

IN THE MATTER OF

M. G. DAVIS & COMPANY, INC., ET AL.*

File No. 3-250. Promulgated January 9, 1970

Securities Exchange Act of 1934—Section 15(b)

BROKER-DEALER PROCEEDINGS

Where, in connection with offer and sale of securities, registered broker-dealer and salesmen made misleading representations and predictions and distributed market letter containing misrepresentations concerning, among other things, increases in price of stock, issuer's financial condition, earnings and sales, merger with and acquisition of other companies, and listing on a securities exchange, *held*, in public interest to revoke broker-dealer registration and to bar individuals from association with any broker-dealer without prejudice to application for supervised association after stated periods.

APPEARANCES:

Charles Snow, Mortimer Gerber, Morris Rosenzweig, Dennis J. Block and Lawrence Jaffe, of the New York Regional Office, for the Division of Trading and Markets of the Commission.

Seymour Kleinman, of Golenbock & Barel, for M. G. Davis & Co., Inc., Lawrence Levine, Walter Wax and Morris Kopel.

Stanley Kligfeld, for Harold R. Rosenberg.

*Lawrence Levine, Walter Wax, Morris Kopel, and Harold R. Rosenberg.

FINDINGS AND OPINION OF THE COMMISSION

The hearing examiner filed an initial decision in these proceedings in which he concluded pursuant to Section 15(b) of the Securities Exchange Act of 1934 that the registration as a broker-dealer of M. G. Davis & Co., Inc. ("registrant") should be revoked and that Lawrence Levine, Walter Wax, Morris Kopel and Harold R. Rosenberg should be barred from association with any broker-dealer.¹ We granted a petition for review filed by respondents, briefs were filed, and we heard oral

¹ Previously we had accepted offers of settlement, pursuant to which the broker-dealer registration of Cerie & Co., Inc. and the investment adviser registration of Mario Trombone Associates, Inc. were withdrawn, and Frank H. Cerie and Mario Trombone were prohibited from engaging in the securities business or becoming associated with a broker-dealer or an investment adviser without our prior permission or until the expiration of the specific period. Securities Exchange Act Releases Nos. 8288 and 8327 (April 2 and June 6 1968).

argument. After an independent review of the record, we agree with the findings and conclusions of the hearing examiner and we adopt the detailed findings set forth in his initial decision except to the extent we indicate otherwise in this opinion.

As the hearing examiner found, registrant in the period from about July to about November 1963 offered and sold about 37,000 shares of common stock of The Cosnat Corporation to approximately 150 public investors. Levine and Wax had become officers, directors and the sole stockholders of registrant in June 1963, and Kopel and Rosenberg were registered representatives who participated in the offer and sale of Cosnat shares.

Cosnat had been organized in 1960 to acquire a phonograph record distributing business which had been started in 1946. Early in 1961, Cosnat acquired three companies, the Monarch Record Group ("Monarch"), which had manufactured records for label owners since 1945, and late in that year acquired an affiliate which had been producing its own records since 1945. Levine had been acquainted with Jerry Blaine, president of Cosnat, prior to these acquisitions, and he assisted Blaine in the Monarch acquisition and was compensated therefor by Blaine.

To finance the Monarch acquisition Cosnat found it necessary to borrow large sums from factors at interest rates of 10 to 15 percent and secured by a pledge of its accounts receivable. Blaine with the assistance of Levine sought to obtain funds at a lower cost to refund that indebtedness, which by June 1962 totalled almost \$1,500,000. To this end, Cosnat in May 1961 filed a registration statement under the Securities Act of 1933, which as amended proposed a public offering through underwriters of \$1,250,000 face amount of 6 percent convertible subordinated debentures. The proposed offering was abandoned, however, and the registration statement was withdrawn in March 1963. Subsequently, other efforts during 1963 by Cosnat to obtain financing to replace the high interest loans were also unsuccessful.

Around July 1963, persons other than the instant respondents prepared a market letter concerning Cosnat, referred to as the Cerie Report. Levine furnished a copy of an earlier analysis of Cosnat called the Meade Report to Cerie for use in preparation of the Cerie Report, read the Cerie Report in draft, and commented thereon. Registrant obtained copies of this report for use by its salesmen in recommending Cosnat stock, and copies were distributed to customers and prospec-

tive customers. As the hearing examiner found, the Crierie Report contained material misrepresentations regarding, among other things, Cosnat's negotiations to merge with or acquire other companies and to refund its existing debt, and its sales and earnings.

The Crierie Report stated that negotiations were in progress for the acquisition of three other companies in the record or related fields which if successful would enable Cosnat to increase its sales to \$16 million plus, that negotiations were also underway to refund some of the existing debt with an institutional loan which could substantially reduce expenses, and that should the negotiations in progress prove successful Cosnat believed it could earn at the rate of \$1 a share during the ensuing year.

In fact, the negotiations with the three other companies consisted principally of expressions of Cosnat's desire for a merger or acquisition, which representatives of the other companies testified Blaine had expressed on various occasions in prior years without any success. A meeting initiated by Blaine was held in May 1963 with principal officers of those companies, at which there was no discussion of or agreement as to terms of any merger and nothing was committed to writing. The only thing accomplished was that each company agreed to submit financial statements to Cosnat's accountants so that the latter could formulate a pro forma financial statement. It was understood that any merger or acquisition would first require that Cosnat secure a firm commitment for a long term loan of \$1,500,000 to refinance its existing high interest indebtedness to factors. Cosnat had discussions with a member firm of the New York Stock Exchange, seeking the assistance of that firm to secure the needed funds from an institutional lender. In these discussions Cosnat was advised that any such financing was contingent on certain conditions including that there be a merger with the three other companies. No substantiation of the prospects of any merger were ever submitted by Cosnat, and no proposal on behalf of Cosnat was submitted by the exchange member to any institutional lender.

We agree with the hearing examiner's conclusion that the statements in the Crierie Report that negotiations were "in progress" or "underway" for the acquisition of three companies and for a refunding of Cosnat's existing debt which if successful would enable Cosnat to increase sales to \$16 million plus and to earn at the rate of \$1 per share were a gross exaggeration of the facts and misleading to prospective pur-

chasers of Cosnat stock. The reference to possible earnings of \$1 per share was doubly misleading, since it was founded on the assumption that a merger would take place, yet was computed on the number of Cosnat shares then outstanding although all the indications were that if a merger were to take place, the number of shares in the merged company would far exceed the existing Cosnat shares with a consequent substantial dilution of the earnings per share.

The Crierie Report also included statements that Cosnat's net income after taxes for the fiscal year ended September 30, 1962 and the six months ended March 31, 1963 was \$162,000 and \$143,000, respectively, and that earnings per share for such periods were 39 cents and 31 cents, respectively. These statements were materially misleading, as the examiner found, because they did not reflect deductions from net income for non-recurring special items, representing principally expenses of the abortive registration statement filed in 1961 and withdrawn in 1963. Such special items amounted to \$41,528 for the 1962 fiscal year period and \$104,500 for the six months period ended March 31, 1963. Net income after deduction of such special items would have been 29 cents per share instead of 39 cents for the year period, and only 8 cents per share instead of 31 cents for the six months period. The misleading nature of the earnings figures resulting from the failure to reflect the special items expenses was compounded by the statement in the Crierie Report that the "earnings" of 39 cents per share in 1962 were achieved "despite the heavy cost (estimated as \$150,000)" of the abortive effort to make a public offering of convertible debentures. This statement falsely implied that the net income figure of \$162,000 was after a deduction of \$150,000, absent which net income would have been \$312,000 or 74 cents a share.

The Crierie Report was incorrect and misleading in various other respects. For example, it stated that Monarch owned two plants in California with a combined capacity for pressing 6 million records per month. Blaine testified that in July 1963 Monarch's capacity was from 3 to 4 million units per month, and an amendment of September 1962 to Cosnat's abortive registration statement recited that the company had a capacity of slightly more than 2 million records per month. The Report further stated that an exclusive one-year contract to supply records to the General Service Administration was expected to add at least \$2 million in sales. The General Services Administration had estimated purchases expected

under the contract at only about \$200,000. The Report also stated Cosnat had entered into the field of film production and that a movie starring a leading actor was going into production November 10 at the studios of a well-known company which would also distribute Cosnat's first two movies. In fact, the actor was never under a commitment to Cosnat, nor was there any commitment for the movie company to produce or distribute Cosnat's pictures. At another point the Crierie Report stated that Cosnat had record distribution centers in various cities and that "additional distribution centers are in the planning stage." In fact, some of the distribution centers had been losing money and three of them were being closed out.

As the hearing examiner further found, respondents Kopel and Rosenberg repeated to customers and embellished the misrepresentations of the Crierie Report and made further misrepresentations in connection with their sales of Cosnat stock. Three customers testified to having purchased Cosnat stock through Kopel, and three others through Rosenberg. All six customers stated that they had been told that the Cosnat stock was going to be or would probably be listed on a national securities exchange. All six customers witnesses, who had made purchases at prices ranging from $4\frac{1}{2}$ to $8\frac{3}{8}$ per share, also testified that Kopel or Rosenberg had represented that the price of the Cosnat stock would rise rapidly, such representations ranging from statements that the price could possibly rise 4 or 5 points in a year to statements that it could or would double or triple or quadruple within six months.

These representations and predictions, as well as those in the Crierie Report previously discussed, were without reasonable basis. There was no indication that Cosnat stock could satisfy listing requirements and in fact no application for listing on an exchange had been filed. And as we have frequently held, predictions of substantial price increases within relatively short periods of time with respect to a speculative security are inherently fraudulent whether expressed in terms of opinion or fact.²

Respondents have contended that they reasonably believed the representations in the Crierie Report and other material emanating from Cosnat. As the hearing examiner found, however, a reasonable investigation of the representations in the Crierie Report would have disclosed that they were materially

² See, e.g., *Cortlandt Investing Corporation*, 44 S.E.C. 45 (1969); *Martin A. Fleishman*, 43 S.E.C. 314, 320 (1966) and cases there cited.

misleading. Levine was in a position to look behind the self-serving statements of management. The respondents themselves requested, and the hearing examiner made, the following finding:

"During the course of the long standing and still-continuing relationship between Levine and Cosnat, 'virtually every aspect of the company's operations was discussed' and Levine attended and participated in many conferences of Cosnat officials, including its general counsel, auditors and other executive officers."

Through his personal participation in some of the events Levine was familiar with the facts relating to the acquisition of the Monarch Group in 1961 and its financing and the abortive and costly efforts to alleviate the attendant expense by a public offering of securities and the difficulties encountered in seeking a private refinancing or a merger with other companies. He should have realized that further inquiries were needed before recommending the Cosnat stock on the basis of optimistic references in the Cerie Report and Cosnat's releases to the benefits to be gained if merger negotiations were successful.

Levine admittedly saw the Special Items deductions in certified financial statements for 1962 prepared by Cosnat's independent public accountants, which were included in Cosnat's 1962 report. Those statements showed the deductions and net income figures reflecting them without any per share earnings computations. Levine testified that since this treatment of the Special Items was at variance with that in the president's letter which immediately preceded the certified financial statements in the report, which gave earnings figures for 1962 equivalent to 39c a share that did not reflect the special items and were the same as those in the Cerie Report, Levine consulted with an accountant friend. He stated that the latter told him there were two schools of thought, one of which considered it proper to treat non-recurring items differently than other items and that he accordingly did not question the Cerie Report's failure to reflect non-recurring expenses in the 1962 earnings figures. He did not, however, consult Cosnat's auditors, who testified in these proceedings that they considered it improper and misleading to show net income and per share earnings without showing the special items deductions and that they did not prepare any statements that failed to reflect such deductions. It is clear that Levine accepted both the year figure of 39c per share and the 31c per share six months figure because these figures were the ones used by

Cosnat, notwithstanding his awareness that the 1962 figures did not reflect the special items deductions. He was not justified in doing so and should at the least have checked with the independent accountants whose financial statements were at variance with them.

We conclude that registrant could not reasonably accept all of the statements in the Cerie Report without further investigation. In recommending the purchase of Cosnat stock on the basis of such Report without further inquiry, registrant and its controlling officers, directors and stockholders, Levine and Wax, willfully violated and aided and abetted violations of Section 17(a) of the Securities Act and Sections 10(b) and 15(c)(1) of the Exchange Act and Rules 17 CFR 240.10b-5 and 15c1-2 thereunder.

We further conclude that Kopel and Rosenberg also willfully violated and aided and abetted violations of the antifraud provisions cited above. Even assuming that there may have been some basis for reliance by Kopel and Rosenberg on the Cerie Report and other Cosnat reports and releases, it is clear that at the least the representations by Kopel and Rosenberg concerning price increases went beyond and cannot be justified by the information emanating from Cosnat. In any event, as we have already noted, such predictions are inherently deceptive and violative of the antifraud provisions. There was no rebuttal or denial of the testimony of the customer-witnesses regarding such price predictions except the testimony of Wax that he monitored salesmen's telephone conversations and heard no such price predictions made, and the testimony of two other salesmen, not respondents herein, that they heard no improper sales representations except in the case of another salesman who was dismissed by registrant after it was reported to Wax that such salesman had made unwarranted representations. The hearing examiner credited the testimony of the customer-witnesses and we see no reason to reach a different conclusion.

OTHERS MATTERS

Respondents contend that they were denied due process in that they were deprived of access to records with which they claim they could have shown that they exercised "due diligence" in connection with their recommendation of Cosnat stock. In 1963 records of registrant and Levine and various other persons relating to Cosnat were subpoenaed by the Office of the Attorney General of the State of New York, and re-

spondents assert that among registrant's records so taken was a "due diligence" file on Cosnat which was not returned despite repeated requests.³ Counsel for respondents have stated that they were informed by that Office that the records were put into a master file and not segregated according to source, and that respondents could have access only to material obtained from them, of which no list had been made and some of which had been returned, and could not examine the materials in that Office's possession to identify which was theirs.⁴

Levine testified that the "due diligence" file contained annual reports, financial statements, financial releases by Cosnat's public relations firm, memoranda of notes concerning conversations between himself and the president and other officials of Cosnat, and "everything that was available [relating to Cosnat] that I was able to get my hands on." Most of these records, however, were introduced in evidence in these proceedings and so were available for use in respondents' defense. Thus, exhibits in the record herein, some of which were offered in evidence by respondents, include copies of Cosnat's annual reports for fiscal years 1961 through 1964; copies of two 1963 special Cosnat reports to shareholders; copies of four 1963 press releases issued on behalf of Cosnat by its public relations firm; and copies of various financial reports prepared for Cosnat by its independent public accountants, including certified statements for the fiscal year 1962, interim statements for the six months ended March 31, 1963, and pro forma uncertified statements giving effect to a proposed merger of Cosnat with three other companies and receipt of a loan to pay off existing notes. Included also among the exhibits are copies of the earlier analysis of Cosnat called the Meade Report which served as a basis for the preparation of the Cerie Report and which Levine testified he had in his Cosnat "due diligence" file and furnished to Cerie for use in preparing the Cerie Report; copies of drafts of the Cerie Report and of the final such report; and copies of a reprint of such report in a financial magazine.

³ There is no contention that any member of our staff in any way suppressed or deprived respondents of their records.

⁴ It appears that, aside from the "due diligence" file, substantially all of the registrant's records were returned to it. Registrant's former bookkeeper testified that he obtained the return of some of registrant's books shortly after they were turned over to the State Attorney General's Office and was almost sure he received back all books except the blotters which he was told could not be located. Presumably the blotters were later found, because they were physically present at the hearings in the instant proceedings in the custody of a representative of the State Attorney General and available for examination by respondents.

Levine did not point to or identify any particular memorandum of discussions with associates or accountants of Cosnat as having been included in the "due diligence" file⁵ and he himself testified extensively in these proceedings as to discussions and conferences concerning Cosnat in which he participated, as did Blaine and the Cosnat employee in charge of marketing, and three representatives of Cosnat's accounting firm.

Our findings of violations are not affected even accepting the assertion that registrant's "due diligence" file contained material with the same statements as appeared in reports to stockholders and press releases issued by Cosnat and the assertion that Levine received similar reports and representations orally from Blaine and associates in Cosnat. Those reports and releases stated that Cosnat's net income for 1962 was 39 cents a share and for the six months ended March 31, 1963 was 31 cents a share, that the General Services Administration contract would lead to at least \$2 million in additional annual sales, that if negotiations in process were successful sales could increase over the \$15 million mark, and that Blaine stated Cosnat would shortly be initiating steps to apply for listing on one of the major stock exchanges. As indicated above, however, we have found that Levine could not reasonably rely on such reports in view of his knowledge of adverse facts.

Accordingly, we conclude that any inability to regain possession of the contents of the "due diligence" file cannot properly be viewed as prejudicial, and we agree with the hearing examiner that respondents were not denied due process in respect to it.

Respondents have further contended that they were prejudiced by the examiner's refusal to allow them to call as witnesses a large number of persons who purchased Cosnat stock from or through registrant. Respondents made an offer of proof that they could call 47 former customers of registrant

⁵ Respondents at no time took any formal legal steps to obtain the return of or subpoena records delivered by them to the State Attorney General in 1963. Respondents were advised by representatives of the State Attorney General several times during the course of the hearings herein, which began on December 20, 1966, that respondents and their counsel could examine any material which had been received from them provided such material remained in the custody of the State Attorney General. None of the respondents made any effort to do so during the pendency of these proceedings, however, until June 19, 1968, the day before the close of the hearings herein, when according to respondents' counsel, he and Levine went to the Office of the State Attorney General and asked to examine records taken from registrant, specifically referring to a due diligence file but not specifically asking for any memoranda prepared by Levine. Counsel stated that a representative of the State Attorney General went through some files seeking to identify material belonging to registrant, and produced a few documents of no importance, not including a "due diligence" file nor any memoranda by Levine.

who would testify that they purchased Cosnat stock on the recommendation of registrant's salesmen, that they received the Crierie Report, and that the representatives of registrant made no misleading representations, excessive claims, or predictions of price rise.

In our opinion, the examiner's refusal to allow the presentation of this large number of additional witnesses was not error.⁶ As the examiner pointed out, the testimony of additional witnesses that in connection with purchases of Cosnat stock they had received copies of the Crierie Report, which has been found to be materially misleading, would have only been cumulative evidence of violations of the antifraud provisions. And the testimony of some customers that other misrepresentations had not been made to them would not negate the testimony of the customers who testified that price predictions had been made to them.⁷

PUBLIC INTEREST

Respondents contend that it is not necessary in the public interest to impose any strict sanctions, and stress their reliance on the information made available through Levine's close and continuing relationship with Cosnat and through the Cosnat reports and releases which publicized the earnings, prospects and plans of Cosnat which was a seasoned company.

In view of Levine's knowledge of Cosnat's financial difficulties arising out of its acquisition of the Monarch group, he acted improperly in distributing to registrant's salesmen and customers and to other broker-dealers copies of the Crierie Report which failed to point out those difficulties.⁸ Moreover, although he was aware that the earnings figure of 39 cents per share for the fiscal year 1962 used in that report did not reflect the special item deduction appearing in Cosnat's certified financial statements and was of questionable propriety, he did not, as has been noted, make any inquiry of the independent public accountants, and he either ignored or overlooked the further misleading statement in the Crierie Report implying that the 1962 earnings figure did reflect an even larger special item deduction.

⁶ The examiner had allowed respondents to present testimony, similar to that proffered, of four former customers.

⁷ *Alexander Reid & Co., Inc.*, 40 S.E.C. 986, 993 (1962).

⁸ While registrant and its salesmen were recommending the purchase of Cosnat stock, four Cosnat employees, including its secretary and its sales manager, were selling an aggregate of approximately 21,800 shares of Cosnat stock. The record does not show the reasons for these sales; there is no evidence in the record that Levine, who was aware of these sales, brought them to the attention of registrant's salesmen or instructed the salesmen to inform customers of such insiders' sales.

Wax, who was registrant's sales manager, testified that he accepted Levine's assurance that he had verified the statements in the Crier Report, that he made the report available to salesmen with the instruction that they confine their representations in selling Cosnat shares to the information in the report, and that he took measures including monitoring salesmen's telephone conversations to prevent any misrepresentations. However, in his position of officer and director of registrant who with Levine owned all its stock, whatever may have been his understanding with Levine of the division of functions, Wax cannot escape responsibility for the use of a materially misleading market letter as a major selling tool.⁹ Moreover, apart from such knowledge of Cosnat's affairs as he acquired from discussions with Levine, Wax could have himself sought to compare the earnings figures in the Crier Report against the company's certified financial statements which were available to him.

With respect to Kopel and Rosenberg, whatever justification there may have been for relying on public statements coming from Cosnat and on Levine's close relationship with Cosnat, the price predictions they made to customers went beyond the information given to them and in any event cannot be condoned.

We have taken into account the factors presented, including the fact that the individual respondents do not appear to have been the subject of any other disciplinary proceedings. In view of the nature of the violations, however, we conclude, as did the hearing examiner, that registrant's registration should be revoked,¹⁰ and that sanctions should be imposed on the individual respondents. We are of the opinion that it is appropriate in the public interest and as a means of protecting investors against a repetition of such conduct, to bar the individual respondents from engaging in the securities business. Nevertheless, the factors listed above have led us to conclude that an application for reentry into the securities business in non-supervisory and supervised capacities would not be inappropriate after the expiration of a period of time. Accordingly, our bar order will be without prejudice to the filing by Levine, after a period of six months, and by Wax, Kopel and Rosenberg, after a period of three months, of an application that they be permitted to become associated with a broker-dealer in

⁹ Wax admitted that registrant sold more shares of Cosnat stock than any other security.

¹⁰ Registrant's application to withdraw its registration, filed before the institution of these proceedings, will be denied.

a non-supervisory capacity upon an appropriate showing that they will be adequately supervised.

An appropriate order will issue.¹¹

By the Commission (Chairman BUDGE and Commissioners OWENS, SMITH and NEEDHAM), Commissioner HERLONG not participating.

¹¹ We have considered the initial decision of the hearing examiner 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.