a)(2), which offers in its language no grounds for arguing that the exemption of an offering which has been completely sold cannot be suspended by the Commission. Moreover, the narrow view of Rule 261(a)(3) urged by the moving parties disregards the persistent and continuing effect which a fraudulent offer of the sale of securities may have, places an unintended and undue importance on the tense of the language, and would be unduly self-limiting for the Commission. It also creates an unwarranted premium for early and speedy success in a sales campaign which might be conducted in flagrant violation of section 17 of the Act.

67. While it may be true, as urged by the moving parties, that the language of the Commission in Cemex on this issue is dictum, inasmuch as an adequate basis for suspension existed in that case under Rule 261(a)(2) because of deficiencies in the offering circular, the principal enunciated is sound and should be followed in this case. See also 1 Loss (op. cit., supra), 1962 Supp. 39; Weiss (op. cit., supra) at 118-19.

13/ Rule 261(a)(2) authorizes suspension of the exemption where the offering circular contains an untrue statement of a material fact or omits such statement.

68. Other arguments suggesting that Cemex is not binding on the Examiner are urged in the briefs. For example, it is argued that only the narrow interpretation is consistent with the background and history of the Commission's adoption of the Rule in 1953. However, the history and stated purpose of the Rule suggest to the Examiner that while it was undoubtedly contemplated and expected by the Commission that prompt and effective action would be taken to nip in the bud any fraudulent offerings made in violation of section 17, it was not intended or desired to circumscribe the Commission's power of action as suggested by the moving parties. Similarly, a suggested distinction between fraudulent or improper activity of a dealer in selling securities, as in the instant case, and the improper acts of the issuer, as in Cemex, does not warrant a different conclusion from that announced in Cemex regarding the applicability of Rule 261(a)(3) to a completed offering.

69. One further aspect of the matter should be mentioned as a basis for denial of the motion (and for denial by the Examiner during the hearing of motions to strike or reject testimony relating to the sales activities, grounded on the same argument). It is a well-settled principle that the interpretation given to a law by an administrative agency which has the duty to administer it, should be given great weight. F.T.C. v. Mandell Bros., 359 U.S. 385 (1959); Sutherland, Statutes and Statutory Construction, sec. 5103 (3rd. ed. 1943). The principle should apply with even greater force when the agency is interpreting its own regulation or rule. See Sutherland, (op. cit., supra) sec. 5103 and

cases cited at note 5. Cf. Norwegian Nitrogen Co. v. U. S., 288 U.S. 294 (1932) where the Supreme Court upheld the authority of a regulatory agency to interpret its own rules and any language therein. The Commission, of course, could amend Rule 261(a)(3) if it thought it necessary to state in positive terms its authority to suspend the exemption of a completed offering for violations of section 17 which had occurred in the sale of the securities. In Cemex, however, it stated its view that the authority for such action exists, and this view that amendment of the Rule is unnecessary must be accorded great weight under the above principle.

III. CONCLUSIONS OF LAW

1. From the above, the Examiner concludes that, as alleged in the order, the offering circular contains untrue statements of material facts and omits to state material facts necessary, in order to make the statements made, in the light of the circumstances under which they were made, not misleading, particularly with respect to:

a. The financial statement of the company and the amount of the outstanding bank loan payable on demand by the Bank;

b. The fact that Laird was an underwriter of the issue;

and that by reason of the above, section 17 of the Act was violated.

2. The Examiner also concludes that Laird, through its representatives engaged in selling Diotron stock, obtained money as indicated above by means of untrue statements of material facts and omissions to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading,

and engaged in transactions, practices and a course of business which operated as a fraud and deceit upon the purchasers of Diotron stock, all in violation of section 17(a) of the Act.

IV. RECOMMENDATIONS

1. It is recommended, for the reasons stated above, that the motion to dismiss the charge of violation of section 17(a) of the Act in the sales activity of Laird representatives be denied.

2. In view of the violations of the Act, it is recommended that pursuant to Rule 261 of Regulation A the Commission enter an order permanently suspending the exemption. 14/

Respectfully submitted,

Sidney Ullman
Hearing Examiner

Washington, D. C.
July 31, 1963

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