IN THE MATTER OF

STONE SUMMERS & COMPANY ET AL.*

File No. 3-2451. Promulgated November 3, 1972

Securities Exchange Act of 1934—Sections 15(b), 15A and 19(a)(3)

BROKER-DEALER PROCEEDINGS

Grounds for Remedial Action

Where registered broker-dealer, aided and abetted by present or former officers, sold unregistered securities in violation of Securities Act of 1933 and while doing so entered bids for such securities, and officers failed reasonably to supervise to prevent such violations, *held*, under circumstances in public interest to impose suspensions on registrant and officers.

APPEARANCES:

Gerald E. Boltz, *Joan H. Saxer*, *Cecil S. Mathis*, and *Charles T. Rose*, of the Fort Worth Regional Office of the Commission, for the Division of Trading and Markets.

Gene Stipe and *Eddie Harper*, of Stipe, Gossett, Stipe & Harper and *George F. Saunders*, for respondents.

FINDINGS, OPINION AND ORDER

Following hearings in these proceedings pursuant to Sections 15(b), 15A and 19(a)(3) of the Securities Exchange Act of 1934, the hearing officer issued an initial decision in which he concluded that the broker-dealer registration and the membership in the National Association of Securities Dealers, Inc. of Stone Summers & Company ("registrant") should be suspended for a period of seven days, that Alexander J. Stone, president of registrant and Thomas E. Summers, formerly a vice-president, should each be suspended from being associated with any broker or dealer for 30 days, and that Bobby Layne Summers, brother of Thomas and formerly secretary-treasurer of registrant, should be similarly suspended for a period of 15 days. We granted petitions for review of the hearing officer's initial decision filed by the

*Alexander J. Stone; Thomas E. Summers; Bobby Layne Summers

above respondents and they and the Division have filed briefs.[1] Our findings are based upon an independent review of the record.

Sales of Unregistered Securities and Related Violations

The hearing officer found that during 1968 registrant willfully violated and Stone and the Summers brothers willfully aided and abetted violations of Sections 5(a) and 5(c) of the Securities Act of 1933 and Section 10(b) of the Exchange Act and Rule 10b–6 thereunder, in connection with the offer and sale of shares of the common stock of United Australian Oil, Inc. ("UAO"), and that Stone and the Summers brothers failed reasonably to supervise persons under their supervision with a view to preventing such violations.

The record shows, and there is no dispute, that during November and December 1968, registrant sold to various other broker-dealers 698,000 shares of UAO stock, 100,000 of which registant had purchased from one Paul Dawson and resold as principal, 100,000 of which registrant sold as agent for Dawson, and the other 498,000 of which registrant sold as agents for one Charles I. Allen.

No registration statement under the Securities Act was filed or in effect with respect to the UAO securities when the above sales were made. Accordingly, such sales of unregistered UAO shares were in violation of Sections 5(a) and 5(c) of the Securities Act [2] unless an exemption applied to them. It is well settled that the burden of providing entitlement to an exemption from the general policy of the Securities Act requiring registration rests with the person claiming the exemption.[3] Respondents have not sustained such burden here.

Respondents claim that registrant's sales as principal of the 100,000 UAO shares purchased from Dawson were exempt as dealers' transactions under Section 4(3) of the Securities Act [4] and that the sales as agent for Dawson and Allen were exempt as brokers' transactions under Section 4(4).[5]

---

[1] The Division has also petitioned us for review of a second initial decision recently filed by the hearing officer in which he denied its motion to suspend registrant's broker-dealer registration pending our disposition of these proceedings. In view of the present final determination of these proceedings with respect to the captioned respondents, the Division's petition is moot and is hereby denied.

[2] As applicable here, Sections 5(a) and 5(c) make it unlawful to use the mails or interstate facilities to sell or deliver a security unless a registration statement is in effect as to such security, or to offer to sell a security unless a registration statement has been filed as to such security.

[3] *S.E.C.* v. *Ralston Purina Co.*, 346 U.S. 119 (1953); *S.E.C.* v. *Culpepper*, 270 F. 2d 241, 246 (C.A. 2, 1959); *Pennaluna & Co., Inc.*, v. *S.E.C.*, 410 F. 2d 861, 865 (C.A. 9, 1969), *cert. denied*, 396 U.S. 1007 (1970).

[4] Subject to certain exceptions, Section 4(3) provides an exemption for a dealer as to trading occurring after a period of distribution. H.R. Rep. No. 85. 73d Cong. 1st Sess., p. 16 (1933).

[5] Section 4(4) exempts brokers' transactions executed upon customers' orders but not the solicitation thereof.

We have previously held that the brokers' exemption is not available when the broker knows or has reasonable ground to believe that his customer is an underwriter since in that event the broker likewise violates Section 5 by participating in a non-exempt transaction.[6] And the dealers' exemption also is not available to a dealer who is selling unregistered securities for an underwriter.[7] The Division contends that both Dawson and Allen were underwriters within the meaning of Section 2(11) of the Securities Act.[8]

Various circumstances link Dawson and Allen to UAO prior to the sales of UAO shares in question here. In 1967 Dawson was the manager of and Allen performed legal services for Sound Tronics, Inc., which was owned by H. B. Todd, president of UAO, and which was acquired by UAO in that year for shares of UAO stock. Both Dawson and Allen received some UAO stock as payment for services rendered. In 1967 and 1968 they requested Paul L. Rice, who was then a registered representative with a broker-dealer for whom the Summers brothers were also working, to sell some of their UAO stock. Subsequently, after the Summers brothers became officers, directors and part owners of registrant, Rice became a registered representative with registrant and Dawson and Allen approached Rice with respect to the sales of the UAO stock involved in these proceedings.[9]

On November 1, 1968 Dawson transmitted to Rice two certificates dated August 26, 1967 for 100,000 shares each of UAO stock, stating that "this stock is free trading stock and is not investment legend stock," and requesting Rice to sell those shares for him. None of the respondents talked to Dawson about the stock, although they knew he had been associated with UAO's subsidiary Sound-Tronics, and UAO's president, Todd.[10] T. Summers stated that he was informed by Rice that Dawson was not an officer or director of UAO and that he had bought some UAO stock "off the market." Stone said he understood Dawson had received the stock from UAO in settlement of an employment contract after UAO's merger with Sound-Tronics and

[6] *Herbert L. Wittow*, 44 S.E.C. 666, 672 (1971); *Quinn and Company, Inc.*, 44 S.E.C. 461, 467 (1971), *aff'd* 452 F. 2d 943 (C.A. 10, 1971).

[7] *Quinn and Company, Inc., supra*, at p. 468.

[8] Section 2(11) defines an underwriter to include any person who purchases securities from an issuer with a view to distribution or participates in any such undertaking. For the purpose of the definition, issuer is defined to include any person who controls the issuer.

[9] Rice was a registered representative with registrant from September 1968 to September 1969. A default order was entered barring him from association with a broker or dealer on the basis of a finding that he had failed to appear at the hearings herein (Securities Exchange Act Release No. 9206, June 14, 1971). Such order has been stayed, however, and on March 29, 1972 at Rice's request a further hearing was ordered with respect to the issues relating to him. Accordingly, the findings made herein relate only to the named respondents not including Rice.

[10] Registrant's New Account card for Dawson showed his employer as Sound-Tronics, and a UAO report in registrant's files showed that UAO had acquired all the stock of Sound-Tronics.

that Rice had assured respondents that Dawson had an exemption based on a change of circumstances. Before respondents undertook to sell Dawson's stock, they sent the two 100,000 share certificates to UAO, which acted as its own transfer agent, for transfer into 1,000 share certificates in registrant's name, and Dawson's certificates were so transferred without question.[11]

Allen testified that prior to his acquisition of the 498,000 shares sold for him by registrant he had negotiated for the purchase of 500,000 UAO shares from certain holders, but upon discovering that those shares were subject to restrictions on further transfers, he sought Todd's assistance to have the restrictions removed. He stated that Todd told him that UAO shares could be acquired from another UAO shareholder whom he identified as one "W. H. Walker". Allen arranged to buy that stock and pay for it by cashier's check to Walker, and sell it through registrant with Rice as the salesman. On Saturday, December 7, 1968, Allen received 500,000 shares of UAO stock from an employee of Todd, such shares being then already in 1,000 share certificates in registrant's name as had been requested by Rice, and on the following Monday Allen delivered the shares to Rice to be sold through registrant.

Respondents did not inquire of Allen as to the manner in which he obtained the stock. Stone stated T. Summers told him that Allen was not connected with UAO and had purchased the stock from someone else. T. Summers said that he considered there were no strictions on the stock because the shares were transferred into registrant's name without question. Allen testified that he subsequently learned that Walker was an alias used by Todd.

We have previously emphasized that broker-dealers have a responsibility to be aware of the requirements necessary to establish an exemption from the registration requirements of the Securities Act and shouid be reasonably certain such an exemption is available.[12] Respondents did not take reasonable measures under the circumstances of this case to assure themselves that an exemption was available for the sales of the Dawson and Allen stock.

Notwithstanding the substantial number of shares involved and the prior association of the sellers with a UAO subsidiary, respondents made no serious effort to determine the source and the circumstances of

[11] Dawson refused to testify at the hearings herein on the ground that his testimony would tend to incriminate him and that he was unable to obtain counsel. The Division introduced into the record a transcript of Dawson's testimony in the staff investigation preceding the institution of these proceedings. Respondents have protested that they had no opportunity to cross-examine Dawson with respect to such testimony. Although hearsay evidence may be admitted in administrative proceedings, we have determined under all the circumstances not to consider Dawson's investigation testimony. Accordingly, all of our findings with respect to the sales of Dawson's stock are based on evidence in the record other than that testimony and the exhibits thereto not otherwise admitted into the record.

[12] See *e.g., Quinn and Company, Inc.*, 44 S.E.C. 461, 469 (1971); *Strathmore Securities, Inc.*, 43 S.E.C. 575, 582 (1967).

the acquisitions of such stock and did not even question either of the sellers. The claim that Dawson had a "change of circumstances" which justified the sale of his 200,000 shares without registration was not asserted by Dawson in connection with the sale of those shares through registrant, but was a claim made earlier by Dawson when he had sought to sell a different block of 90,000 UAO shares through Rice when Rice worked for another broker-dealer.[13] Although it was obvious that Allen was immediately reselling stock obtained from "Walker," no attempt was made to find out who the latter was.

In essence, respondents were satisfied by the fact that the certificates presented for sale had no restrictive legend and were accepted for transfer by the transfer agent. We have encouraged issuers when they issue securities in so-called "private offerings" to place a legend on the certificates and to issue stop-transfer instructions as a precaution against illegal distributions.[14] The failure of an issuer to take such measures, however, cannot relieve a broker-dealer from his duty as a professional in the securities business to make reasonable inquiry to assure himself that he is not participating in an illegal sale of unregistered securities.[15] Respondents in this case in particular were not entitled to rest on the absence of any restrictive legend on the securities and on the willingness of the issuer as its own transfer agent to transfer shares.[16] In addition to the other factors mentioned, respondents had reason to be generally suspicious of trades, particularly of large blocks, in UAO stock because in T. Summers' words, "there was in the broker's community . . . a general joke going around that that they are printing stock." [17] While Summers qualified this statement by asserting that no one took it "seriously," the existence of such a comment was certainly a warning "flag" requiring a more searching inquiry with respect to the sale of substantial blocks than was made here.[18]

Since respondents have failed to meet their burden of showing that an exemption was available for the sale of the 698,000 shares of UAO, we find that such sales constituted willful violations of sections 5(a) and 5(c) of the Securities Act.

The record also establishes, as found by the hearing officer, that registrant was bidding for and making a market in UAO shares while

[13] The hearing officer in referring to this earlier sale, characterized it as having been made 'under a questionable opinion that he [Dawson] had had a change of circumstances."

[14] See Securities Act Release No. 5121 (December 30, 1970); Securities Act Release No. 4997, p. 16 (September 15, 1969).

[15] *Quinn and Company, Inc.*, 44 S.E.C. 461, 470 (1971).

[16] *Cf. Stead* v. *S.E.C.*, 444 F. 2d 713, 716 (C.A. 10, 1971), where the Court stated that calling the transfer agent was "obviously not a sufficient inquiry".

[17] A UAO report in registrant's files showed 4,103,499 shares outstanding as of January 31, 1967 and 7,456,383 shares outstanding as of January 31, 1968, or an increase of 3,352,884 shares in one year.

[18] *Cf. S.E.C.* v. *Mono-Kearsarge Consolidated Mining Company*, 167 F. Supp. 248, 259 (D. Utah. 1958); *Dlugash* v. *S.E.C.*, 373 F. 2d 107, 109 (C.A. 2, 1967).

it was participating in the above distributions of UAO shares. We find therefore that in this respect respondents also willfully violated and willfully aided and abetted violations of Section 10(b) of the Exchange Act and Rule 10b–6 thereunder.[19]

FAILURE TO SUPERVISE

The hearing officer further found and the records shows that Stone, T. Summers, and B. Summers failed reasonably to supervise with a view to preventing the violations of Sections 5(a) and 5(c) of the Securities Act and of Section 10(b) of the Exchange and Rule 10b–6 thereunder in connection with the sales of the Dawson and Allen UAO stock.

At the time, these three respondents were all officers and directors and together owned all the stock of registrant. Stone, the president, was the only registered principal,[20] but came to the office only two or three days a week. He shared supervisory responsibility with T. Summers, who functioned primarily as a trader, but was the supervisor in the office on a day-to-day basis. In his absence, B. Summers, who also functioned primarily as a trader, was in charge but in fact exercised little supervision.

Respondents argue that the supervision was adequate under the circumstances. They contend that it was reasonable for them to believe that Dawson had an exemption for his sales of his stock. As to Allen's transactions, they state that the critical factor was the source of his stock, and argue that further inquiries as to this point would have been fruitless because, as Allen testified, he had an agreement with Rice to share the profits of the sales of Allen's stock. However, as we have already noted, respondents did not make appropriate inquiries as to the sources of the securities and the circumstances under which securities were acquired and accepted as sufficient the transfer agent's advice as to the transferability of the shares. Respondent's failure to make inquiry cannot be justified by the existence of Allen's agreement with Rice, of which respondents were not aware, even assuming such inquiry would have been fruitless as respondents urge.[21]

Respondents do not deny that Stone and T. Summers had a duty of supervision, but urge that B. Summers was not charged with such a duty and did not in fact exercise any supervision. While B. Summers' responsibility was of a lesser nature than that of the other two, the fact that he was then an officer and director and one of the three

[19] Section 10(b) and Rule 10b–6 thereunder prohibits any underwriter or broker or dealer who is participating in a distribution of securities from bidding for those securities or purchasing them for any account in which he has a beneficial interest while they are the subject of such distribution.

[20] The firm had another registered principal who came to the firm in April 1969, after the Dawson and Allen transactions, and is not a respondent.

[21] Assuming, as respondents imply, that Rice and Allen would not have given satisfactory or truthful answers, respondents' resulting inability positively to identify Walker in itself would have been sufficient grounds for declining to effect the transactions.

owners of registrant imposed on him at least a measure of responsibility which we find he did not satisfy.[22]

PUBLIC INTEREST

Having found violations and a failure to exercise reasonable supervision in connection with the distribution of unregistered UAO shares, we must determine what remedial sanctions, if any, are in the public interest. The registration and related provisions that were violated set forth basic requirements of the securities laws for the protection of investors, and we have emphasized the responsibility of broker-dealers in dealing with substantial blocks of unregistered securities.

In determining the sanctions deemed necessary in the public interest in this case, the hearing officer found it appropriate to consider the circumstances that since June 1970, pursuant to a stipulation respondents entered into to obviate a hearing on the question of an interim-suspension of registration, registrant has been subjected to specified limitations upon the activities that it could engage in pending final determination of the issues in these proceedings. The hearing officer found that these limitations have exerted an adverse economic effect upon registrant as well as the other respondents who are its owners.

We also note that it does not appear that registrant, Stone or B. Summers have been found to be engaged in any prior violations; T. Summers was enjoined in 1965 on a consent decree from aiding or abetting another broker-dealer from violations of the credit extension and net capital requirements under the Exchange Act. We have also considered, as found by the hearing officer, that Stone, who at the time was registrant's only principal, and T. Summers, who had greater knowledge of Rice's activities, had primary responsibility for the failure to exercise proper supervision.

Upon consideration of all the circumstances and factors presented we conclude that it is appropriate in the public interest to impose the sanctions ordered by the hearing officer, namely, to suspend registrant's registration and NASD membership for seven days, and to suspend Stone and T. Summers for 30 days each and B. Summers for 15 days, from association with any broker or dealer.[23]

---

[22] The hearing officer held that the record did not sustain the charge that respondents violated Section 10(b) of the Exchange Act and Rule 10b–5 thereunder in connection with registrant's trading activities. After review of the record and a consideration of the contentions with respect to these alleged violations, we concur in his conclusion.

[23] We have considered the initial decision of the hearing officer and the exceptions thereto, and to whatever extent such exceptions involve issues which are relevant and material to the decision of the case, we have by our Findings and Opinion herein ruled upon them. We hereby expressly sustain such exceptions to the extent that they are in accord with the views set forth herein, and we expressly overrule them to the extent that they are inconsistent with such views.

Accordingly, IT IS ORDERED that:

1. The registration as a broker and dealer and the membership in the National Association of Securities Dealers, Inc. of Stone Summers & Company be, and they hereby are, suspended for a period of seven days.

2. Alexander J. Stone and Thomas E. Summers be, and they hereby are, suspended from being associated with any broker or dealer for thirty days, and Bobby Layne Summers be, and he hereby is, suspended from such association for fifteen days.

3. Such suspensions are to commence with the opening of business on November 13, 1972.

By the Commission (Chairman CASEY and Commissioners OWENS, HERLONG and LOOMIS).