

IN THE MATTER OF
RICHARD BRUCE & CO., INC., ET AL.*

File No. 3-134. Promulgated April 30, 1968

Securities Exchange Act of 1934—Sections 15(b) and 15A

BROKER-DEALER PROCEEDINGS

Grounds for Revocation of Registration
Grounds for Bar from Association with Broker-Dealer
Fraud in Offer and Sale of Securities

Where salesmen of registered broker-dealer, in offer and sale of speculative securities, made fraudulent representations, variously consisting of extravagant unconfirmed reports concerning issuer and unreasonable price and earnings predictions, and officers of broker-dealer authorized dissemination of such reports to customers, *held*, willful violations of anti-fraud provisions of securities acts, and in public interest to revoke broker-dealer's registration and to bar associated persons who participated in such violations.

APPEARANCES:

Robert M. Berson, Howard A. Bernstein, Bruce A. Ricqh, and Evan L. Gordon, of the New York Regional Office of the Commission, for the Division of Trading and Markets.

Seymour M. Heilbron and Stanley G. Schrager, of Hays, St. John, Abramson & Heilbron, and *Hartley J. Chazen*, for Richard Bruce & Co., Inc., Melvyn Hiller, George Granat and Stanley Gross.

Milton Norman, of Koenigsberg, Norman & Drangel, for Aaron Fink.

Martin M. Frank, of Feldshuh and Frank, for Jeanne S. Earle.

FINDINGS AND OPINION OF THE COMMISSION

The hearing examiner, in private proceedings pursuant to Sections 15(b) and 15A of the Securities Exchange Act of 1934 ("Exchange Act"), filed an initial decision in which he concluded,

* Melvyn Hiller, George Granat; Stanley Gross; Aaron Fink; Jeanne S. Earle.

among other things, that the registration as a broker and dealer of Richard Bruce & Co., Inc. ("registrant") should be revoked; that Melvyn Hiller, president, George Granat, treasurer, Stanley Gross, vice president and secretary, and Aaron Fink, a salesman of registrant, should each be suspended from association with any broker or dealer for periods of 6 months, 3 months, 2 months, and 2 months, respectively; and that Hiller and Granat should each be barred from any such association in a supervisory capacity.¹ Various respondents filed petitions for review of the initial decision and, pursuant to Rule 17 CFR 201.17(c) of our Rules of Practice, we ordered review with respect to the issues which were before the examiner concerning all the respondents.² Briefs were filed by Hiller, Granat, Gross, and our Division of Trading and Markets ("Division"). Our findings are based upon an independent review of the record.

FRAUD IN OFFER AND SALE OF SECURITIES

(a) TRANSITION SYSTEMS, INC.

Between October 1961, and March 1962, nine customer-witnesses purchased a total of 2,600 shares of the stock of Transition Systems, Inc. ("Transition") through a saleswoman of registrant at prices ranging from $2\frac{3}{4}$ to $16\frac{1}{2}$. The saleswoman, in soliciting purchases, represented that Transition, which was organized in December 1960 to develop a "correlator," an electronic device to improve signal detection systems, was engaged in highly secret operations and had a government contract; that its correlator would be used to transmit information on the bodily condition of a certain astronaut during his orbital flight; that a certain United States senator was going to be highly influential in obtaining government contracts for the company; that the correlator would detect cancer and "almost anything in the human body," and the American Medical Association was interested in it; and that Transition stock was "terrific," comparable to the stock of a certain well-known company, and would "skyrocket," unquestionably go up about 30 points, and rise to about \$40 per share in 6 months. At a meeting in December 1961 in registrant's office, which was attended by a customer-witness, the saleswoman, Hiller, Granat, and two persons, including a representative of another broker-dealer, who were introduced as "analysts" of Transition stock, the latter two persons spoke of Transition "in a most fervid way,"

¹ The examiner also concluded that registrant should be expelled from membership in the National Association of Securities Dealers, Inc. Registrant's membership, however, has been terminated by the Association for failure to pay assessments, thereby rendering this issue moot.

² Jeanne S. Earle, a saleswoman of registrant, died subsequent to our order for review and, accordingly, these proceedings will be dismissed as to her. Robert A. Monahan, a salesman of registrant, has been barred from association with a broker-dealer with his consent.

stated that its plant was heavily guarded and shrouded in secrecy, and that the company "really had something that was good." Hiller told another of the customer-witnesses in March 1962 that he thought Transition could be equated to a certain company whose stock had had a remarkable rise in price within a short period of time, and he reiterated some of the statements that had been made to the customer by the saleswoman.

The above representations and predictions were made without a reasonable basis and were materially false and misleading.

Registrant had been the underwriter with respect to a registered public offering of 72,200 shares of Transition stock at \$4.50 per share, which was completed in July 1961. The registration statement, which became effective in June 1961, recited that Transition had not yet commenced operations and had made no arrangements for the sale of any products or services, that the proceeds of the offering might not be sufficient to meet its needs for the period required to develop a practical correlator, that the company to a large extent would be dependent upon government contracts for the development and production of a correlator, and that there was no assurance that the government would make funds available for such purpose or that Transition would obtain any, or, if it did, that it would be able to develop a correlator or manufacture and sell it at a profit.

Transition's correlator was only in the planning stage until December 1961, when Transition began to occupy a leased plant. Its first annual report, which covered the period from its inception to September 30, 1961, and was issued in January 1962, showed a net operating loss of \$11,417, representing pre-production costs and expenses, and stated that the company, as of January 9, 1962, had equipped an electronics laboratory where "the critical research and development program for its general purpose correlator [was] being conducted."

In an April 1962 news release, subsequent to the representations set forth above, Transition announced that its correlator was available for sale at \$10,000 per unit on a 30-day delivery basis. Shortly thereafter, a large manufacturer offered a similar product for half the price and Transition was unable to compete. It never received a single order for its correlator or a government contract, and its plant had one guard obtained from a private detective agency. The correlator was not used on the orbital flight, had no application for cancer detection, Transition had not communicated with the American Medical Association concerning the device, and the Association had not expressed an interest in it. Transition's

federal income tax return for the fiscal year ending September 30, 1962, showed a net loss of \$69,650.

Registrant's officers contend that Hiller, after "having received glowing assurances from persons close to" Transition which he was unable to confirm, properly instructed the salesmen that they "might" offer the stock "only to persons who were interested in speculations and could afford losses" and to tell such persons what they had heard, provided they also told them the source of the information, and emphasized that such information was unconfirmed and that according to published information the company had no earnings.

The chief source of the extravagant reports reflected in the saleswoman's fraudulent representations was a brother of the president of Transition who had been engaged by the company as a "business consultant."³ He had also given information to persons who were associated with other broker-dealers and such persons gave similar reports to Hiller and Granat and, at the request of Hiller and Granat, to a group of registrant's salesmen. It is clear from the record that Hiller did not regard the president's brother as a reliable source of information concerning Transition's operations and considered the reports to be of "poor quality."⁴ Hiller and Granat attempted to obtain confirmation of the reports from Transition's officers but were unsuccessful.⁵ Nevertheless registrant's salesmen were authorized to repeat the reports in offering Transition stock to customers. Although according to Hiller's testimony he told the sales staff to inform customers that the reports had not "in many cases" come "directly from the company," the saleswoman testified that she told customers her information came largely from the brother whom she erroneously described as "second in command" of Transition, and that, pursuant to Hiller's instructions, she advised her customers that "if

³ The brother's contract with the company, which was approved by the board of directors at a meeting attended by Hiller who was then a director of the company, recited that the brother was not an employee or agent of the company but an independent contractor. His activities as a consultant included finding suitable quarters for the company and ordering office and nonscientific plant equipment. The president testified he did not discuss corporate affairs with him.

⁴ When another saleswoman of registrant reported to Hiller that she had been told by a representative of another broker-dealer that Transition had perfected "an all-purpose correlator that would detect 97 percent of all conceivable types of cancer," Hiller replied that "it was a lot of garbage and he didn't know whether it was fact or fiction." A salesman of registrant testified that he "had absolutely no proof of any of the rather wild stories" being circulated concerning Transition, although he considered the sources reliable.

⁵ Hiller resigned as a director of the company in May 1962, because of his stated inability to secure information as to its products and other matters.

We may note that even if members of Transition's management had given registrant information similar to that reported by the president's brother, the question of whether registrant would be warranted in relying upon it so as to excuse the representations that were made would depend upon a consideration of all the circumstances. See *A. T. Brod & Company*, 43 S.E.C. 289, 291 (1967), and cases there cited.

the company had what they said they had, then the stock might do very well."

There is no indication in the record that any of the customer-witnesses were cautioned as to the unreliable nature of the reports. Indeed, as previously mentioned, Hiller himself reiterated to a customer a number of the reported statements and, in effect, forecast a spectacular price rise in Transition stock. The record does not show that he informed the customer that he had been unable to verify the reports. Moreover, the customer-witnesses were not told that Transition had no earnings. In fact, the saleswoman stated to one customer that she did not know whether or not the company had earnings, and Hiller advised the same customer that he did not have a recent financial statement of the company, notwithstanding the fact that financial statements for fiscal 1961 were then available.

The picture that emerges from this record is of registrant authorizing, if not encouraging, the solicitation of orders for a speculative stock on the basis of unconfirmed and extravagant reports or rumors, and of sales personnel being instructed to transmit such reports to persons who in the salesmen's judgment could afford to lose money or would not complain if they did, in a situation where losses were or could reasonably be anticipated.⁶ Since broker-dealers and their associated persons hold themselves out as professionals in the securities business, a report disseminated by them in connection with recommending a security, notwithstanding the fact that customers are advised that the report is unconfirmed, gains in authority and credibility.⁷ Under these circumstances, the use of such reports as part of a sales pitch was contrary to the basic obligation of a broker-dealer to deal fairly with the investing public.⁸

Hiller, Granat and Gross were equal shareholders in registrant

⁶ Hiller told one salesman, "Don't give [Transition stock] to crybabies, they can't take their losses." A saleswoman testified that in the case of speculative stocks such as that of Transition the sales force was instructed to offer the stock "to people who had the means, who were not susceptible to weeping in their beer if they lost money." Granat testified that sales personnel were reminded that the reports were "still hearsay," and "that they should be very careful to whom they sold the stock."

Of course, even if it were assumed that all the customer-witnesses could afford to speculate and lose money, that circumstance cannot excuse the fraudulent representations made to them. See *R. Baruch and Company*, 43 S.E.C. 13, 19 (1966).

⁷ See *Denis Timothy Donovan*, Bulletin of Ontario Securities Commission for June 1967, p. 26. Cf. *Anne Caseley Robin*, 41 S.E.C. 634, 637 (1963); *Heft, Kahn & Infante*, 41 S.E.C. 379, 388-89 (1963). Even assuming that disclosure to customers that the reports were unconfirmed would constitute a defense or were to be considered a mitigative factor, it is clear that in view of the danger inherent in the dissemination of such reports, registrant's officers did not take adequate steps to assure such disclosure or to detect nondisclosure by sales personnel. As previously mentioned, it does not appear that Hiller himself made such disclosure to the customer to whom he personally transmitted such reports.

⁸ See *Mac Robbins & Co., Inc.*, 41 S.E.C. 116, 117-19 (1962), *aff'd sub nom. Berko v. S.E.C.*, 316 F.2d 137 (C.A. 2, 1963).

and all actively participated in managing its affairs. Although Gross was in charge of registrant's trading and back office operations and appears to have taken a less active role in registrant's retail sales activities, he usually attended registrant's weekly sales meetings. We are of the opinion that he must be held responsible along with Hiller and Granat for the fraudulent representations that were made.

We conclude that in the offer and sale of Transition stock, registrant, together with or willfully aided and abetted by Hiller, Granat and Gross, willfully violated the anti-fraud provisions of Section 17(a) of the Securities Act of 1933 and Sections 10(b) and 15(c) (1) of the Exchange Act and Rules 17 CFR 240.10b-5 and 15c1-2 thereunder.

(b) *Honig's-Parkway, Inc.*

Fraudulent representations were also made in the offer and sale of the common stock of Honig's-Parkway, Inc. ("Honigs") in March and April 1962, in advance of and during a public offering of 100,000 shares of such stock at \$3 per share through registrant as managing underwriter. Such offering, which commenced on April 4, and was completed on April 24, 1962, was made pursuant to a claimed Regulation A exemption from registration (17 CFR 230.251 et seq.) under the Securities Act.

Six customers, who purchased a total of 700 shares of the Honigs offering, testified to representations and predictions made to them by registrant's salesman, Fink. He variously represented that Honigs, which owned and operated three retail discount stores in the Bronx, New York, would have "high earnings," probably between 50 cents and \$1 per share, that he expected a "good rise" in the price of the stock, and that the price would at least double in a short period of time and should rise to \$10. Two other members of registrant's sales staff variously stated to three customer-witnesses that the price of Honigs stock would probably go up, might rise to 8, would go up to around 10 when its "very, very fine earnings report" was issued in the "very near future," and that "paper" losses on Transition stock could be recouped by purchasing Honigs stock.

There was no reasonable basis for the representations and predictions made. Not only were the price predictions inherently fraudulent, but the predictions of "a sharp increase in earnings with respect to a speculative stock without disclosure of the uncertainties as well as the known facts upon which a prediction rests" were also "inherently misleading."⁹ Although the offering circular

⁹ *James De Mamos, aff'd*, C.A. 2, Docket No. 31469 (October 13, 1967).

showed an increase in Honigs' net profit after taxes from \$23,012 for the fiscal year ended September 30, 1960, to \$56,411 or 27½ cents per share for fiscal 1961, it noted that the 1960 profit was earned by Honigs' two predecessor partnerships and that the increase in fiscal 1961 resulted in part from the fact that upon the transfer on October 1, 1960 of their assets and business to Honigs, which was organized for that purpose, quantity purchases could be effected at a lower cost. This should have put Fink on notice that the increase may have been non-recurring in nature and, therefore, was no basis for projecting a further increase. Moreover, the offering circular pointed out that Honigs faced strong competition from similar businesses which might have greater financial resources and sales. In fact, Honigs' net earnings per share after taxes declined to 23.1 cents in fiscal 1962 despite the tax benefits it received through its acquisition in May 1962 of another company with a substantial carry-over operating loss.¹⁰ Nor were the optimistic representations justified by the circumstance that, according to Honigs' president, the company had been considering possible expansion of its operations and a possible eventual listing of the company's stock on a national securities exchange.¹¹

Fink admitted that the only information he had available on Honigs was that contained in the offering circular and that his prediction of a substantial increase in company earnings was based merely on the description in the circular of a store opened by the company 5 months before. No basis appears for predicting whether or not this store would be profitable. He also testified that there was no basis for predicting a rise in the price of the stock.

We conclude that registrant, together with or willfully aided and abetted by Fink, willfully violated the above cited anti-fraud provisions in the offer and sale of Honigs stock.¹²

PUBLIC INTEREST

We agree with the hearing examiner that it is in the public interest to revoke registrant's registration as a broker-dealer, but we think that, with respect to the individual respondents, sanc-

¹⁰ Registrant's officers cite Honigs' report to stockholders for fiscal 1962, to show that its earnings per share after taxes increased from 16.4 cents in fiscal 1961 (instead of the 27½ cents figure shown in the offering circular) to 23.1 cents in fiscal 1962. However, the 16.4 cents figure was based on 314,000 shares of stock outstanding, of which 100,000 shares were not issued until the public offering in April 1962, and 9,000 shares were not issued until the May 1962 acquisition of the other company.

¹¹ The President of Honigs, in response to a question whether the company in 1962 contemplated listing the stock, testified:

"... this is a thing that I guess I dreamt about, and we always discussed . . . We had hoped that eventually, after getting several acquisitions and building the business up, . . . we would go into . . . a second issue and get more capital to get a bigger and better business . . . but there was no discussion of anything definite at that time."

¹² On the record before us, we are unable to make adverse findings with respect to Hiller, Granat, and Gross in connection with the transactions in Honigs stock.

tions more severe than those at which he arrived should be imposed. The argument of registrant's officers, that a bar of Hiller and Granat from supervisory positions is not warranted and that the suspensions should be reduced or, at least, not increased because the charges relate to only a small portion of registrant's business, "involve no dishonesty," and "at most, resulted from over optimism," is untenable. They participated in a serious fraud upon registrant's customers in the offer and sale of the Transition stock. We conclude that Hiller, Granat and Gross should be barred from association with a broker-dealer. Hiller was primarily responsible for and himself participated in making fraudulent representations to customers and he as well as Granat actively encouraged the dissemination of the unconfirmed reports concerning Transition. Gross attended sales meetings, shared in the profits from registrant's retail sales, and knew or should have known of the improper activities. However, since Granat's participation in the misconduct was not as extensive as Hiller's, and Gross apparently had a less active role in registrant's retail sales than either Hiller or Granat, we are of the opinion that their bar should not preclude Granat's association, after a period of 12 months, and Gross' association after a period of 9 months, with a broker-dealer in a nonsupervisory capacity upon a showing that they will be adequately supervised. In view of Fink's fraudulent representations, he should be barred.¹³

An appropriate order will issue.

By the Commission (Commissioners OWENS, BUDGE, WHEAT and SMITH), Chairman COHEN not participating.

¹³ The exceptions to the initial decision of the hearing examiner are overruled or sustained to the extent they are inconsistent or in accord with our decision.