BEFORE THE SECURITIES COMMISSIONER

OF THE STATE OF DELAWARE

IN THE MATTER OF:	)	
	)	
ALLIED CAPITAL GROUP, INC.,	)	
FLOYD J. STUMPF,	)	Case No. 89-02-04
	)	
Respondents.	)	

Gregg E. Wilson, Esquire, Deputy Attorney General, Department of Justice, Wilmington, Delaware, attorney for the State of Delaware.

Glenn C. Kenton, Esquire, Richards, Layton & Finger, Wilmington, Delaware, attorney for Allied Capital Group, Inc.

James L. Schwartz, Esquire, James L. Schwartz, P.C., Denver, Colorado, attorney for Allied Capital Group, Inc.

Harry Winderman, Esquire, Winderman, Selman & Claire, Boca Raton, Florida, attorney for Floyd J. Stumpf.

OPINION AND ORDER

January 16, 1990
Wilmington, Delaware

I. Background

This administrative proceeding was commenced on April 6, 1989, by the issuance of a document entitled "Summary Order of Suspension and Notice of Intent to Revoke Broker-Dealer and Agent Registrations." The document consisted of two parts, one being a notice of allegations against the two respondents and the other a summary order of suspension of their registrations to sell securities in the State of Delaware.

Although Allied Capital Group, Inc. ("Allied") was still a registered broker-dealer in Delaware at that time, the Delaware registration of its former agent, Floyd J. Stumpf, had been withdrawn in February 1989 when Mr. Stumpf transferred his employment to Oppenheimer & Company. Nevertheless, §7316(e) of the Delaware Securities Act (6 Del. C. Chapter 73) provides that, within certain time limits, disciplinary proceedings may be initiated subsequent to registration withdrawal. The provision of the Uniform Securities Act (adopted substantially in approximately 36 states, including Delaware) that authorizes license revocation on the basis of an order of revocation in another state makes a post-registration disciplinary proceeding more than an academic exercise.

The notice of allegations alleged that Floyd Stumpf, acting on behalf of Allied, had misrepresented material facts while selling securities to nine Delaware residents during the period of June through October 1988 in violation of 6 Del. C. §7303. The notice also alleged that Stumpf had recommended unsuitable investments to the nine Delaware investors in violation of 6 Del. C. §7316(a)(7). It further alleged that the securities were not registered and that the sales were therefore in violation of 6 Del. C. §7304. Finally, the notice alleged that for each of the sales Allied had violated 6 Del. C. §7316(a)(10) by failing to supervise reasonably its agent, Floyd Stumpf, and that Allied had also violated 6 Del. C. §7315(c) and Rule 14(a)(2) of the Rules Pursuant to Delaware Securities Act by failing to report the February 2, 1989 entry of a temporary restraining order ("TRO") against it by a New York State court.

Counsel for Allied and for Mr. Stumpf both requested a hearing. The State presented its prima facie case at the first stage of the proceeding. Nine Delaware residents testified over the course of two days, June 20-21, 1989, that they had purchased securities over the telephone from Mr. Stumpf and Allied during the summer and autumn of 1988. In addition to the investors, an investigator employed by the Securities Division testified briefly. Documents were admitted as exhibits pursuant to an oral stipulation between the State and the respondents. A recess was then taken to enable the respondents to prepare their case.

On June 26, 1989, the State moved to amend the Summary Order of Suspension and Notice of Intent to Revoke Broker-Dealer and Agent Registrations to conform to the evidence produced at the hearing on June 20-21. On June 30, 1989, local counsel for Allied filed an objection to the State's motion to amend the charges and also filed Allied's motion for judgment. On July 11, 1989, I issued an Opinion and Order granting the State's motion to amend the charges and denying Allied's motion.

On July 12, 1989, the hearing was reconvened. Local counsel for Allied appeared and informed me that Allied would not cross examine the State's witnesses. A recess was called, during which the State and Mr. Stumpf reached a tentative agreement to settle the charges. On the next day, July 13, a conference was held on the record, with Allied's local counsel present, at which time Mr. Stumpf proffered the testimony that he would give on behalf of the State if the settlement agreement were approved by the Commissioner. After listening to the proffer, I decided to approve the agreement, which was executed on July 14. The terms of the agreement required Mr. Stumpf to pay $24,000 in partial restitution to the complaining investors in addition to giving testimony on behalf of the State.

On July 14 the hearing was continued with Mr. Stumpf testifying on behalf of the State. Counsel for Allied appeared and cross examined him. A continuance was then granted to enable Allied to prepare its defense further.

On July 25, 1989, the hearing was reconvened. At this time various documents were put into the record by Allied's counsel with a stipulation by the State as to authenticity. Some of the exhibits consisted of investor tax records, which were admitted with the proviso that they were to be kept confidential. Also on this date, the testimony of William

Masucci, the branch manager of Mr. Stumpf's Pompano Beach, Florida office, was taken telephonically. Mr. Masucci asserted the Fifth Amendment privilege not to incriminate himself in response to each question asked by counsel for Allied and for the State.

Paragraph 13 of the July 14, 1989 settlement agreement and consent order between Mr. Stumpf and the State required his payment of $24,000 in partial restitution to the investors on or before July 26, 1989. After several letters of warning, on August 9, 1989, I issued an order vacating the July 14 consent order because Mr. Stumpf's failure to make the required payment constituted a material violation of that agreement. The August 9 order reinstituted the charges and the summary order of suspension. Mr. Stumpf was directed to submit his request for subpoenas on or before August 21, 1989. No response was received from Mr. Stumpf or his attorney. On August 23, 1989, a letter was sent to Stumpf and to his attorney, at their separate addresses, advising them that they must respond by September 1, 1989 or waive his right to cross examine and to present a defense. Again no response was received, and both Stumpf and his attorney have had no further communication with my office since that time.

On September 19, 1989, the hearing in this case was reconvened for the last time. Allied's attorney, Mr. Schwartz, was permitted to participate by telephone from his Chicago, Illinois office. The two witnesses, who also participated telephonically, were   and   , both former Allied employees. Mr. was called by Allied, and Mr. was called by the State. Mr asserted his Fifth Amendment privilege not to incriminate himself in response to each question asked by counsel. Additional exhibits were put into the record by the State with Allied's stipulation as to authenticity.

Although there was no further testimony after September 19, several additional exhibits--consisting of the investors' tax records and certain loan documents--were placed into the record by Allied with the State's stipulation as to authenticity.

II. The Amended Charges

The relevant charges in this case are found in the "Summary Order of Suspension and Amended Notice of Intent to Revoke Broker-Dealer and Agent Registrations," filed on June 26, 1989, along with the State's motion to amend the charges. My order of July 11, 1989, granted the State's motion.

The charges against Stumpf (also against Allied) may be broken down into three general categories:

(1) misrepresentations in the course of the sale of securities in violation of §7303 and §7316(a)(2),

(2) sales of unregistered securities in violation of §7304 and §7316(a)(2), and

(3) dishonest or unethical practices in violation of §7316(a)(7) and §7316(a)(2).

Section 7316(a)(2) incorporates the other provisions of the Delaware Securities Act ("Act") by providing that any "willful" violation of the Act makes the registrant subject to disciplinary action under §7316.

Every charge against Stumpf was also made against Allied, and Allied was the subject of additional charges not made against Stumpf. One of those was Allied's alleged failure to report a New York temporary restraining order entered against it in February 1989. The other charges alleged §7316(a)(10) violations for Allied's alleged failure to supervise reasonably its agent, Mr. Stumpf.

In determining the separate violations charged, I treated all of the allegations of dishonest or unethical practices under §7316(a)(7) occurring at the time of sale as one violation with respect to each security sold. While I think that each dishonest or unethical practice could constitute a separate violation of §7316(a)(7), it is simpler to treat them as one. Similarly, although each material misrepresentation or omission at the time of sale could constitute a separate violation of §7303, it is simpler to treat the multiple allegations of misrepresentation as one violation of §7303 with respect to each security sold. If I were to adopt the view that favors disaggregation, the number of alleged violations would be in the hundreds.

III. The Investors' Testimony

Nine Delaware investors testified against the respondents: , , , , , , , , and . Most of them were employed as salesmen by the same automobile dealership at the time of their purchases. Thus, they knew each other and had discussed their investments with Allied among themselves prior to their testimony. Mr. , however, was an accountant at the time of his purchases who happened to know one or several of the salesmen.

A.

testified that in September 1988 he purchased from respondents shares of stock in a company called "Taste It Presents" at a cost of $5370. (31).[1] Exhibit 1 is a copy of an account statement from Allied reflecting that purchase. Initially, when sought to purchase the stock he was told by Stumpf that it was unavailable. (35-36). Mr. said "no problem," and it was agreed between them that "maybe something else will come along." (36). Subsequently, Stumpf called , told him that he had purchased 5000 shares of Taste It Presents for him, and requested that send him a check. did send Stumpf a check as payment for the stock. (37).

[1] References to the transcript of the hearing on June 20-21, 1989, are by page number with no further designation.

further testified that there was "very little or no real discussion with Floyd as to what my objectives were." (38). He testified that although there was no discussion of speculation, he received a form in the mail from Stumpf that was already checked to indicate that was interested in speculation and high risk investments. (39). Stumpf included a note instructing to sign the form and return it. (39).

Stumpf told that out of 80 past investments for his clients, only one had suffered a loss. (39-40). Stumpf added that when he spoke of the possibility of loss, he did not mean that could lose the entire investment. (40). Rather, he could lose a small portion of it--just like normal fluctuation in any stock. (78, 85).

Stumpf told that Taste It Presents was a gourmet candy manufacturer that sold candies over the counter in luxury hotels and upscale restaurants. (46). He said that the company had been negotiating a contract with Burger King to supply candies to that chain, and the contract was "all but signed." (45).

Stumpf told that the investment would be short term and that he could sell his interest in "six weeks to two months" at a profit. (32, 47). Stumpf told that the price of the stock would possibly double, but more conservatively would reach $1.60/share in two months from its present $1.00/share. (56).

After the purchase, when informed Stumpf that he wanted to sell the stock, he was told that all of the Delaware investors would be selling their interests at the appropriate time as determined by Stumpf. (80). Though repeatedly expressed his desire to sell, he was left with the impression that he could not control the determination as to when the stock would be sold. (81).

At a time subsequent to the purchase, called Stumpf but ended up speaking to a manager of the office named "Steve." (60). inquired about Taste It Presents but was told, "Good luck. We can't get any information from them." Steve told that the stock was down to $.11/share and that it would soon be worth nothing. (70-73). He also said, however, that the price was "temporarily depressed" because Allied's brokers were "jumping ship." (69). Mr. was very upset during this conversation with the manager. (74).

When asked whether he had relied on Stumpf's representations, said, "pretty much so." (47). He testified that the money he lost on this investment had been intended to finance a trip to Australia that he was planning, a fact that he had communicated to Stumpf. (32, 79).

B.

testified that in August 1988 he purchased from Mr. Stumpf shares of stock in a company called "Taste It Presents" at a cost of $5000. (91). Exhibit 2 is a copy of a check dated August 3, 1988, in the amount of $5080 and made payable to Allied Capital Group, which check identified as the payment for this purchase. (92). testified that in September 1988 he purchased additional shares of the same stock at a cost of approximately $1500. (93). Exhibit 3 is a copy of the check that was used to make that purchase. (93). (The date of the check reflects that the second purchase was actually in August rather than September).

testified that prior to each sale, there was no discussion with Stumpf of what his investment goals were. (89-90). Stumpf did tell that Taste It Presents was "the best that he had seen," "a guaranteed double within a 30 to 45 day period." (90). Stumpf told him that the company was about to sign a contract with a major national hotel chain, which contract would cause a phenomenal increase in its business. (90). Stumpf told that he was so confident that he had put $10,000-12,000 of his own money into the venture. (91).

At the time of second purchase, Stumpf pressured to invest an additional $5000. told Stumpf that he only had $1500, which was money that was needed to pay his mortgage with. (95). Stumpf assured that the investment would be safe and that he could get his money back within 30 days. (95).

The possibility of a total loss was unacceptable to (113), but Stumpf guaranteed him that the investment would double (97, 112). The fact that Taste It Presents had just landed a national contract would catapault it into prominence in the industry. (98).

Later, learned that the value of the stock had dropped to $.25/share from the $1.07/share price at which he had purchased it. (108). was told by Stumpf not to sell the stock. Stumpf said the entire company was going to be purchased by a group of lawyers. At that time, when the company was sold, the group of lawyers would buy all of the outstanding shares. (101). When called back still later, he was told that the foundation of the deal had been laid but there was a technical snag. (106-107).

never received any stock certificates for the shares he had purchased, nor did Stumpf ever discuss the matter of certificates with him. (111-112). did not know he had a right to receive a certificate. (112). He did not think he could sell the shares without going through Stumpf. (107).

C.

testified that on July 29, 1988, he purchased 4700 shares of "Taste It Presents" from Mr. Stumpf at a cost of approximately $5000. (120, 130). Exhibit 5 is a copy of a confirmation slip that received in the mail from Allied, manifesting the transaction. (130). (There are minor discrepancies between Exhibit 5 and testimony as to the price and date of purchase). testified that Stumpf's representations to him were "extremely important" in his decision to buy the stock. (122).

Prior to the purchase, was advised by Stumpf that Allied had a research department that found several good investments each year on a short term basis. Allied would pool the investors' money, buy the stock on a short term basis, and then sell the stock back to the company. (119).

asked whether the stock was risky and was told that it was "low risk." (122). asked whether anyone had ever lost money, and Stumpf told him that once someone had lost 10% of his investment in a particular company. (122). Stumpf assured , however, that because of the research that had been done by Allied on Taste It Presents it was a "safe investment." (129).

was not willing to risk more than a 10% loss on his investment. (149). He had recently received $5000 from his prior employer's retirement fund when he left (121), and he wanted to use the money towards the purchase of a house. (131-132).

Stumpf told that he should obtain a 30-40% return on his investment and that it might even double. (122). Stumpf said that Allied's research department had learned of a pending contract between Burger King and Taste It Presents. (126). Negotiations were being finalized whereby the Burger King chain of restaurants would sell Chocolate Indulgence, the dessert made by Taste It Presents, and this would greatly increase the stock's value. (124, 150).

Stumpf told that he should get his money back in 30-45 days (119), but he had to act immediately. (120). wanted to invest $3000, but Stumpf told him the minimum "block" that was available cost $5000. (120).

About a month after the purchase, called Stumpf and told him that he ( ) was anxious to sell his shares. (132). Stumpf told him to "sit tight," that "they were looking to negotiate it to two dollars a share and that we should be out in a week's time." (132). When called Stumpf again in another two weeks, he was told that "we had to sell together, that I couldn't just sell my shares." (132).

In late November or early December of 1988, Stumpf advised that his stock had dropped in value to $.50/share. (133). Subsequently, called the Allied office and spoke with an individual named "Billy Masucci," as Stumpf was unavailable. (133). Masucci also advised to "sit tight," telling him that the drop in value was a normal market fluctuation because it was the end of the year and people sell off for capital gains purposes. (147-148).

Calling still later, spoke to an individual at Allied named "Steven Zafir." (148). Zafir advised that his stock was worth less than $.50/share.

never received his stock certificates. He seemed to think the confirmation slip for the sale was the only documentation to which he was entitled. (149-150).

D. ______________

Mr. testified that he purchased two securities, "OTC America" and "Taste It Presents," from Mr. Stumpf in July 1988 and then again in August 1988. (162, 172). Exhibits 7-11 manifest Mr. transactions with Allied and Stumpf. Exhibit 7 is a confirmation slip that shows the purchase of 20,000 shares of OTC America on June 30, 1988 (trade date) for $5,020. Exhibit 9 is a confirmation slip that shows the purchase of 3,800 shares of Taste It Presents on August 5, 1988 (trade date) for $4,086. Exhibit 10 is a confirmation slip that shows the sale of 20,000 shares of OTC America on August 17, 1988 (trade date) for $5880. Exhibit 11 is a confirmation slip that shows the purchase of 5,500 shares of Taste It Presents on August 18, 1988 (trade date) for $5,905. These exhibits show that bought and sold the same number of shares of OTC America and made two separate purchases of Taste It Presents.

Although Exhibits 7 and 10 indicate that made a profit on his OTC America transactions, in fact he never received any of that paper profit. (166). never authorized the sale of OTC America. As he put it, "I didn't know my stocks could be sold without me saying they should be sold." (163). Mr. said he thought the confirmation slips from Allied did not accurately reflect the dates or even the order of the transactions. (169). He testified that the initial purchase of Taste It Presents was made with the proceeds of the OTC America sale, and less than a week later he bought an additional amount of Taste It Presents for approximately $4000. (167-169).

Mr. testified that Stumpf's representations were important factors in the decision to purchase OTC America. (159). He testified that Stumpf made the following statements to him:

> This is a good investment. It is a minimum of $5000 down. Chuck Cirigliano has it. He has made good money. Trust me. We will be out of it in 30 days and we will make 30, 40 percent profit.

(159). Stumpf did not mention any risk being associated with this stock. (157). testified that he told Stumpf that he needed to "minimize" his investment risk. (156). Further, told Stumpf that he did not want to invest in a company called "Westwind" because it was highly speculative. (154-55, 177). testified that a loss of more than 10% of his investment was unacceptable to him at all times. (177).

With respect to Taste It Presents, testified that Stumpf represented it was a new company and that the sale was an "initial offering." (163). Stumpf also described it as a "ground floor opportunity" that would lead to a 50%-100% return. (164). Stumpf assured that he could realize that profit within 60 days. (165). Stumpf suggested that there would be a significant development with respect to Burger King. He added that he could not discuss this impending matter. (165). Although requested a prospectus, he never received one. (163-64). Nor did he ever receive his stock certificates. (177).

In November 1988 called Stumpf and was told that the price of Taste It Presents was down to $.75/share. Stumpf suggested that Allied salesmen who had left the office had perhaps sold the stock short. (179).

In late November called Stumpf's office and spoke to a "Mr. Masucci," who was Mr. Stumpf's boss. (181). told Masucci that Stumpf had said the price of Taste It Presents was $.75/share. Masucci replied, "Well, it's not. It's at a quarter." (181).

Shortly before his conversation with Masucci, had learned for the first time of the pricing structure of a penny stock, which involves a large spread between the price at which a broker-dealer sells the stock (the "asked") and the price at which it is willing to buy it back (the "bid"). During his conversation with Masucci, learned that, although the Allied asked price for Taste It Presents may have been $.75/share, the Allied bid was only $.25/share. told Masucci that he did not understand the price variance, that he had purchased the security at $1.07/share. Masucci's response was "Well, what can I tell you?" (182).

E. ____________

Mr. was a New Castle County police officer for 20 years before he became a car salesman. (195). He testified that he purchased shares in three companies--Express Tech Inc., Davin Enterprises, and CIP Holdings Inc.--from Allied and Stumpf. (193-94). Exhibit 13 is a confirmation slip that shows Mr. purchased 55,000 shares of Express Tech Inc. on September 6, 1988 (trade date) at a cost of $10,332.50. Exhibit 14 is a confirmation slip that shows that sold 55,000 shares of Express Tech Inc. on October 18, 1988 (trade date) at the price of $12,630. Exhibit 15 is a confirmation slip that shows that bought 79,000 shares of Davin Enterprises on October 18, 1988 (trade date) at a cost of $12,660. Exhibit 16 is a confirmation slip that shows that bought 53,000 shares of CIP Holdings Inc. on October 21, 1988 (trade date) at a cost of $5,055. Although appeared to have made a profit on Express Tech Inc. (Exhibits 13 and 14), in fact it was a paper profit only as the proceeds of the sale went to the purchase of Davin Enterprises. (209). Although there is some ambiguity, I infer from testimony that he never authorized the sale of Express Tech Inc. or the purchase of Davin Enterprises. Stumpf informed him after the fact of these transactions. (207).

Mr. testified that Stumpf never alerted him to the risk involved in his investments. (200). To the contrary, Stumpf told him that, although he could not 100% guarantee a profit, "with the stocks we deal with, the risk is very minimal." (201). Stumpf said that his clients were averaging a 48% return, and Express Tech would be a good investment. (196). Stumpf said that Allied did "extensive research," and he seemed to think that Express Tech "would really take off." (196). Stumpf told that he could expect to make approximately 30% on Express Tech. told Stumpf that he did not want to get into anything risky. (197). Stumpf said that if there was any chance of losing money, he would get in touch with (198). He also said that shares of Express Tech were in limited supply. (204).

requested a prospectus prior to his investment in Express Tech. (205). Stumpf's initial response was that did not need one. (214). Then he said he would try to find one and send it. never received a prospectus. (214). Also, never received his stock certificates, nor did Stumpf ever discuss the matter of certificates with him. (215, 266).

With respect to CIP Holdings, Inc., Stumpf told that there was a "high likelihood" of a takeover and that the price of the stock would appreciate 12 to 13 cents per share within 30 days. Stumpf emphasized the thorough research that Allied performed in looking at these investments. (208-209).

Similarly, Stumpf emphasized the research that had been done on Davin Enterprises. (207). Stumpf suggested that would make a profit on Davin Enterprises within 60 days. (206).

As with , apparently never understood that there are two prices (bid and asked) with penny stocks and a frequently substantial spread between them.

discussions with Stumpf assumed there was only one price. (217).

In early November of 1988, learned that the value of his investments was going down. (216). In the middle of November, Stumpf told that the prices of his securities were at the same level as when he had purchased them. (217). In late November, called the Allied office and spoke to one of Stumpf's bosses, an individual with a name something like "Steve Zernauf," who informed that Davin was down to a penny and CIP was at three cents. Steve also said that Davin had been down for "months." (218). In response, said to Steve: "Well, something is wrong. I just talked to Floyd about a week ago, and he was telling me that it was at my original purchase price." (218).

Subsequently had another conversation with Stumpf, who told him that he should not have been talking with Steve, that in fact there were two Davins, and the Davin that had purchased had not lost more than a few cents. (219). testified that, as of the time of the hearing on June 20, 1989, his shares of Davin were worth $.0001 per share. (200).

After Stumpf left Allied, ended up with Steve "Zernauf" and Bill Masucci as his agents. (221). When the branch office was closed, was referred to Allied's Denver office, where his agent was an individual named "Bruce Chandler." (222).

never sold his shares of Davin Enterprises and CIP Holdings Inc. 55,000 shares of CIP were transformed into 550 shares when CIP engaged in a 100:1 reverse split. testified that those 550 shares were worth $.12 each at the time of the hearing. (225).

F. ____________

Mr. testified that he purchased shares of a company called "Taste It Presents" from Allied and Mr. Stumpf. (234). Exhibit 20 is a confirmation slip that shows purchase of 5000 shares of Taste It Presents Inc. on August 19, 1988 (trade date) at a cost of $5370.

was motivated to call Mr. Stumpf because of enthusiastic statements from a fellow employee named (229). However, when called Stumpf he ( ) was told that all the shares of Taste It Presents were sold and that he was too late. (231). forgot about the matter until he received a confirmation slip in the mail. (231-32). then called Stumpf and was told to expect the stock to double in price within 30 to 60 days. (233). Stumpf also said that price of the stock was then $1.25 per share even though had purchased it at $1.07. (232-33). testified that Stumpf's representations were an important factor in his decision to buy. (240). There was no discussion of risk. (236).

After the 60-day period had lapsed, called Stumpf on one or two occasions. learned from Stumpf that the price of his shares had dropped and that the drop had something to do with employees leaving Allied. Stumpf advised to "hang in there." (245). never received his stock certificates, never discussed them with Stumpf, and had no idea where they were or what had happened to them. (235).

G.

Mr. invested approximately $50,000 with Allied and Mr. Stumpf. (288). He testified that he purchased shares of stock in the following companies: Data Display Corporation, OTC America Inc., Taste It Presents Inc., and CIP Holdings Inc. (260-61, 263, 269, 272, 282). Exhibit 22 is a confirmation slip that shows Mr. bought 25,675 shares of Data Display on June 16, 1988 (trade date) at a cost of $10,028.25. Exhibit 24 is an account statement that shows Mr. bought 60,000 shares of OTC America on July 18, 1988 at a cost of $15,020, sold 60,000 shares of the same stock on July 19, 1988 at a price of $13,180, and bought 60,000 more shares of OTC America on July 28, 1988 at a cost of $14,980. Exhibit 25 is a confirmation slip that shows Mr. bought 37,400 shares of Taste It Presents on August 18, 1988 (trade date) at a cost of $40,038. Exhibit 27 is a confirmation slip that shows Mr. bought 120,000 shares of CIP Holdings on October 28, 1988 (trade date) at a cost of $11,420. Exhibit 29 is a confirmation slip that shows Mr. bought 32,000 shares of CIP Holdings on October 21, 1988 (trade date) at a cost of $3,060.

Although the confirmation slip for the Data Display sale is marked "unsolicited trade" (Exhibit 22), Mr. testified that that sale was the result of at least four separate telephone calls from Mr. Stumpf in which he urged to purchase securities from Allied. (256-57, 260). testified that Stumpf guaranteed him that he would not lose money on the investment. (263-64). Stumpf said that he had never lost money for any of his clients. (264).

Stumpf explained to that the company would be buying back its stock within 30 to 45 days at a higher price. (263). The company was doing this to avoid problems associated with loans and to raise a larger amount of capital than it could obtain through a loan. (264). Stumpf said would double his money. (265).

testified that he made it clear to Stumpf that he was risk averse. (266). informed Stumpf that he was not in a position to lose any money because he had to draw from this money to run his accounting business. (278). In response to statement of his attitude towards risk, Stumpf said that the investment was guaranteed because the company would be buying back the stock. (266).

As with the other investors, was never able to sell any of the stock. (268). The sale of OTC America was not on instruction, but was a trade initiated by Mr. Stumpf. (268). Curiously, the transaction was reversed again about 10 days later when the same number of shares of OTC America was then purchased for Mr. account. (Exhibit 24).

Mr. Stumpf's enthusiastic sales pitches were similar for each of the securities sold to . (265). Each time he emphasized a large return to be obtained in a period of one or two months. There were some variations. With Taste It Presents, Stumpf said it was selling for $1.20/share but that he could get it for for $1.07/share. (273). He claimed there was a limited amount of stock available in Taste It Presents and that it was an "active market." (274). With respect to one of the stocks sold to , Stumpf claimed that Donald Trump was at that time engaged in negotiations to purchase the shares at a much higher price than the price offered to . (276). Stumpf said that stock in Taste It Presents was "safer than a CD." (277). For every stock, was told that it came in blocks that required minimum purchase amounts. (283).

Stumpf assured that, for each of the securities, Stumpf had invested his own money. (284). For one of the securities, was told that a takeover was imminent. (265).

For each of the securities he purchased, requested a prospectus from Stumpf. Although Stumpf said he would send the prospectuses, he never did. (270). When later asked him why they had not been sent, Stumpf blamed the problem on the "back room." (270). also requested 10-Qs (quarterly financial statements filed with the SEC), which were never sent.

Similarly, Mr. never received the certificates for the shares he had purchased. (289). When asked Stumpf for them, Stumpf blamed the back room for messing up. asked for them on at least three occasions. (289).

During November and December 1988 called Stumpf on about 10 occasions to request that he sell the securities. (286). He could sell none of them, however. (286). Stumpf explained that traders who were leaving Allied had sold off large blocks of the securities, driving down the prices. Mr. learned that Taste It Presents, for example, was worth only pennies in January 1989. (287).

In January 1989, called Allied and learned that Stumpf had left. (287). spoke with an individual who said he was a manager, that he was closing the office down, and that he had been led down a "primrose path" by Allied. (288). said to the manager that he had been the victim of misrepresentations. said he thought he had been sold a "bill of goods," and the manager said that he thought he had been, too. (288).

lost $50,000. (288).

H. ______________

Mr. testified that he purchased one security from Allied and Mr. Stumpf. (295, 300). Exhibit 29 is a confirmation slip that shows purchase of 32,000 shares of CIP Holdings, Inc. on October 21, 1988 (trade date) at a cost of $3,060.

testified that, motivated by the apparent success of his friends' investments, he called Mr. Stumpf to say that he was "interested" in investing with Allied. (298). He was told by Mr. Stumpf that he would hear from Stumpf when something became available. (298). said that Stumpf "qualified" him as a customer by asking how much he made and what assets he owned. Subsequently, heard from Stumpf that a company named "CIP Holdings" was the subject of a rumored takeover and that "hopefully" would almost double his money in four to six weeks, and then he would sell out and buy something else after the takeover had taken place. (299-300, 303). Stumpf suggested to that Allied's research gave the brokerage firm an edge over other investment groups. (302). said he relied "totally" on Stumpf's representations in making the purchase. (323).

About one week after he made the telephonic purchase, received a new account card in the mail. (303; Exhibit 31). Although had never told Stumpf that he was interested in speculative, high risk investments, noticed that the new account card was already marked to indicate that speculation was his investment objective. (303). called Stumpf and asked for an explanation. Stumpf said that should not worry about it because, even though with stocks of this nature there is risk involved, marking the speculation objective was no more than a formality because Allied's track record was so good. (303). Mr. , under the impression that he was not taking much of a risk, signed the form and returned it with his payment. (303-304).

After his purchase, in November 1988, Mr. continued to call Allied to inquire about his investment and whether the merger had taken place. Sometimes he spoke with Stumpf and sometimes he spoke with another individual, and he was told that the merger had not yet taken place but that it would happen soon. (308).

One individual at Allied that spoke to was Steve Zafir, who said he was a manager. (310-11). Zafir told that he (Zafir) did not think the stock was worth what Mr. and the other investors had been led to believe. (312). Zafir said that he did not think there would be a takeover, and he implied that the stock was not worth what had paid for it. Zafir told to contact Floyd Stumpf. (313).

In a December 1988 telephone conversation, Zafir told that his stocks had gone down. Zafir explained, however, that there was nothing to worry about because it was near Christmas and that it is traditional for all stocks to decline around Christmas because people are more interested in Christmas than in investing. (313-14).

In a conversation with Stumpf shortly before Christmas, was told that his shares were "down almost to nil" and that it was foolish to sell at that time because they were worth so little. Stumpf assured that the value of the shares would go back up. (320).

Like the other investors, Mr. never received a certificate for his shares. (321). Moreover, he did not seem to understand that his confirmation slip and account statement were not the equivalent of a certificate. (321). Stumpf never discussed the matter of certificates with him. (324).

I.

Mr. testified that he purchased two securities, Express Tech Inc. and Davin Enterprises, from Allied and Mr. Stumpf. (328-29, 350-51). Exhibit 32 is a confirmation slip that shows bought 40,000 shares of Express Tech Inc. on October 18, 1988 (trade date) at the price of $9,180. Exhibit 35 is a confirmation slip that shows bought 57,500 shares of Davin Enterprises on October 18, 1988 (trade date) at a cost of $9,220. Although Exhibits 32 and 34 suggest that obtained a profit of $1700 on the Express Tech transaction, in reality it was a paper profit only. The proceeds of the Express Tech sale went towards the Davin Enterprises purchase, and never received any of his investment money back as his shares became worthless. (388).

Asked whether he had relied on Stumpf's representations in making the purchases, said "one hundred percent." (389). Stumpf told before the Express Tech purchase that the most he could lose would be $100 or $200. Stumpf said that the possibility of doubling money in 30 to 40 days made that risk worthwhile. (335). Stumpf told that Express Tech was soon to be merged into another company. (338). The result of the merger would be a bigger company whose stock value would be enhanced, possibly doubling. (342). Stumpf told that the source of this information was "Bill Matucci," the head of the company at that office. (342).

Although wanted to invest only $2000-3000, Stumpf told him that investors had to buy in large blocks, and $7500 was the minimum Stumpf would accept. (336). would not have made the purchase if he had known that he might lose his entire investment, and he specifically asked Stumpf what was the most he might lose. Stumpf said $100 to $200 was the most could lose. (346).

In October 1988 agreed to sell his shares of Express Tech when Stumpf told him that the merger had occurred and the stock price had reached its probable zenith. Stumpf recommended that use the proceeds to purchase shares of Davin Enterprises, which he did. At this time told Stumpf that the money being invested would soon be needed so that could purchase a new house. Stumpf assured that he did not need to worry. (352). Stumpf said that with Davin Enterprises could duplicate his success with Express Tech in the same period of time as before. (353). Stumpf said that at worst the Davin Enterprises shares would stay at the same price, and Stumpf predicated a 40-50% return within a short time. (355).

In or about November 1988, Mr. called the Allied telephone number and spoke to an individual named Steve "Safir," who informed that the price of Davin Enterprises had dropped to about five or six cents per share. When next spoke with Stumpf, Stumpf said that actually had a different type of stock in Davin Enterprises than the stock for which Steve had quoted a low price. (360-61). Stumpf assured that his Davin Enterprises stock was still worth the same as before. (361).

Sometime in November or December of 1988, Mr. learned from Stumpf himself that the price of Davin Enterprises had dropped to about eight cents per share. Stumpf still advised against selling though, for it was common for stock prices to drop before the holidays. Also, he said that a number of employees in his office had quit and when they left they took their money out of this security. (363-64). Stumpf persuaded not to sell. (364).

At some point during December 1988 or January 1989 (could not remember which month), Mr. and spoke to Stumpf over what described as "a conference type of a phone." (366, 371). Stumpf's first response was to ask whether and were recording the conversation. After they replied in the negative, Stumpf asked the same question again. He then stated that he was totally innocent of anything. During the conversation, or another conversation between and around the same time, Stumpf said that "something wasn't quite right" with the company he was working for and for the first time he was "starting to see a pattern." (369). During one of those conversations, Stumpf told that it was impossible for him to sell stock because no one was buying it. (373).

In January 1989, spoke with an individual named "Bill Matucci," who said he was Mr. Stumpf's boss. (373). At this time Mr. was apparently unhappy with Mr. Stumpf, for had asked to speak with Stumpf's supervisor. (374). Matucci told that he (Matucci) has "certain clients that he could take care of" if they stayed with him. (375). asked Matucci what he meant. Matucci replied, "Sometimes you got to take a loss to make more." Again asked what he meant, and Matucci said, "[I]n other words, give me some more money. Forget about this thing here, but give me some more money and we can more than make up for what your loss was on this one here." (375). Matucci told that his stock was worth nothing but that he should "hang in there." (376).

Again in January 1989, Matucci called and informed him that he (Matucci) had sold the company. He said that someone else was taking over and he was "just there to be the punching bag for whatever was coming down." (380).

Still later in January 1989, Matucci called and gave him a Denver telephone number for Allied. called the number and spoke to an individual who identified himself as the compliance officer for Allied. (386-87). told that individual that he wanted to sell his stock, and he gave the individual information about his account. He was told that the stock was at zero, and he was advised to talk to Stumpf or Matucci about it. (388).

As with the other investors, Mr. never received a certificate for his shares. (388). He never bought the house he had intended to purchase, and at the time of the hearing he was living in an apartment. (389).

IV. The Securities at Issue

The nine Delaware investors testified that they purchased shares of stock in the following companies: Taste It Presents Inc., OTC America Inc., Express Technologies Inc., Davin Enterprises Inc., CIP Holdings Inc. and Data Display Corporation. The State and Allied introduced prospectuses and financial reports into the record for each of the companies.

A. Taste It Presents Inc. ("Taste It")

The State introduced Exhibits 55, 56, 57 and 58. Exhibit 55 is a prospectus dated July 8, 1987 for Taste It. Exhibit 56 is a Form 10-Q (quarterly financial report to the Securities and Exchange Commission) dated July 14, 1988, for the quarter ending May 31, 1988. Exhibit 57 is a Form 10-Q dated October 14, 1988, for the quarter ending August 31, 1988. Exhibit 58 is an amended S-18 registration statement stamped as received by the Securities and Exchange Commission ("SEC") on July 6, 1987. The registration statement contains the company's proposed prospectus, which was submitted to the SEC for its review.

Allied introduced Exhibit 76, which contains the purported contents of Allied's "due diligence" file on Taste It.[2]

---

2 A "due diligence" file is maintained by a broker-dealer for a security as to which it acts as an underwriter or market-maker in order to demonstrate that it has met any applicable standard of due care or duty of investigation owed to a purchaser with respect to that security.

The exhibit contains a prospectus, several financial statements, a letter to stockholders from the president of the company, and a copy of the company's listing in Moody's OTC Industrial manual with a letter from Moody's to Allied's attorney, Mr. Schwartz.

The prospectus states on the front cover that the offering involves a "high degree of risk." Paragraph 12 of the discussion of risk factors states the following:

> Prior to this offering, there has been no established market for the Company's Common Stock and there can be no assurance that any public market will develop after this offering, or if developed, that it will be sustained. Accordingly, purchasers may not be able to resell their shares of Common Stock at the public offering price, and a purchaser may not be able to liquidate his investment without considerable delay, if at all.

(Exhibit 76, prospectus dated July 8, 1987, at 6).

At the time of the initial public offering of Taste it (July 8 to October 6, 1987), the company had two full-time employees: Paul Orlando, the president, and John Alair, the secretary/treasurer who also held the title of director of marketing. In addition, there was a part-time employee who assisted in manufacturing the product. (See Exhibit 76, prospectus dated July 8, 1987, at 13). The product was "Chocolate Indulgence," a three-pound, non-baked chocolate cake. (Id. at 10). The manufacturing premises also functioned as the personal residence of one of the stockholders. (Id. at F-8).

Mr. Orlando and Mr. Alair were paid $30,000 each for their executive services for the year ending with the completion of the stock offering. (Id. at 14). They also comprised two of the three directors of the board. In March 1987 the board granted a bonus to the officers of the company (Mr. Orlando and Mr. Alair) in the amount of $47,000, paid by the issuance of additional shares of common stock. (Id. at F-7). In April 1987 Mr. Orlando and Mr. Alair received their accrued bonuses: 20,099,800 shares of common stock. (Id. at F-9, note 9).

The date of incorporation of Taste It was March 29, 1985. During its first year, it suffered a net loss of $3,438. (Id. at F-4). In its second year, 1987, it lost $46,070. (Id. at F-3). As of February 28, 1987, Taste It's current liabilities exceeded its current assets by approximately $13,000. (Id. at F-2).

Prior to the offering, 28,430,400 shares of common stock were issued and outstanding (Id. at F-2). The agreement between the company and the underwriter provided that the latter would distribute between 10,000,000 and 11,200,000 additional shares of common stock in Taste It on a best efforts basis. (Id. at F-9). The underwriter was Allied Capital Group, Inc.

According to the company's 10-Q report to the SEC, for the six-month period ending August 31, 1988, Taste It suffered a net loss of $97,707. In comparison, during the six-month period ending August 31, 1987, the company had a net loss of

$34,678. (Exhibit 57). According to an unaudited statement introduced by Allied, for the year ending February 28, 1989, Taste It suffered a net loss of $147,581. The prior year's loss was $107,887. The cumulative loss for Taste It from its inception to February 28, 1989 was $304,976. (Exhibit 76). None of the materials presented by Allied indicated the existence of a contract or negotiations between Taste It and any national chain of restaurants or hotels.

B. <u>OTC America Inc. ("OTC America")</u>

The State introduced Exhibits 49-53. Exhibits 49 is a registration statement for OTC America filed with the SEC on September 30, 1986. Exhibit 50 is a prospectus dated February 17, 1987. Exhibit 51 is a supplement to the prospectus, dated October 19, 1987. Exhibit 52 is a Form 10-Q financial report dated May 10, 1988, for the quarter ending March 31, 1988. Exhibit 53 is an amended Form 10-Q dated July 29, 1988, for the quarter ending March 31, 1988.

Allied introduced Exhibit 78, which contains the purported contents of Allied's due diligence file for this company. The documents include a prospectus dated February 17, 1987, a Form 10-K for the fiscal year ending June 30, 1987, several Forms 10-Q, and copies of some news releases. None of the materials indicate the occurrence of a merger, tender offer or corporate takeover, or negotiations for such.

The front cover of the prospectus dated February 17, 1987 states that "these securities involve an extremely high degree of risk." The prospectus' discussion of risk factors states the following:

> There is no public market for the Units, Common Shares or Warrants of the Company and no assurance such a market will develop at the conclusion of this offering or, if developed, that it will continue. Purchasers of the securities may, therefore, have difficulty in selling such securities should they desire to do so.

(Exhibit 50 at 7-8).

OTC America was organized on June 13, 1986 for the primary purpose of providing consulting services to start-up firms. However, at the time of its initial public offering, it had made no effort to identify prospective clients and had never entered into an agreement with anyone to provide consulting services. (Id. at 13).

At the time of the offering, OTC America had a total of three employees, each of whom worked for the company on a part-time basis. (Id. at 16). The president, Terry Freeman, was committed to devote 30% of his time to the company. The executive vice president, William Bauerle, was committed to devote 20% of his time to the company. The vice president and secretary, Don Montague, was committed to devote 10% of his time to the company. (Id. at 6-7).

According to the unaudited financial statement at the back of the prospectus, the company had a net loss of $5,337 in 1986. (Id. at F-3). Prior to the offering, there were 24,000,000 shares of common stock outstanding. (Id. at 4). owned 12,000,000 of those shares. (Id. at 22).

The offering was to consist of units that would include 16,000,000 additional common shares and 16,000,000 warrants. (Id. at 4). These figures do not include contingencies whereby many more additional shares would be issued to certain parties.

The discussion of risk factors included the following statement: "[I]nvestors will entrust their funds with management on whose judgment investors must depend, with only limited information about management's specific intentions." (Id. at 8).

The company's amended Form 10-Q dated July 29, 1988, for the quarter ending March 31, 1988, showed that the net loss for the nine-month period ending March 31, 1988 was $204,175. The accumulated deficit at the end of that period was $234,650. (Form 10-Q at 2). Bad debts for the nine-month period ending March 31, 1988 amounted to $77,400. (Id. at 4). As of March 31, 1988, there were 48,052,644 shares outstanding.

On July 7, 1988, the company sent a letter to its shareholders. A copy of this letter was sent to the SEC as a Form 8-K Current Report. (Exhibit 54). The letter noted that the prior year's offering raised $577,735, of which the company received $430,311. However, the letter recited various losses and then stated, "The bottom line is that we are now running out of cash." (Exhibit 54 at 5).

C. Express Technologies, Inc. ("Express Tech")

The State introduced Exhibits 47 and 48. Exhibit 47 is a registration statement for Express Tech dated August 5, 1988 and stamped as filed with the SEC on August 8, 1988. Exhibit 48 is a consolidated financial statement for December 31, 1988 and 1987.

Allied introduced Exhibit 74, consisting of several documents that purportedly were the contents of Allied's due diligence file on Express Tech. The exhibit contains a copy of the August 5, 1988 registration statement, financial statements of "BBB East, Inc." (the former name of Express Tech), and a May 3, 1988 report to the SEC.

The prospectus which forms the bulk of the August 5, 1988 registration statement has the following statement prominently displayed on the first page: "These securities involve a high degree of risk and should be purchased only by persons who are able to afford the loss of their entire investment." (Exhibit 47; Exhibit 74).

Page five of the prospectus states that the company was organized on March 26, 1987, sold 1,500,000 shares of its common stock at $.05 per share from November 1987 through February 1988 in a "blind pool" offering, and as of August 1988 had a history of no revenues or earnings from operations.

As of August 1988, Express Tech had a total of two part-time employees. (Id. at 27). In the "Conflicts of Interest" section, the prospectus stated the following:

> The officers, directors and shareholders of the Company may be subject to certain conflicts of interest in regards to their relationship with the Company and other entities. The Company's officers, directors and shareholders are and will be officers,

> directors and shareholders of other companies, some of which may be deemed competitors of the Company.

(Id. at 30). In fact, the competitors were Genexus International, Inc. and Utah Innovative Associates, Inc. As of August 1988, Express Tech owed Genexus $50,000 for shares in two other companies that it had received from Genexus. (Id. at 31). Moreover, Express Tech rented its office space at 419 Wakara Way, Suite 206, Salt Lake City, Utah, from Genexus. (Id. at 27). The risk factors discussion emphasized that the use of the proceeds of the offering might benefit the affiliates of management--Genexus and Utah Innovative. (Id. at 9). In the following paragraph, the prospectus stated: "Investors will be entrusting their funds to management in whose judgment they must depend for specific expenditure of the funds." (Id. at 9). No specific use was required.

The consolidated financial statement showed that Express Tech had a net loss of $64,270 for the year ending December 31, 1988. The previous year it had lost $151. As of December 31, 1988, current liabilities exceeded current assets by more than $75,000. There were 83,400,000 shares of common stock issued and outstanding at that time. In the notes to the statement, it was mentioned that until June 1, 1988, the corporate offices had been located in the personal home of one of the company's officers. (Exhibit 48).

D. Davin Enterprises, Inc. ("Davin")

The State introduced Exhibits 44, 45 and 46. Exhibit 44 is a registration statement dated August 3, 1988. Exhibit 45 is a Form 10-Q dated August 11, 1988 for the quarter ending June 30, 1988. Exhibit 46 is a Form 10-K annual financial report dated June 14, 1988 for the fiscal year ending March 31, 1988.

Allied introduced Exhibit 75, consisting of documents that purportedly were the contents of Allied's due diligence file on Davin. The documents include a prospectus dated July 21, 1987, a Form 10-K report for the fiscal year ending March 31, 1988, several Form 8-K Current Reports, copies of two letters dated January 11, 1989, and January 31, 1989, to shareholders, which letters are attached to a Form 10-Q report for the quarter ending December 31, 1988, and copies of some newspaper articles and press releases.

The prospectus dated July 21, 1987, introduced by Allied, contains the following statement in boldface print on the front cover:

> These securities involve a high degree of risk. . . . Prospective purchasers should be prepared to lose their entire investment.

(Exhibit 75).

In its discussion of risk factors, the prospectus states that the company is a "blind pool" whereby management has unlimited discretion to search for or participate in any business opportunity it deems beneficial. The prospectus further states that:

> Inasmuch as investors in this offering will be entrusting their funds to management of the Company with no idea as to the specific purpose to which such funds will be utilized, this type of offering involves extreme risk and speculation for purchasers.

(Id. at 6).

The prospectus further noted that the company had no full-time employees:

> Management of the Company is currently employed in other positions, and each will devote only a portion of its time to the business affairs of the Company. In addition, in the face of competing demands for their time, it should be anticipated that the officers and directors may grant priority to their full-time positions rather than to the Company. . . . Conflicts of interest may exist between the company and its management, and conflicts may develop in the future. Although Company management will attempt to resolve any such conflicts in favor of the Company, there is no assurance that this will be the case.

(Id. at 7).

The officers and directors of Davin were Arthur Seidenfeld, age 36, president and director, and his parents, Samuel and Anne Seidenfeld, ages 76 and 74 respectively. Samuel Seidenfeld was secretary and director, and Anne Seidenfeld was treasurer and director. Arthur's parents expected to devote 5% of their time to the company, whereas Arthur would devote 15% of his time. (Id. at 17-18).

The prospectus also noted that there was no market for the company's securities and that even if a market did develop there would be no assurance that it could be sustained. (Id.

at 9). The prospectus noted that limited funds and lack of full-time management meant that there would be no detailed studies of business opportunities prior to the commitment of capital. (Id. at 7).

Prior to the 1987 offering, the company had 120,000,000 shares outstanding with total assets of $25,080. (Id. at 5).

In its Form 10-K for the fiscal year ending March 31, 1988, Davin reported that it completed its public offering in September 1987, selling 40 million units (each with one share common stock and two warrants) at $.01 each and raising $331,295 net. (Exhibit 46; Exhibit 75). The Form 10-K also reported that on April 21, 1988, Davin concluded a merger agreement with a company called "Target Vision, Inc." (Id. at 3).

The management's discussion section of the Form 10-K stated that Davin suffered a net loss of $13,113 for the fiscal year ending March 31, 1988, and that since the date of its incorporation the company had conducted no business activity other than organizational activities. (Id. at 3).

In its Form 10-Q dated August 11, 1988 for the quarter ending June 30, 1988, Davin reported that its loan to Target Vision, Inc. ("TVI") had grown to $660,078. (Exhibit 45 at 9). Davin generated a net loss of $4,419 during the quarter.

In a registration statement dated August 3, 1988, Davin proposed another public offering. Of the 120,000,000 shares of Davin to be sold, more than 100 million shares were owned by

Arthur Seidenfeld and Modern Technology Corporation, another company that Arthur owned with his parents. (Exhibit 44 at 4). The prospectus portion of the registration statement contained the following language in boldface print on the front cover of the proposed prospectus:

> These securities involve a high degree of risk. . . . Prospective purchasers should be prepared to lose their entire investment.

(Id. at 4). Much of the discussion in this prospectus concerned the proposed merger between Davin and TVI.

In a letter dated January 31, 1989, to shareholders, Arthur Seidenfeld reported that the merger between Davin and TVI would not be consummated. The unaudited financial statement in Davin's Form 10-Q for the quarter ending December 31, 1988 (copy attached to January 31, 1989 letter to shareholders) showed an operating loss during the previous nine months of $59,128. This was largely offset by interest income, and the net loss for that period was only $3,956. (Exhibit 75, Form 10-Q).

In its Form 8-K Current Report to the SEC dated April 4, 1989, Davin reported that TVI had defaulted on its loan in the amount of $685,078.08 from Davin, which was suing on a promissory note. (Exhibit 75, Form 8-K).

E. <u>CIP Holdings, Inc. ("CIP")</u>

The State introduced Exhibits 38, 39 and 40. Exhibit 38 is a copy of a registration statement filed with the SEC on July 3, 1986. Exhibit 39 is a copy of an amended registration statement filed with the SEC on August 21, 1986. Exhibit 40 is a copy of a prospectus dated September 29, 1986 and filed with the SEC on October 9, 1986. (It also bears an SEC date stamp of October 22, 1986).

Allied introduced Exhibit 79, consisting of documents that were purportedly the contents of Allied's due diligence file on CIP. The documents include a more legible copy of the prospectus that constitutes Exhibit 40, various newspaper clippings, press releases and correspondence, and other materials concerning CIP. Many of the documents in Exhibit 79 are redundant.

The front page of the September 1986 prospectus states the following:

> These securities are highly speculative and involve substantial risks. . . . The purchase of these securities should be considered only by persons who can afford the loss of their entire investment.

(Exhibit 40; Exhibit 79). This language is repeated at the beginning of the prospectus' discussion of risk factors. (<u>Id.</u> at 4-5).

CIP Holdings, Inc., was incorporated in Florida on February 26, 1986, under the name of "Curtin International Productions, Inc.," for the purpose of producing an independent television and video movie entitled "One Minute to Midnight." (Id. at 10). The screenplay for the movie was written by Lawrence Curtin. (Id. at 12). The officers and directors of the company as of September 1986 were Lawrence Curtin, president and director, and William Hoffman, vice president, secretary and director. (Id. at 14). Prior to the September 1986 offering, the company had no salaried employees. Upon successful completion of the offering, Mr. Curtin would be the company's only full-time employee. Mr. Hoffman would be a part-time employee. (Id. at 13). Mr. Curtin's background was primarily in the business of installing solar energy equipment for the outdoor advertising business. Mr. Hoffman had been a beverage manager for several years, and at the time of the offering he was employed part-time in a bank.. (Id. at 14). The company envisioned that Mr. Curtin would produce the movie. Mr. Curtin had no experience in the production of movies. (12). The company's financial viability was entirely dependent upon the success of this one project. The company's offices were located in Mr. Curtin's home. No arrangements had been made for shooting the movie or distributing it. (Id. at 13).

In its discussion of risk factors, the prospectus states: "There is nothing at this time upon which to base an assumption that the Company's business plans will prove successful." (Id. at 5). It also states the following:

> No member of management has any substantial experience in the production and distribution of

> motion pictures. The experience of management is crucial to the viability of any company.

(Id. at 5).

The initial public offering in September 1986 offered 900,000 shares of CIP common stock to the public at a price of $.40 per share. Commissions on the underwriting were to be $36,000, leaving the net proceeds of the offering to CIP at $324,000 (Id. at 1). Prior to the offering, Mr. Curtin had received 1,000,000 shares of CIP common stock in exchange for the rights to the screenplay. The prospectus noted: "Although the Company believes that the price for this screenplay is fair and equitable, it may be considered that this transaction is not an arms length transaction." (Id. at 12).

According to a notice in a publication called "Investment Traders," the CIP public offering was successful and the public purchased 37.8% of CIP's stock at a cost of $360,000. (Ex. 79 at K-915).

In a mostly illegible copy of a letter, Mr. Curtin states that the name of Curtin International Productions, Inc., will be changed to "CIP Holdings, Inc." (Ex. 79 at K-835). This change must have occurred in or shortly after October 1987 because several letters dated in October 1987 refer to the company by its former name. In a letter dated October 1, 1987, a representative of Moody's Investors Service wrote to Mr. Curtin and informed him that for CIP to be listed in one of Moody's manuals Mr. Curtin would have to provide an audited financial statement. (Id. at K-836). In a letter dated October 3, 1987, to Rick Marchese of Power Securities in Denver, Colorado, Mr. Curtin informed Mr. Marchese that he (Curtin) had applied for a listing in Moody's for 1987.

In a letter dated October 7, 1987, to Dominick Dequarto at "National Quote" in New Jersey, Mr. Curtin states that the Curtin International Productions, Inc. board of directors met and approved an increase in its capitalization from 30 million shares to 300 million shares and a ten for one stock split. He states that the change is to be effective October 7, 1987, and that he is the sole member of the board of directors. (Id. at K-838). In a letter dated October 6, 1987 to Julie Salamon at the Wall Street Journal, Mr. Curtin states that he will call her when "One Minute to Midnight" is out in LA and ready for release. (Id. at K-839). Apparently, Julie never wrote back, for Exhibit 79 does not include a response. According to a copy of a notice that was contained in Exhibit 79, "One Minute to Midnight" made its debut at the Grove Cinema in Coconut Grove, Florida, on January 22, 1988. (Id. at K-849). The record does not disclose how it was received.

In a release dated February 26, 1988, the newly named "CIP Holdings Inc." announced its intention to acquire a company called "Players Panorama Inc." in exchange for shares of CIP stock. Players Panorama was allegedly a "recognized gaming newspaper" in Las Vegas and Reno, Nevada. The release stated that it was the intention of CIP to become "the fastest growing company in the gaming industry." For more information one could contact Power Securities Corporation. (Id. at K-847).

In a letter agreement dated October 28, 1988, purportedly from a "Bruce Zicari" of CIP Holding, Inc. to the executive officers of "DHA Dental Inc." and "Trinity Towne Investments, Inc.," there was to be a corporate reorganization among the above-stated companies involving an exchange of stock. In the first paragraph of the letter, it states that Power Securities Corporation ("Power") is acting on behalf of CIP with respect to the reorganization. In fact, since the letter was apparently generated from Rochester, New York, it would seem that a Power employee drafted the letter rather than anyone at CIP, which had its offices in Florida. (Id. at K-859).

Exhibit 79 contains a copy of an amendment to the company's articles of incorporation, filed March 30, 1989 with the Florida Secretary of State, whereby CIP Holdings, Inc. changed its name to "Pan-International Holdings, Inc." (Id. at K-887). Also on March 30, 1989, Mr. Curtin wrote a letter to the shareholders of CIP Holdings, Inc., explaining that DHA Dental and Trinity Towne Investments had breached their contract with CIP. Mr. Curtin informed the shareholders that he was going to sue those two companies for $32,700,000 in "actual damages." (Id. at K-888). He also stated that he was trying to "rebuild value" and that his next step would be a reverse stock split of one share for every 100 shares held.

This change would occur on April 11, 1989, when there would be 2,908,336 shares of Pan-International Holdings outstanding.

Exhibit 79 also contains unsigned, unstamped copies of apparently pro se pleadings dated April 13, 1989, by Mr. Curtin in a supposed civil action in the United States District Court for the Southern District of Florida. The documents look as though they were printed on a low-budget computer printer. (Id. at K-854 to K-858).

In a document dated April 14, 1989, that appears to be a press release, Mr. Curtin announced that Pan-International Holdings through its licensee had entered into a contract for the distribution of the movie "One Minute to Midnight." The licensee, DSL Entertainment, was claimed to have been financially backed by "leading media analysts in the country." It was reported that "DSL has affected [sic] limited sales of the film to date."

Mr. Curtin also reported that he was personally filing "the largest civil rights action against the State of Florida and certain officials for a present and continuing violation of his civil rights." In the next paragraph Mr. Curtin said that "[a]lthough it is not the purpose of the action to promote the movie it may be a collateral effect of the filing...." (Exhibit 79 at K-885). There is no indication in any of the documents concerning CIP that "One Minute to Midnight" ever produced significant revenues for the company.

F. Data Display Corporation ("Data Display")

The State introduced Exhibits 41, 42 and 43. Exhibit 41 is a copy of a Form S-18 registration statement dated June 27, 1986. Exhibit 42 is a copy of a prospectus dated September 10, 1986. Exhibit 43 is a copy of a Form 10-Q financial report dated May 10, 1988, for the quarter ending March 31, 1988.

Allied introduced Exhibit 77, consisting of documents that purportedly were the contents of Allied's due diligence file on Data Display. The documents include another copy of the September 10, 1986 prospectus, several Form 10-K and Form 10-Q financial reports, several copies of the corporation's annual report, and several press releases.

The first page of the September 1986 prospectus, which is the prospectus summary, contains the following language: "The shares offered hereby involve an extremely high degree of risk, including the Company's dependence on present management, competition, and immediate substantial dilution of the public's investment." (Exhibit 42 at 1; Exhibit 77 at 1).

My review of the Data Display prospectus and financial reports to the SEC suggests that, unlike the above-described companies, it had some substantial business operations. For example, according to the September 1986 prospectus, the company's unaudited income statement showed $594,079 in net sales for the first six months of 1986, with a gross profit of $341,839 and net income of $43,881. (Id. at F-4). Moreover, as of June 30, 1986, the company's unaudited balance sheet showed that current assets exceeded current liabilities by more than $100,000. (Id. at F-2, F-3).

Nevertheless, Data Display was also a company with serious financial problems. According to the prospectus, its net income of $130,586 in 1984 declined to $53,260 in 1985. (Id. at F-4). Although the net income (unaudited) for the first six months of 1986 was $43,881, which suggested a recovery, the audited net income figure for the entire year of 1986 was only $48,031. (Exhibit 77, 1987 annual report at 10, K-531). The next year (1987) was a financial disaster, resulting in a net loss of $179,104. (Id.). The year in which the shares of Data Display were sold to Delaware investors, 1988, witnessed another substantial loss in the amount of $50,131. (Exhibit 77, 1988 annual report at 9, K-611).

Additionally, there was a question as to the loyalty of the top officers of Data Display to the corporation. In its 1987 annual report, the company reported that on December 30, 1986, it had purchased a parcel of land and building for approximately $230,000 on behalf of "certain of its officers" for whom it was acting as an agent. (Exhibit 77, 1987 annual report at 15, K-536). The company remained contingently liable on a $180,000 note by the officers until July 21, 1987, when the note was paid. After assisting the officers in their purchase of the property, the company was so kind as to enter into a five-year lease of the premises. It paid $59,300 rent showed that current assets exceeded current liabilities by more than $100,000. (Id. at F-2, F-3).

Nevertheless, Data Display was also a company with serious financial problems. According to the prospectus, its net income of $130,586 in 1984 declined to $53,260 in 1985. (Id. at F-4). Although the net income (unaudited) for the first six months of 1986 was $43,881, which suggested a recovery, the audited net income figure for the entire year of 1986 was only $48,031. (Exhibit 77, 1987 annual report at 10, K-531). The next year (1987) was a financial disaster, resulting in a net loss of $179,104. (Id.). The year in which the shares of Data Display were sold to Delaware investors, 1988, witnessed another substantial loss in the amount of $50,131. (Exhibit 77, 1988 annual report at 9, K-611).

Additionally, there was a question as to the loyalty of the top officers of Data Display to the corporation. In its 1987 annual report, the company reported that on December 30, 1986, it had purchased a parcel of land and building for approximately $230,000 on behalf of "certain of its officers" for whom it was acting as an agent. (Exhibit 77, 1987 annual report at 15, K-536). The company remained contingently liable on a $180,000 note by the officers until July 21, 1987, when the note was paid. After assisting the officers in their purchase of the property, the company was so kind as to enter into a five-year lease of the premises. It paid $59,300 rent in 1988 on that lease. (Exhibit 77, 1988 annual report at 12, K-614).

On May 23, 1988, the company amended its articles of incorporation to provide that monetary liability of a director to the corporation or its shareholders for breach of fiduciary duty as a director was thereby eliminated to the maximum extent permissible by law. (Exhibit 77, Form 10-Q for quarter ending June 30, 1988 at K-565, K-566).

The management of Data Display also had a credibility problem. In a press release dated January 4, 1989, the company stated: "In July of 1988, the company announced the acquisition of Hallmark Glassworks, Inc., a leading wholesale neon glass manufacturing company in the Rocky Mountain region." (Exhibit 77, press release at K-660). However, the company's 1988 annual report disclosed that Hallmark's net assets were no more than $17,000, and in fact it stated that "the acquisition is not material and the operations of Hallmark are minimal." (Exhibit 77, 1988 annual report at K-614).

According to the September 1986 prospectus, the officers and directors of Data Display were T. Bryan Alu, Alan Bloom, and Martin McElwain. (Exhibit 42 at 16). Prior to the 1986 public offering, the company had 26,949,750 shares of common stock outstanding (excluding underwriter's shares). The net tangible book value per share was $.009. (Id. at 1). Mr. Alu owned 14,045,711 shares, or 52.1%. Mr. Bloom owned 3,000,000 shares, or 11.1% (Id. at 17).

The 1986 public offering consisted of 10,000,000 shares, which were sold to the public at a price of $.10 per share. (Id. at 6). According to the 1987 annual report, the public offering closed on October 21, 1986, with the sale of 8,180,450 shares for gross proceeds of $818,045 and net proceeds of $627,783. (Exhibit 77, 1987 annual report at 15, K-536). After the offering, there were 35,380,200 shares outstanding. The public had paid $.10 per share for stock whose pro forma net tangible book value per share after the offering was $.0276. The investing public thus suffered an immediate dilution in the value of its shares of about $.072 per share, nearly 75% of the purchase price.

On June 16, 1988 (trade date), Mr. bought 25,675 shares of Data Display at a price of $.39 per share. (Exhibit 22). There is nothing in Data Display's 1986 prospectus, 1987 annual report, or 1988 annual report that explains this appreciation in the company's stock price from a rational financial perspective.

V. Mr. Stumpf's Testimony

Floyd Stumpf testified at the hearing on July 14, 1989. He said that he had been an agent in the securities business since 1985 and that he was employed by Allied from March 1988 to February 1989. (A36-37).[3] He said that he had received little training prior to his employment at Allied and none while at Allied. (A37). He said that William Masucci was the manager of the office in which he (Stumpf) worked and that Masucci owned that particular office. (A38). Stumpf testified that an individual named "Martin Baren" was the assistant manager. (A38).

Stumpf testified that he received very little supervision from his managers. (A38). His supervisors never contacted his customers or tried to confirm the details of his reported transactions. (A-38-39). New customer accounts were never rejected by his managers for lack of investor suitability. (A39).

Only penny stocks were sold at the Allied office. (A-40). Generally, only one penny stock was sold during a given period of time. (A58, A92). The commission paid to agents for sales to clients was generally six to ten times as great as the commission paid for purchases from clients. (A79). Allied was

---

[3] References to the transcript of the hearing on July 14, 1989, are by page number preceded by the letter "A".

a market-maker for the securities sold to the nine Delaware residents.[4] (A93).

Mr. Stumpf received all of his information as to projected holding periods and returns, business outlook, and imminent contracts and negotiations from his superiors at Allied and from Rick Marchese of Power Securities. (A41-42, A45-46, A58). This information was provided by Marchese and William Masucci, the Allied office manager, to the agents at informational and "motivational" meetings. (A46). Specifically, Rick Marchese of Power Securities touted Taste It Presents to Allied's agents at the Pompano Beach office in September or October of 1988. He told the agents, including Stumpf, that the price per share could go as high as $2.00 or more and that they should recommend it to their clients. (A45-46).

Mr. Stumpf never received a memorandum from Allied's research department or from its regulatory compliance officer. (A102). In fact, Stumpf said he was unaware of the name of anyone in the Allied research department or of the size of the department. (A102). Stumpf was provided by Masucci with scripts to assist in the selling of the penny stocks. (64-65).

---

[4] A "market-maker" is a broker-dealer that holds itself out as willing to buy or sell a security as a principal at quoted bid and asked prices.

There was a generic script for all of the securities, and there were specific scripts for several of them. The scripts would be used to create an argument as to why it would be beneficial for the prospective investors to purchase the stock being sold. (A65). The scripts did not mention that the securities being sold were penny stocks or that they were highly speculative. (A103).

Customer requests to sell their securities were frequently rejected by the office managers. They would say that the market was not "in alignment" or that the transaction could not be matched with a purchaser even though Allied was a market-maker and was quoting its bid price for the security on a board to its agents. (A43, A80). At the same time that sell orders were being rejected for the lack of bids at the quoted price, Allied agents were instructed to tell their clients not to sell because the price would go higher. (A80).

Although Stumpf read Allied's due diligence file on Taste It Presents, he never observed any information pertaining to a contract or negotiations between Taste It and Burger King or any other restaurant or hotel chain. (A47, A91-92). In fact, Stumpf had no basis (other than Masucci's assertion) to make such a representation to his customers. However, he did make such claims to the Delaware investors. (A44).

Stumpf never provided a prospectus, Form 10-Q, Form 10-K, or any other financial information to any of the Delaware investors. (A63-64). When he informed Masucci of his customers' requests for prospectuses, he was told the prospectuses were outdated and irrelevant. (A63).

Masucci told Stumpf to tell the investors not to sell their securities when they learned that the prices of those securities were dropping. The managers at Allied told Stumpf to tell the investors that the Christmas season caused a temporary depression in the stock prices. (A86-87).

Stumpf also testified that Allied's records as to trade dates of securities did not match the dates when he turned in his order tickets to initiate the trades. (A49).

When customers' securities were sold by Allied, the sales occurred all at one time on the instructions of William Masucci. (62). Masucci would instruct his agents that the time was right for their clients to sell, and all of the agents would sell all of their clients out of the security at the same time. (A62).

William Masucci informed Stumpf that it was Peter Mercaldi, the president of Allied, who arranged the deals in which Allied made a market in the securities sold to the Delaware investors. It was Peter Mercaldi who provided Masucci with the projected returns and holding periods. Generally, the information that was repeated by Stumpf to the Delaware investors came from Peter Mercaldi via William Masucci. (A77-78).

VI. Other Relevant Evidence

Denise Salvatore, an investigator employed by the Delaware Securities Division, testified at the hearing on June 21, 1989, that the Division had no registration records for CIP Holdings, Inc. (414). Also at the hearing that day, pursuant to a stipulation as to authenticity (410), the State introduced a copy of a temporary restraining order dated February 2, 1989, issued by the Supreme Court of the State of New York. (Exhibit 59, "Order Pursuant to G.B.L. §354," at 1-12). There was no testimony as to the circumstances of the order or the necessity that Allied report it. Certain broker-dealer registration forms ("BD Forms") were introduced as exhibits, though each seemed to be an amendment rather than a complete form. (See Exhibits 65-69).

One of the exhibits introduced by the State is a memorandum to the file dated March 3, 1989, written by Ms. Salvatore. In the memorandum she documents her telephonic conversation with Floyd Stumpf, who denied any personal wrongdoing but asserted that Allied had been manipulating the prices of the securities and had given him misinformation to transmit to his clients. (Exhibit 60).

Also placed in evidence were the registration records of Floyd Stumpf, William Masucci, and Stephen Zafir. Stumpf's records showed that he was registered to sell securities in Delaware as an agent of Allied during the period of June 1, 1988, through February 8, 1989, and as an agent of Oppenheimer

& Company, Inc., during the period of January 30, 1989, through March 28, 1989. (Exhibit 63 at 2). Masucci's records show that he was registered to sell securities in Delaware as an agent of Allied during the period of May 6, 1988, through February 8, 1989. (Exhibit 37 at 1). Zafir's records show that he was registered to sell securities in Delaware as an agent of Allied during the period of May 31, 1988, through February 7, 1989. (Exhibit 64 at 1). Records for the three Allied agents show that each worked for Allied at the Pompano Beach, Florida branch office. (Exhibit 63 at 3, Ex. 37 at 3, Ex. 64 at 3).

Exhibits 61 and 62 are copies of Allied's monthly commission reports for June and July 1988 at the Pompano Beach, Florida branch office. They show that Mr. Stumpf earned $34,659 in June and $14,138 in July.

VII. Arguments of the Parties

A. The State

The State contends that the evidence clearly shows that Mr. Stumpf engaged in misrepresentations and omissions of material fact in his sales of penny stocks to the public. It contends that Stumpf failed to convey the risks of those investments to his customers and that Allied failed to supervise him as he engaged in that conduct.

The State further argues that the financial reports of the companies whose securities were sold show that they had little or negative earnings and millions of shares of stock outstanding. The State argues that, even though the respondents were not required to recite each risk factor to the investors, something more than what he provided was required of Mr. Stumpf to convey the riskiness of those investments. The State notes Mr. Stumpf's admissions as to the practices at Allied and the fact that generally only one stock was offered to investors at a time.

As to Allied's failure to supervise, the State argues that conversations between the Delaware investors and the managers of the Pompano Beach branch office must have alerted management to Stumpf's dishonest sales presentations. In addition to Stumpf's testimony, the State emphasizes that the invocation of the Fifth Amendment privilege by William Masucci and Martin Baren supports an adverse inference as to their conduct.

As to the registration violations, the State argues that for CIP Holdings, Inc., Allied is not entitled to an exemption from registration under 6 Del. C. §7309(b)(13) because it failed to prove that the sale was not for the benefit of an owner of 10% or more of the outstanding voting securities of the issuer. The State argues that Power Securities Corporation ("Power") owned more than 10% of CIP's outstanding voting shares and that Exhibits 100 through 105 show that Allied bought millions of shares of CIP from Powers, transferred the stock to its clients, and then sold the stock back to Power.

Finally, the State argues that Allied violated 6 Del. C. §7315(c) and Rule 14(a)(2) of the Rules Pursuant to Delaware Securities Act by not reporting the issuance of the February 2, 1989 temporary restraining order against Allied by a New York court.

B. Allied

Allied argues that it reasonably supervised its agent, Mr. Stumpf. It relies on William Masucci's answer to charges filed in another proceeding to argue that routine supervisory practices were followed in the Pompano Beach office at the time of its sales to Delaware investors. (A copy of Masucci's answer is attached to Allied's November 2, 1989 letter to me). To support its argument, Allied attached to its brief copies of the National Association of Securities Dealers ("NASD") Supervisory Manual and section 27 of the NASD Rules of Fair Practice. Allied argues that the State produced no evidence that Allied's managers failed to review opening account statements, order tickets, and cross reference books or that Allied did not engage in periodic reviews of its Florida branch office. Allied argues that it has no duty to train its employees, especially those who are experienced in the securities business. Allied argues that no evidence was produced to show that the investment recommendations were unreasonable when made. It also argues that Stumpf's testimony is not credible and the investment recommendations were made to sophisticated investors who assumed the risks of penny stock investing.

As to the charge of selling an unregistered security, CIP Holdings, Inc., Allied argues that it met the requirements of the §7309(b)(13) exemption. It argues that it was a registered broker-dealer and that the record does not demonstrate that it sold the security for the benefit of the issuer or a holder of more than 10% of the outstanding voting shares. Specifically, it argues that the State's exhibits do not show whether the Power transactions were on behalf of Power or its customers. Further, it argues that, even if Power did act as a principal, Allied had no way of knowing that fact and could not reasonably be expected to have known it.

Although Allied admits that a temporary restraining order was issued against it, which it did not report, nevertheless it argues that the dismissal of Allied from that proceeding within 30 days of the order eliminated any reporting requirement.

Allied argues further that, even if there were a violation, any violation under these circumstances was <u>de minimis</u> in nature.

C. <u>Mr. Stumpf</u>

Mr. Stumpf and his counsel absented themselves halfway through this proceeding and did not submit any brief or memorandum. When he did attend, Stumpf's position was that he did nothing wrong.

VIII. Applicable Legal Standards

There are five sections of the Delaware Securities Act involved in this case that require some discussion: §7316(a)(2), §7303, §7304, §7316(a)(7), and §7316(a)(10).

Section 7316 contains the principal disciplinary provisions of the Act. As a prerequisite to a license denial, suspension or revocation, it requires at least two findings by the Commissioner:

(1) that the discipline imposed is in the public interest, and

(2) that one of the statutory "triggers" contained in subsections 7316(a)(1) through (a)(11) has been found to exist.

A. §7316(a)(2): A willful violation

This section is used in combination with other provisions in the Act that do not themselves contain a penalty. For example, a violation of the anti-fraud provision, §7303, or of the registration provision, §7304, must be joined with a finding of willfulness under §7316(a)(2) before a license denial, suspension or revocation may be imposed.

In contrast, §7316(a)(2) need not be joined with another §7316(a) finding--such as §7316(a)(7), which concerns unethical or dishonest practices--because each §7316(a) subsection itself is sufficient to trigger the imposition of a licensing penalty. The statute reads as follows:

§7316. Denial, Revocation, Suspension, Cancellation and Withdrawal of Registration of Broker-Dealers, Investment Advisers and Agents

> (a) The Commissioner may by order deny, suspend, or revoke any registration if he finds that the order is in the public interest and that the applicant or registrant or, in the case of a broker-dealer or investment adviser, any partner, officer, director, or any person occupying a similar status or performing similar functions, or any person directly or indirectly controlling the broker-dealer or investment adviser:
>
> (1) * * *
>
> (2) has willfully violated or willfully failed to comply with any provision of this chapter....

The term "wilful" (or "willful") has acquired a distinct meaning in the securities law context: it means that an individual acted intentionally in the sense of being aware of his actions, not in the sense of having a bad motive. Section 7316(a)(2) was derived from §204(a)(2)(B) of the Uniform Securities Act, which contains very similar language. I note that the Official Code Comment on this clause is the following:

> Clause (B): As the federal courts and the SEC have construed the term "willfully" in §15(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78o(b): all that is required is proof that the person acted intentionally in the sense that he was aware of what he was doing. Proof of evil motive or intent to violate the law, or knowledge that the law was being violated, is not required. The principal function of the word "willfully" is thus to serve as a legislative hint of self-restraint to the Administrator.

1 BLUE SKY LAW REPORTER ¶5524 (CCH).

It is not difficult to see the rationale behind this interpretation: a license suspension may be appropriate in the case of incompetence as well as in the case of bad motive. Where there is a net capital violation, for example, the broker-dealer puts the public equally at risk by its proximity to insolvency whether or not the principals are ignorant of the law and the rules for net capital calculations. Those who act willfully but without bad motive are protected from the criminal penalties of the Securities Act by §7322, which allows the defense of ignorance of the rule or order that was violated.

Moreover, as the official comments to the Uniform Act observe, the term "willfully" in §15(b) of the Securities Exchange Act of 1934, codified at 15 U.S.C. §78o, which is similar to the applicable provision here, has been interpreted by the federal courts to require only an intentional commission of the act constituting the offense. It does not require an intent to violate the law. Hinkle Northwest, Inc. v. SEC, 641 F.2d 1304, 1307 (9th Cir. 1981); Decker v. SEC, 631 F.2d 1380, 1386 (10th Cir. 1980); Nees v. SEC, 414 F.2d 211,221 (9th Cir. 1969); Capital Funds, Inc. v. SEC, 348 F.2d 582,588 (8th Cir. 1965); Tager v. SEC, 344 F.2d 5 (2d Cir. 1965); Gearhart Otis, Inc. v. SEC, 348 F.2d 798, 802 (D.C. Cir. 1965); Hughes v. SEC, 174 F.2d 969, 977 (D.C. Cir. 1949).

B. §7303: The Anti-Fraud Provision

Section 7303, entitled "Sales and Purchases," is the anti-fraud provision of the Act. It reads as follows:

> §7303. Sales and Purchases
>
> It is unlawful for any person in connection with the offer, sale or purchase of any security, directly or indirectly:
>
> (1) to employ any device, scheme, or artifice to defraud.
>
> (2) to make any untrue statement of a material fact or to omit 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
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

6 Del. C. §7303. Subsection 7303(2) is the most pertinent part of the statute in this case.

Section 7303 is derived from and identical to §101 of the Uniform Securities Act. The Official Code Comment to §101 states that this section is substantially the same as Rule 10b-5 of the Securities and Exchange Commission, but that this version expressly covers purchases as well as sales of securities. 1 BLUE SKY LAW REPORTER ¶5511 (CCH).

Since Rule 10b-5 is the progenitor of §7303, a brief discussion of Rule 10b-5 seems appropriate. The language and structure of Rule 10b-5 are nearly identical to §7303, with the rule's subsections (a), (b) and (c) corresponding to §7303's subsections (1), (2) and (3). See 17 C.F.R. §240.10b-5 (1988). The rule and its statutory foundation, §10(b) of the Securities Exchange Act of 1934, embrace a "fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry." Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972), quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963). The Supreme Court emphasized in the two cases just cited that Congress intended securities legislation to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." Id.

As one commentator has noted, Rule 10b-5 has generated a staggering quantity of law, but the cases demonstrate little uniformity regarding the elements of a prima facie case. See Fletcher, Sophisticated Investors Under the Federal Securities Laws, 1988 DUKE L. J. 1081, 1085. There are several reasons for this confusion. Most importantly, Rule 10b-5 is a regulatory construct that has been interpreted by the courts as implying a private right of action. Although the courts agree that a complaint in a private civil action under the rule need not allege all of the elements of common law fraud, there has been disagreement as to whether the elements of scienter, reliance, and causation are required. See generally, Brooks, Rule 10b-5 in the Balance: An Analysis of the Supreme Court's Policy Perspective, 32 HASTINGS L. J. 403 (1980).

The question of the prima facie case is less difficult in the regulatory context. Since the government seeks to protect the public rather than to obtain compensation, there is no point in inferring tort elements such as reliance, causation or damages. The danger to the public is revealed in the proof of material misrepresentations or omissions without a further showing. See Norville v. Alton Bigtop Restaurant, Inc., Ill. App., 317 N.E.2d 384, 390-91 (1974). The duty of care on the investor's part, normally an element of the prima facie case (or lack of care pled as an affirmative defense) in a private action, does not pertain to an action brought by a regulatory authority. Dupuy v. Dupuy, 551 F.2d 1005, 1015 (5th Cir. 1977), cert. denied, 434 U.S. 911 (1977). See Sachs, The Relevance of Tort Law Doctrines to Rule 10b-5: Should Careless Plaintiffs Be Denied Recovery?, 71 CORNELL L. REV. 96, 99 n.17 (1985). Although the facts of investor carelessness, reliance and damages may bear on the appropriate penalty for a violation of §7303(2), they are not required to prove the violation. An investor's actual knowledge of material facts may cause an otherwise material omission to be deemed immaterial, however. Straub v. Vaisman and Company, Inc., 540 F.2d 591, 596 (3d Cir. 1976).

At the federal level, the Supreme Court has grafted a scienter requirement upon Rule 10b-5 in the context of SEC injunctive actions. Aaron v. SEC, 446 U.S. 680 (1980). The rationale is based on the plain language of §10(b) of the Securities Exchange Act of 1934, which seems more directly concerned with fraud than does the broader language of Rule 10b-5, which focuses on the effect on those who are misled rather than on the perpetrator's state of mind. Relying on its analysis in Ernst & Ernst v. Hochfelder, 425 U.S. 185, 213-14

(1976), the _Aaron_ Court found Rule 10b-5, an administrative regulation, insufficient authority to eliminate the scienter requirement of the statutory §10(b). 446 U.S. at 691. However, in _Hochfelder_ and _Aaron_ the Court acknowledged that, standing alone, Rule 10b-5 in subsections (b) and (c) requires no more than negligent conduct. 446 U.S. at 696.

The Supreme Court's reasoning in those two cases suggests that subsections 7303(2) and (3) of the Delaware Securities Act, which are statutory rather than administrative provisions, do not require the element of scienter. In fact, state courts have interpreted their "blue sky" versions of Rule 10b-5 as requiring no more than proof of a material misrepresentation or omission. _Shermer v. Baker_, Wash. App., 472 P.2d 589, 596 (1970); _Norville v. Alton Bigtop Restaurant, Inc._, Ill. App., 317 N.E. 2d 284, 390-91 (1974).[5]

Thus, the _prima facie_ case under §7303(2) only requires a showing that: (1) in connection with the offer, sale or purchase of a security, (2) the respondent made an untrue statement of fact or failed to state a fact (3) that was material to the transaction. In the case of an omission, the materiality of the omitted statement is in part determined by

[5] In Delaware, §7316(a)(2)'s willfulness requirement, which must be joined with a §7303 violation to authorize a license suspension or revocation, adds a limited intent requirement. Moreover, if relatively innocent conduct is heavily penalized by the Commissioner, the Court of Chancery has the authority under §7324 to modify an unreasonable penalty.

the statements that are made by the respondent. If the statements that are made are technically true but would convey a misleading impression in the absence of further disclosure, then the omission is material and there is a duty to disclose.

Generally, the test of materiality is whether a reasonable investor might have considered the information important when making his investment decision. Affiliated Ute Citizens, 406 U.S. at 153-54. In another case, the Supreme Court defined a material fact or omission as one that "would have been viewed by the reasonable investor has having significantly altered the 'total mix' of information made available." TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). This standard of materiality has been expressly adopted by the Third Circuit Court of Appeals as applicable to Rule 10b-5 cases. Sharp v. Cooper & Lybrand, 649 F.2d 175, 187 (3d Cir. 1981).

Section 7303(2) requires that the misrepresentation or omission pertain to a "fact" rather than an "opinion," but in the securities context the term "fact" is given the broadest interpretation reasonably possible. An excellent discussion of the modern rejection of the old doctrine of "puffing," as regards securities, may found in Norville, supra, 317 N.E.2d at 389. The Illinois appellate court in that case noted that "recent authorities are unanimous in condemning the concept of 'puffing' in the context of securities regulations," and concluded that "[i]t is immaterial, then, whether the statements involved in this appeal are to be characterized as 'facts' or 'opinion.'" 317 N.E.2d at 389-90.

The Norville court's approach is supported by case law. In SEC v. Capital Gains Research Bureau, 375 U.S. 180, 194 (1963), the Supreme Court stated:

> There has also been a growing recognition by common-law courts that the doctrines of fraud and deceit which developed around transactions involving land and other tangible items of wealth are ill-suited to the sale of such intangibles as advice and securities and that, accordingly, the doctrines must be adopted to the merchandise in issue.

One court has stated that "where there is a question as to whether a given misleading statement is a statement of fact or merely an expression of opinion, it is likely that it will be found to be a statement of fact." First Mobile Home Corporation v. Little, Miss. Supr., 298 So.2d 676, 681 (1974), quoting 69 AM. JUR. 2d Securities Regulations §102 at 1130 (1973).

Similarly, treatises and expert commentators have adopted this approach. 11C-Part 2 Business Organizations, SOWARDS & HIRSCH, BLUE SKY REGULATION §6:04[1] at 6-80; L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION at 717 (1988).

In particular, baseless recommendations and optimistic forecasts that have no grounds in historical fact are treated as material misrepresentations of fact. Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 651 F.2d 615 (9th Cir. 1981); Mihara v. Dean Witter & Co., Inc., 619 F2d 615 (9th Cir. 1980). Myzel v. Fields, 386 F.2d 718, 734 n.8 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968); Hiller v. SEC, 429 F.2d 856 (2d Cir. 1970); SEC v. North Am. Research & Dev. Corp., 424 F.2d 63 (2d Cir. 1970); Hanly v. SEC, 415 F.2d 589 (2d Cir. 1969); Fondren v. Schmidt, 626 F.Supp. 892 (D.Nev. 1986); Norville v. Alton Bigtop Restaurant, Inc., Ill. App., 317 N.E.2d 384, 390 (1974); SEC v. Broadwell Securities, Inc., 240 F.Supp. 962 (S.D.N.Y. 1965). See also 11C-Part 2 Business Organizations, SOWARDS & HIRSCH, BLUE SKY REGULATION §6:04[1] at 6-80.

The need for securities regulatory authorities to treat baseless recommendations and predictions as fraudulent representations is especially acute in the area of low priced, highly speculative stocks that are sold over the counter ("OTC").[6] One expert has suggested that revocation of a broker-dealer's license on the basis of recommendations lacking a reasonable foundation may be one of the most effective weapons of combatting abuses in the OTC markets. Bloomenthal, Market-Makers, Manipulators and Shell Games, 45 ST. JOHN'S L. REV. 597, 626 (1971); Bloomenthal, The Case of the Subtle Motive and the Delicate Art--Control and Domination in the Over-the-Counter Securities Markets, 1960 DUKE L. J. 196, 220. Nowhere is the need for aggressive regulatory protection of investors greater than in the OTC markets. Rogoff, Legal

[6] "Over the counter" securities are those not listed on any national or regional exchange.

Regulation of Over-the-Counter Market Manipulation: Critique and Proposal, 28 MAINE L. REV. 149, 159 (1976).

C. §7304: Registration Violations

Section 7304 states that "[i]t is unlawful for any person to offer or sell any security in this State unless it is registered under this Act, or the security or transaction is exempted under §7309." A violation of this provision must be joined with a finding of willfulness under §7316(a)(2) and a public interest determination before a registrant's license to sell securities may be suspended or revoked.

Section 7309 contains the Act's registration exemptions for securities and transactions. Subsection 7309(a) sets forth the exemptions for exempt securities, which never require registration. Subsection 7309(b) sets forth the exemptions for certain securities transactions. Securities being sold pursuant to an exempt transaction may subsequently require registration if sold in a nonexempt transaction.

Subsection 7309(d) puts the burden of proving an exemption upon the person claiming it. Where a securities registration violation has been charged, the respondent bears this burden once the State has proven that the security was sold in Delaware without being registered.

D. §7316(a)(7): Dishonest or Unethical Practices

Subsection 7316(a)(7) provides a statutory "trigger" for discipline where the applicant or registrant "has engaged in dishonest or unethical practices." Although this standard is written in general language, a general standard can be filled with content when the conduct at issue is judged in light of case law establishing prohibited conduct. See Selig v. Novak, Ark. Supr., 506 S.W.2d 825, 830 (1974) ("those charges which cannot be found in the statutes are covered by general language . . . and reinforced by case law which has been developed over the years to protect the public from unethical conduct").

Generally, broker-dealers and their agents have the following duties with respect to nondiscretionary accounts: 1) the duty to recommend a stock only after studying it sufficiently to become informed as to its nature, price and financial prognosis, 2) the duty to carry out the customer's orders promptly in a manner best suited to serve the customer's interest, 3) the duty to inform the customer of the risks involved in purchasing or selling a particular security, 4) the duty to refrain from self-dealing or refusing to disclose any personal interest the broker may have in a particular recommended security, 5) the duty not to misrepresent any fact material to the transaction, 6) the duty to transact business only after receiving prior authorization from the customer, and 7) where the customer is unsophisticated about financial matters, the duty to define the potential risks of a particular transaction carefully and cautiously. Leib v. Merrill Lynch, Pierce, Fenner & Smith, 461 F.Supp. 951, 953 (E.D. Mich. 1978) (citations omitted).

Some federal courts have found that the securities industry's ethical standards as set forth in the NASD's Rules of Fair Practice ("NASD's Rules") constitute a sufficient basis for liability in a private tort action. <u>SEC v. First Securities Co. of Chicago</u>, 463 F.2d 981, 988 (7th Cir. 1972), <u>cert. denied</u>, 93 S.Ct. 85 (1972). Whether or not the NASD's Rules are a valid basis for a tort action, they certainly are valid evidence of ethical standards in the securities industry.

Probably the most pertinent of the NASD's Rules with respect to this case is section two, which states the following:

> <u>Recommendations to Customers</u>
> In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

NASD MANUAL, Rules of Fair Practice §2152 (CCH).

I tend to view unreasonably optimistic forecasts and recommendations without reasonable historic justification as violations of §7316(a)(7) rather than violations of §7303(2). Despite the authority noted above as to the broad interpretation of the term "fact" in the context of Rule 10b-5 language, I am more comfortable viewing an unreasonable prediction of large profits as an unethical practice rather than as a misrepresentation of a material fact. Moreover, there is still some vitality to the puffing doctrine--especially in federal court in the Southern District of New York. See Newman v. Rothschild, 651 F.Supp 160, 163 (S.D.N.Y. 1986); Frota v. Prudential-Bache Securities, Inc., 639 F.Supp. 1186, 1190 (S.D.N.Y. 1986).

E. §7316(a)(10): Duty to Supervise Reasonably

Subsection 7316(a)(10) states that a statutory "trigger" for discipline exists where an applicant or registrant "has failed reasonably to supervise his agents if he is a broker-dealer." This provision applies to Allied because it is a broker-dealer, but not to Stumpf or Masucci, who were agents. "Broker-dealer" and "agent" are technical terms that are defined in §7302 of the Act.

Section 7316(a) of the Delaware Securities Act was derived from §204(a) of the Uniform Securities Act. Subsection 7316(a)(10) corresponds to Clause (J) of §204(a)(2), which states: "(J) has failed reasonably to supervise his agents if he is a broker-dealer or his employees if he is an investment adviser." 1 BLUE SKY L. REP. §5524 at 1528 (CCH). The only significant difference between the two is that §204(a)(2)(J) applies to investment advisers and §7316(a)(10) does not. The Official Code Comment to Clause (J) states the following:

> This clause represents a codification of the view held by a number of Administrators, as well as the SEC, to the effect that a registrant must be held responsible for violations resulting from inadequate supervision of subordinates. This Act, unlike §15b) of the Securities Exchange Act 1934, 15 U.S.C. §78o(b), does not authorize the Administrator to proceed against the registration of a broker-dealer merely because one of his agents has violated the

> statute (unless the agent happens to be a director, officer or partner). But, when an agent's violation is found to be due to a violation of the broker-dealer's duty of reasonable supervision, and when the Administrator finds it is in the public interest to proceed against the broker-dealer's registration, he may do so under Clause (J). This is not to say that proof of a violation by the agent is essential to an order under Clause (J).

1 BLUE SKY L. REP. ¶5524 at 1530 (emphasis in original).

The importance of the comment that "a registrant must be held responsible for violations resulting from inadequate supervision of subordinates" is underscored by the statute's authorization to revoke a broker-dealer's registration on this basis. The responsibility to supervise must be interpreted broadly, for a broker-dealer's duty to supervise its employees is a "stringent" obligation. Rochez Brothers, Inc. v. Rhoades, 527 F.2d 880, 886 (3d Cir. 1975), *cert. denied*, 425 U.S. 993 (1976).

The statute does not specify what must be done by a broker-dealer. Presumably, one reason for this lack of specification is that what manner and degree of supervision is reasonable may vary with the circumstances. The flexibility here is similar to the negligence standard of the "reasonable man." Just as the parent who gives his child a real bow and arrow will be expected to monitor the child more closely than the parent who gives his child a toy bow and arrow, the broker-dealer that deals in highly risky securities may be expected to monitor its agents' sales practices more closely than would the broker-dealer that sells Treasury bills. Thus, factors such as product availability and compensation incentives may be relevant.

Frequently, a determination that a securities violation occurred must made on the basis of inference rather than direct evidence. One would not expect the Artful Dodger to testify against Fagan, and the existence of fraudulent intent and sham supervisory measures often can be deduced only from the "totality of events." Ruder, Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution, 120 U. PA. L. REV. 597, 635 (1972), quoting Trussel v. United Underwriters, Ltd., 228 F.Supp. 757, 772 (D.Colo. 1964). See also Rolf v. Blyth, Eastman Dillon & Co., Inc., 570 F.2d 38, 47 (2d Cir. 1978).

In this regard, the insightful statement of one commentator merits consideration:

> There are risks in allowing employers to escape liability by reason of their supervision and internal control systems. The typical employer in the securities industry may be quite capable of structuring a detailed system of supervisory and control procedures which actually stand little chance of preventing fraud but which create, in anticipation of litigation, a cosmetic appearance of good faith. . .That such an artificial endeavor could insulate an employer from liability for an employee's fraud perpetrated within the course and scope of employment or within his scope of authority is not defensible. The law, at least as a matter of social policy, should not encourage implicitly conduct amounting to a sham which is then relied upon to defeat a defrauded investor's suit.

Musewicz, Vicarious Employer Liability and Section 10(b): In Defense of the Common Law, 50 GEO. WASH. L. REV. 754, 800 n.256

(1982). That comment, made in the context of a private tort action, has equal application in the regulatory context. Although broker-dealers should not be strictly liable for their agents' conduct, the great majority of employees follow management's lead, and substantial and prolonged misconduct by an employee which benefits his company financially and which is not exposed by the company is probably due to supervisory indifference, if not fraudulent intent.

If a hearing officer were overly reluctant to adopt that conclusion, then the public would be vulnerable to the practices of any broker-dealer where management is clever enough to shield itself from the fraudulent acts of its employees by erecting a "Chinese wall" and relying upon sham supervisory procedures. See Sharp v. Coopers & Lybrand, 649 F.2d 175, 184 (3d Cir. 1981).

IX. Findings of Fact and Conclusions of Law

A. Floyd Stumpf

Mr. Stumpf was charged with making material misrepresentations and omissions in connection with the sale of securities in violation of §7303, engaging in unethical and dishonest conduct by recommending highly speculative securities without a reasonable basis to investors who were not suited to those investments, in violation of §7316(a)(7), and selling unregistered, nonexempt securities in violation of §7304. Each violation was alleged to have been willful, in violation of §7316(a)(2).

The charge of selling unregistered securities will be discussed in another section below in connection with the charges against Allied.

I accept the testimony of the nine Delaware investors. I believe that they purchased securities from Allied and Mr. Stumpf under the circumstances they described. The specific transactions are well documented in the exhibits.

Although the investors knew each other at the time of the transactions and discussed the events with each other prior to the hearing, they seemed to testify on the basis of personal knowledge. Their testimony appeared forthright and not calculated to help attain a particular result.

In contrast, Mr. Stumpf's testimony seemed self-serving. He denied making the statements that obviously would have been improper, such as the guarantees referenced by Mr.

and Mr.   , and as to the less obviously improper statements he portrayed himself as the innocent intermediary between Allied's managers and his helpless clients. Despite his youth, Mr. Stumpf had been in the securities business for four years. He was sophisticated enough to know that, for civil liability purposes under federal law, whether Allied acted as a market-maker in the security being sold could determine the scope of his legal duties to his customers.

Mr. Stumpf's willingness to bend his version of reality to the purpose at hand was illustrated by the inconsistencies in his testimony. He responded to leading questions from Allied's counsel by agreeing that nothing wrong transpired in connection with his sales to the Delaware investors. (A118). Later, he agreed with counsel for the State that his recommendations of the securities were unsuitable for some of the investors, who did not receive all of the relevant information. (A154-55). In his telephone call to Denise Salvatore several months prior to the hearing, he told her that Allied had been manipulating the prices of the securities it sold. It is noteworthy that when two of the investors called Stumpf on a speakerphone, he was immediately alarmed that the conversation was possibly being recorded.

In any instance of inconsistency between Stumpf's testimony and the investors' testimony, I am inclined to believe the investors.

My findings and conclusions as to Stumpf are the following:

1. Floyd Stumpf violated §7303(2) and §7316(a)(2) by willfully making misrepresentations of material fact and omissions of material fact in connection with his sale of securities to a Delaware resident, on or about September 6, 1988. Selling over the telephone into Delaware, Stumpf willfully misrepresented the degree of risk inherent in the highly speculative common stock of Taste It Presents, Inc., when he told that would not be likely to lose his entire investment. Stumpf also made a willful misrepresentation in telling that contract negotiations were ongoing between Taste It and Burger King when Stumpf had no reasonable basis for making that statement. Stumpf made a willful omission when he stated that the price of the stock would appreciate by 60% in two months without informing that the company had a poor financial history and had millions of shares of common stock outstanding with no positive earnings.

2. Stumpf also violated §7316(a)(7) when he made the above-referenced sale to . Stumpf recommended a security without having reasonable grounds to believe that the security was suitable for the investor. He also purchased a security for without having his authorization to do so.

3. Floyd Stumpf violated §7303(2) and §7316(a)(2) by willfully making misrepresentations of material fact and

omissions of material fact in connection with his sale of securities to ________, a Delaware resident, on or about August 3, 1988. Selling over the telephone into Delaware, Stumpf made a willful misrepresentation when he told without having any reasonable basis for making the statement, that the issuer (Taste It Presents, Inc.) was about to sign a contract with a major national hotel chain. Stumpf also made a willful misrepresentation when he said that he was putting $10,000 to $12,000 of his own money into the company even though he was not doing that. Stumpf made a willful omission by failing to inform that the company had a poor financial history and had millions of shares of common stock outstanding with no positive earnings.

4. Stumpf also violated §7316(a)(7) when he made the above-referenced sale to . Stumpf recommended a security without having reasonable grounds to believe that the security was suitable for the investor. He also violated §7316(a)(7) by stating that the security was "a guaranteed double within a 30 to 45 day period" when he had no basis for making that statement. Moreover, guarantees are <u>per se</u> unethical in the context of equity sales.

5. Floyd Stumpf violated §7303(2) and §7316(a)(2) by willfully making misrepresentations of material fact and omissions of material fact in connection with his sale of securities to , a Delaware resident, on or about August 19, 1988. This second sale was made over the telephone

into Delaware by Stumpf, who willfully misrepresented the degree of risk inherent in the highly speculative stock of Taste It Presents, Inc., when he told that it was a safe investment. Stumpf also made a willful misrepresentation when he stated that the company had just landed a national contract. Stumpf made a willful omission by failing to inform that the company had a poor financial history and had millions of shares of common stock outstanding with no positive earnings.

6. Stumpf also violated §7316(a)(7) when he made the above-referenced sale to . Stumpf recommended a security without having reasonable grounds to believe that the security was suitable for the investor. He also violated §7316(a)(7) by guaranteeing that the value of the investment would double when he had no reasonable basis for making that statement.

7. Floyd Stumpf also violated §7316(a)(7) subsequent to the above-referenced sales by inducing through willful misrepresentations not to sell his securities. Fraud which induces an investor to refrain from purchasing or selling securities is equally culpable as fraud which induces an investor to act. Marbury Management, Inc. v. Kohn, 629 F.2d 705, 709-710 (2d Cir. 1980). Having no reasonable basis for the statement, Stumpf told that he should wait to sell his shares because a group of lawyers were preparing to purchase all of the outstanding shares in the company.

8. Floyd Stumpf violated §7303(2) and §7316(a)(2) by making willful misrepresentations of material fact and omissions of material fact in connection with his sale of securities to _____, a Delaware resident, on or about August 18, 1988. Selling over the telephone into Delaware, Stumpf made a willful misrepresentation when he told , without any reasonable basis for the statement, that the stock (Taste It Presents, Inc.) would be repurchased by the company. Stumpf also made a willful misrepresentation when he told that the investment was low risk. Stumpf also made a willful misrepresentation when he told , without any reasonable basis for the statement, that Allied's research department had learned of a pending contract between Taste It Presents and Burger King. Stumpf made a willful omission by not informing that the company had a poor financial history and had millions of shares of common stock outstanding with no positive earnings.

9. Stumpf also violated §7316(a)(7) when he made the above-referenced sale to . Stumpf recommended a security without having reasonable grounds to believe that the security was suitable for the investor. He also violated §7316(a)(7) by telling , without any reasonable basis for the statement, that he should obtain a 30-40% return on the investment.

10. Stumpf also violated §7316(a)(7) subsequent to the sale of Taste It Presents, Inc., to when Stumpf

refused to sell shares and induced not to sell them by telling him that negotiations were ongoing that would cause to receive a higher price.

11. Floyd Stumpf violated §7303(2) and §7316(a)(2) by making willful omissions of material fact in connection with his sale of securities to , a Delaware resident, on or about June 30, 1988. Selling over the telephone into Delaware, Stumpf sold shares of OTC America, Inc., by willfully omitting to inform that the security was extremely risky, that the company had a poor financial history, and that it had millions of shares outstanding with no positive earnings.

12. Stumpf also violated §7316(a)(7) when he made the above-referenced sale to . Stumpf recommended a security without having reasonable grounds to believe that the security was suitable for the investor. He also violated §7316(a)(7) by telling , without any reasonable basis for the statement, that the price of the stock would appreciate 30-40% in 30 days.

13. Floyd Stumpf violated §7303(2) and §7316(a)(2) by making willful misrepresentations of material fact and omissions of material fact in connection with his sale of securities to , a Delaware resident, on or about August 18, 1988. This second sale was made over the telephone into Delaware by Stumpf, who willfully misrepresented the risks inherent in shares of stock in Taste It Presents, Inc. Stumpf

also willfully misrepresented that the security was part of an initial offering when it was not. Stumpf also willfully omitted to inform that Taste It Presents had a poor financial history and had millions of shares of common stock outstanding with no positive earnings.

14. Stumpf also violated §7316(a)(7) when he made the above-referenced sale to . Stumpf recommended a security without having reasonable grounds to believe that the security was suitable for the investor. Stumpf also violated §7316(a)(7) by telling , without any reasonable basis for the statement, that the price of the stock would probably appreciate 50-100% within 60 days of the purchase.

15. Floyd Stumpf also violated §7316(a)(7) in August 1988 by selling shares of stock in OTC America, Inc., without authorization to do so.

16. Floyd Stumpf violated §7303(2) and §7316(a)(2) by making willful misrepresentations of material fact and omissions of material fact in connection with his sale of securities to ____, a Delaware resident, on or about September 6, 1988. Selling over the telephone into Delaware, Stumpf sold shares of Express Technologies, Inc., by willfully misrepresenting the degree of risk inherent in the security. Stumpf also willfully omitted to inform that Express Tech had a poor financial history and had millions of shares of common stock outstanding with no positive earnings.

17. Stumpf also violated §7316(a)(7) when he made the above-referenced sale to . Stumpf recommended a security without having reasonable grounds to believe that the security was suitable for the investor. Stumpf also violated §7316(a)(7) by predicting that the security would appreciate 30% when Stumpf had no reasonable basis for making that statement.

18. Floyd Stumpf violated §7303(2) and §7316(a)(2) by making willful misrepresentations of material fact and willful omissions of material fact in connection with his sale of securities to , a Delaware resident, on or about October 18, 1988. This was the second sale of securities to over the telephone into Delaware by Stumpf, who willfully misrepresented that Allied's research department had thoroughly researched the company, Davin Enterprises, Inc. In fact, Stumpf had no idea whether Allied even had a research department. Stumpf also willfully omitted to inform that Davin Enterprises had a poor financial history, that it had never conducted any business activity other than organizational activities, and that it had millions of shares of common stock outstanding with no positive earnings.

19. Stumpf also violated §7316(a)(7) when he made the above-referenced sale of stock in Davin Enterprises, Inc., to . Stumpf recommended a security without having reasonable grounds to believe that the security was suitable for the investor.

20. Floyd Stumpf violated §7303(2) and §7316(a)(2) by making willful misrepresentations of material fact and willful omissions of material fact in connection with his sale of securities to , a Delaware resident, on or about October 21, 1988. This was the third sale of securities to over the telephone into Delaware by Stumpf, who willfully misrepresented that Allied's research department had thoroughly researched the company, CIP Holdings Inc. In fact, Stumpf had no idea whether Allied even had a research department. Stumpf also willfully omitted to inform that CIP Holdings had a poor financial history, and had several million shares of common stock were outstanding with no positive earnings.

21. Stumpf also violated §7316(a)(7) when he made the above-referenced sale of stock in CIP Holdings, Inc. Stumpf recommended a security without having reasonable grounds to believe that the security was suitable for the investor.

22. Floyd Stumpf violated §7303(2) and §7316(a)(2) by making willful misrepresentations of material fact and willful omissions of material fact in connection with his sale of securities to _______, a Delaware resident, on or about August 19, 1988. Selling over the telephone into Delaware, Stumpf willfully misrepresented the price and value of the securities (Taste It Presents, Inc.) by telling that the price of the stock was $1.25 per share and could buy it for $1.07 per share. Stumpf also willfully omitted to inform that the company had a poor financial history and had

millions of shares of common stock outstanding with no positive earnings.

23. Stumpf also violated §7316(a)(7) when he made the above-referenced sale of stock to . Stumpf made a recommendation of a security without having reasonable grounds to believe that the security was suitable for the investor. Stumpf also violated §7316(a)(7) by purchasing the security for without authorization.

24. Floyd Stumpf violated §7303(2) and §7316(a)(2) by making willful misrepresentations of material fact and willful omissions of material fact in connection with his sale of securities to ______, a Delaware resident, on or about June 16, 1988. Selling over the telephone into Delaware, Stumpf willfully misrepresented the risk inherent in the security, shares of common stock in Data Display Corporation. Stumpf also willfully misrepresented that the security was guaranteed because the company would buy back the stock from the investor within 30 to 45 days. Stumpf also willfully omitted to disclose that Data Display had more than 35 million shares of common stock outstanding with no positive earnings in 1987 or 1988.

25. Stumpf also violated §7316(a)(7) when he made the above-referenced sale to . Stumpf recommended a security without having reasonable grounds to believe that the security was suitable for the investor. Stumpf also violated §7316(a)(7) by telling that the price of the security

would double without having any reasonable basis for that statement.

26. Floyd Stumpf violated §7303(2) and §7316(a)(2) by making willful misrepresentations of material fact and willful omissions of material fact in connection with his sale of securities to . a Delaware resident, on or about July 18, 1988. This was the second sale of securities made to over the telephone into Delaware by Stumpf, who willfully misrepresented the degree of risk inherent in the security, shares of common stock in OTC America Inc. Stumpf also willfully misrepresented that he had invested his own personal funds in the security when he had not. Stumpf also willfully omitted to inform that the company had a poor financial history and had millions of shares of common stock outstanding with no positive earnings.

27. Stumpf also violated §7316(a)(7) when he made the above-referenced sale of stock in OTC America, Inc., to . Stumpf recommended a security without having reasonable grounds to believe that the security was suitable for the investor. Stumpf also violated §7316(a)(7) by telling , without any reasonable basis for the statement, that the price of the security would greatly appreciate in a short period of time.

28. Floyd Stumpf violated §7303(2) and §7316(a)(2) by making willful misrepresentations of material fact and willful omissions of material fact in connection with his sale of

securities to , a Delaware resident, on or about August 18, 1988. This was the third sale of securities to over the telephone into Delaware by Stumpf, who willfully misrepresented the degree of risk inherent in the security, shares of common stock in Taste It Presents, Inc. Stumpf also willfully misrepresented the price of the security when he told that the security was selling for $1.20 per share but that could buy it for $1.07 per share. Stumpf also willfully omitted to inform that the company had a poor financial history and had millions of shares of common stock outstanding with no positive earnings.

29. Stumpf also violated §7316(a)(7) when he made the above-referenced sale of stock in Taste It Presents, Inc., to . Stumpf recommended a security without having reasonable grounds to believe that the security was suitable for the investor. Stumpf also violated §7316(a)(7) by telling , without any reasonable basis for the statement, that the price of the security would greatly appreciate in a short period of time.

30. Floyd Stumpf violated §7303(2) and §7316(a)(2) by making willful misrepresentations of material fact and willful omissions of material fact in connection with his sale of securities to , a Delaware resident, on or about October 21, 1988, and on or about October 28, 1988. These sales of CIP Holdings, Inc., to were made by Stumpf over the telephone into Delaware. Stumpf willfully misrepresented

the degree of risk inherent in the security and willfully misrepresented that Stumpf had invested his own personal funds in the security when he had not. Stumpf also willfully omitted to inform that the company had a poor financial history and had several million shares of common stock outstanding with no positive earnings.

31. Stumpf also violated §7316(a)(7) when he made the above-referenced sale of stock in CIP Holdings, Inc., to . Stumpf recommended a security without having reasonable grounds to believe that the security was suitable for the investor. Stumpf also violated §7316(a)(7) by telling , without any reasonable basis for the statement, that the price of the security would greatly appreciate in a short period of time.

32. Stumpf also violated §7316(a)(7) in connection with each of the above-referenced sales by failing to deliver the stock certificates to for the securities had purchased.

33. In November 1988, subsequent to the above-referenced sales, Stumpf violated §7316(a)(7) by failing to sell securities upon many requests and by omitting to disclose that Allied's managers were quoting bid prices as a market-maker and selling securities to investors, but were refusing to buy them back.

34. Floyd Stumpf violated §7303(2) and §7316(a)(2) by making willful misrepresentations of material fact and willful

omissions of material fact in connection with his sale of securities to a Delaware resident, on or about October 21, 1988. Selling over the telephone into Delaware, Stumpf willfully misrepresented that Allied's thorough research gave it an edge over other firms when in fact Stumpf had no idea whether Allied even had a research department. Stumpf also willfully omitted to inform that CIP Holdings had a poor financial history and had several million shares of common stock outstanding with no positive earnings.

35. Stumpf also violated §7316(a)(7) when he made the above-referenced sale of stock to . Stumpf recommended a security without having reasonable grounds to believe that the security was suitable for the investor. Stumpf also violated §7316(a)(7) by telling , without any reasonable basis for the statement, that might double his money in four to six weeks.

36. Subsequent to the sale, Stumpf violated §7316(a)(7) by marking on new account form that investment objective was speculation when had not said that to Stumpf. Stumpf also violated §7316(a)(7) by telling that marking "speculation" as his objective was just a formality and that 's investment was not really risky because Allied's track record was so good.

37. Floyd Stumpf violated §7303(2) and §7316(a)(2) by making willful misrepresentations of material fact and willful omissions of material fact in connection with his sale of

securities to ______, a Delaware resident, on or about October 18, 1988. Selling over the telephone into Delaware, Stumpf willfully misrepresented the degree of risk inherent in the security, shares of common stock in Express Technologies, Inc., when he said that the most could lose would be several hundred dollars. Stumpf also willfully omitted to inform that the company had a poor financial history and had millions of shares of common stock outstanding with no positive earnings.

38. Stumpf also violated §7316(a)(7) when he made the above-referenced sale of stock to . Stumpf recommended a security without having reasonable grounds to believe that the security was suitable for the investor.

39. Floyd Stumpf violated §7303(2) and §7316(a)(2) by making willful misrepresentations of material fact and willful omissions of material fact in connection with his sale of a security to , a Delaware resident, on or about October 18, 1988. This second sale of securities to was made over the telephone into Delaware by Stumpf, who willfully misrepresented the degree of risk inherent in the security (shares of commons stock in Davin Enterprises, Inc.) when he told that at worst the security would stay at the same price. Stumpf also willfully omitted to inform that the company had a poor financial history and had millions of shares of common stock outstanding with no positive earnings.

40. Stumpf also violated §7316(a)(7) when he made the above-referenced sale of stock in Davin Enterprises, Inc., to . Stumpf recommended a security without having reasonable grounds to believe that the security was suitable for the investor. Stumpf also violated §7316(a)(7) by predicting, without any reasonable basis for the statement, that the price of the security would appreciate 40-50% within a short period of time.

41. Subsequent to the two above-referenced sales of securities to , Stumpf violated §7316(a)(7) by failing to sell 's securities upon his request and by failing to inform that Allied's managers were refusing to purchase securities from Allied's customers even though Allied was a market-maker in those securities and was quoting bid prices for them.

B. Allied Capital Group, Inc.

1. §7316(a)(10) violations

I find that Allied failed, in violation of §7316(a)(10), to supervise reasonably its agent, Floyd Stumpf, with respect to each of the sales to the Delaware investors. Aside from the testimony of Stumpf, the fact that an agent routinely used willful misrepresentations and omissions of material fact as the essence of his sales technique for more than six months suggests that either he knew he was not being monitored or he knew that his supervisors would not penalize him. The frequency and egregiousness of his dishonesty suggests that this was not isolated, surreptitious behavior. Moreover, Stumpf testified that many of the misleading statements he used to sell the securities came from Mercaldi and Masucci, and Allied's managers gave him scripts that presented a misleading impression of these relatively worthless securities.

Allied argues that no written complaints from investors were received. Even if that is the case, it does not negate the fact that at least several investors engaged in conversations with Allied's managers (Masucci, Baren and Zafir) in such a way that Stumpf's misrepresentations were made apparent to them. The managers took no disciplinary action against Stumpf. Rather, they themselves participated in the unethical behavior by telling the investors not to sell their securities, telling them the securities could not be sold, and repeating some of Stumpf's most dubious assertions (e.g., the prices of the securities were down 50 to 75% because of the Christmas season and they would rebound after the holiday). Masucci even had the audacity to ask for more money from one of the victims after the investor had learned of his loss.

Allied argues that Stumpf's past dishonesty means that he cannot be believed, but I am not willing to discredit all of Stumpf's testimony. His statements that he never saw any regulatory compliance rules at Allied and that his managers never rejected a sale for investor suitability reasons were consistent with the testimony of the investors. Stumpf's testimony against Allied was only one piece of a mosaic depicting a company that wanted to maximize its profits at the expense of its customers. Stumpf did not select the worthless securities that were foisted on the Delaware investors. Stumpf did not set the commission schedule that rewarded sales at a rate six to ten times that of purchases. Stumpf did not write the misleading scripts. Stumpf could not have been solely to blame for Allied's failure to deliver any of the stock certificates to the investors.

Allied argues that the investors willingly undertook the risk of speculative investing, as shown by the new account forms where the objective of speculation was marked by nearly all of the investors. There are several problems with this argument. Even if the investors' objectives had been speculation, that fact would not excuse the many misrepresentations and omissions. Secondly, I do not agree that most or all of the investors stated that their objective was speculation. 's new account form showed no objective whatsoever. (Exhibit 71). 's form was marked to indicate that his goal was "growth with risk," presumably a less risky category than speculation. At the hearing, and explained that Stumpf had marked their forms to show speculation as their objective and he told them to sign the form. testified that Stumpf said that the investment was not really risky and that signing the form was just a formality. Thirdly, an investor's stated goal of speculation is not an authorization for the agent to victimize him. Regardless of the goals of the investors in this case, I do not think the recommendations of these securities were made in good faith by Stumpf or his superiors at Allied.

Allied focuses on the income level ($50,000 +) of the investors and argues that they understood the nature of the investments and assumed the risk of loss. It is true that in a private civil action investors have a duty of due care, and where they are sophisticated the federal courts may find that the duty was not met or that obvious misinformation was immaterial. *See generally* Fletcher, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L. J. 1081. This is not a tort action, however, and my concern is with deterring unscrupulous sales behavior rather than investor carelessness.

Moreover, Allied's argument that all nine of the Delaware investors should be deemed to have been sophisticated investors because of their income is incorrect. The primary determinant of investor sophistication is actual understanding of the investment markets, not the income level of the investors. (Id. at 1149). , the accountant, was the only one of the nine who could be deemed a sophisticated investor. The others did not even know they were entitled to the stock certificates which were never delivered. Even as to , his relative sophistication did not legitimize the fraudulent statements made to him. "Sophisticated investors, like all others, are entitled to the truth." Stier v. Smith, 473 F.2d 1205, 1207 (5th Cir. 1973).

Allied suggests that it must be judged by the supervision standards in §27 of the NASD's Rules of Fair Practice. Since §7316(a)(10) is a statutory standard of the State of Delaware that is independent of any NASD rules, the hearing officer is not bound to judge Allied's supervision by the NASD's rules. Nevertheless, consideration of the NASD's supervision standards is appropriate.

Section 27(a) of the NASD's Rules of Fair Practice states the following:

> Each member shall establish, maintain and enforce written procedures which will enable it to supervise properly the activities of each registered representative and associated person to assure compliance with applicable securities laws, rules, regulations and statements of policy promulgated thereunder and with the rules of this Association.

Section 27(b) states that "[f]inal responsibility for proper supervision shall rest with the member."[7] I fail to see how these standards assist Allied's case in any way. Other parts of §27 set forth more detailed requirements as to inspections and investigations by a broker-dealer, but they are in addition to the general standards and do not relieve Allied of its responsibility for the events in this case.

Allied also relies on the NASD Supervisory Manual. (Relevant sections attached to Allied's Responding Brief). Part II, Section III.A. of that manual states that the broker-dealer must establish a review process to spot the sales practices of unsuitable recommendations, unauthorized transactions, and guarantees against loss. The record is replete with these improper practices by Stumpf and his manager, and there is no indication a serious effort was made to stop them. Part II, Section III.H. states that the broker-dealer must review the accounts of individual salespersons to determine if there is an undue concentration of transactions in a single security. Since Allied sold only one or two stocks at a time, it is difficult to see how it could have complied with this requirement.

Allied adopts a minimalist view of its supervision responsibility. It submits a copy of its compliance manual,

---

[7] "Member" refers to the broker-dealer. NASD MANUAL ¶1101 at 1045 (CCH).

provides no testimony that it was distributed or that anyone ever looked at it (much less followed it), and argues that the State failed to produce any evidence that account cards were not checked, branch offices were not inspected, or that other particular supervisory measures were not taken.

There are two points here. First, it does not matter what particular measures were taken by Allied if the fraud that occurred here could reasonably have been prevented by proper supervision. When a company selects a portfolio of worthless securities for its agents to sell, pays the agents to sell only those securities, pays the agents handsomely for selling the securities but not for buying them back, in fact refuses to buy the securities in which it claims to make a market, distributes misleading scripts to its agents, never sends the stock certificates to its customers, and employs branch managers who join in an agent's misrepresentations, it does not matter whether the firm has its compliance manual printed on 24-karat gold leaf and has every new account form subjected to microscopic scrutiny. The firm is still in violation of §7316(a)(10). In this regard, Allied did not have a <u>per se</u> obligation to train its agents, but, when one of its agents acts in a flagrantly dishonest manner over an extended period of time, Allied must suffer the consequences of its failure to train and discipline.

Secondly, Allied's statement that there is no evidence of lack of supervision on this record is doubly wrong.

Circumstantial evidence is good evidence, and the testimony as to the conduct of Stumpf by itself would, in my opinion, be sufficient to support an inference of inadequate supervision. Beyond that, there is direct evidence in this case from the investors that suggests managerial complicity in Stumpf's conduct and by Stumpf himself, testifying that there was very little, if any, effort on Allied's part to enforce regulatory compliance.

Reviewing the record, I count a minimum of 17 sales of securities by Allied and Stumpf to the nine Delaware investors. Each sale was made with a failure on Allied's part to supervise reasonably its agent, Floyd Stumpf. There were 17 violations of §7316(a)(10) by Allied.

2. <u>§7316(a)(7) violations</u>

The Amended Notice of Intent to Revoke Broker-Dealer and Agent Registrations charged Allied with each violation that was alleged against Stumpf, including §7303, §7316(a)(2), and §7316(a)(7) violations. In an Opinion and Order dated July 11, 1989, I stated that my interpretation of the Delaware Securities Act is that the actions of a single agent will generally not lead to broker-dealer liability, except under §7316(a)(10), in the absence of evidence of culpable conduct on the part of a director, officer, or controlling person. I stated at that time that "should I finally conclude that Masucci and Baren were not partners, directors, officers, or controlling persons, then I will dismiss the charges against

Allied except as to the charges of failure to supervise." (Opinion and Order, July 11, 1989, at 5).

Masucci and Baren were the branch managers of Allied in the Pompano Beach, Florida office where Stumpf worked. They were the only managers of Allied directly implicated in the testimony of the nine Delaware investors at the hearing on June 20 and 21, 1989. The above-quoted statement assumed that the evidence in the State's case would be limited to what was produced on June 20-21. However, an unexpected turn of events occurred when Mr. Stumpf agreed on July 13, 1989, to testify on behalf of the State. Because Stumpf's agreement was a surprise, I notified Allied's counsel--who had absented themselves from that portion of the proceeding for financial reasons.

Stumpf's testimony directly implicated Peter Mercaldi, the president of Allied, and therefore added evidentiary support to the allegations of fraud and unethical conduct on the part of the broker-dealer. In the State's closing brief, counsel for the State did not argue that Allied violated §7303 or §7316(a)(7). However, my authority extends to an independent determination of the charges on the record. Blinder, Robinson & Co., Inc. v. Bruton, Del. Supr., 552 A.2d 466, 474 (1989) ("[State's request not to impose sanction] clearly did not bind the Commissioner to the suggested result").

Stumpf testified that William Masucci, the branch manager, informed him that Peter Mercaldi made the "deals" for the securities that were sold by the Pompano Beach office and that Mercaldi provided Masucci with the projected returns and holding periods for each security. (A77-78). Those projected returns and holding periods had no reasonable basis. The absence of reasonable grounds to make those projections was the reason for my finding that each security was sold by Stumpf in violation of §7316(a)(7), which makes dishonest and unethical conduct a basis for discipline.

Stumpf's testimony as to what Masucci said is competent evidence, in my view, because it involves an admission by an employee (Masucci) within the scope of his employment. See E. CLEARY (ed.), MCCORMICK'S HANDBOOK OF THE LAW OF EVIDENCE §267 at 640-41 (2d ed. 1972) Thus, the statement bears sufficient indicia of reliability to escape the hearsay rule of exclusion. Nevertheless, there is still a concern about reliability because the statement is in the nature of hearsay and is coming in through the testimony of a witness with limited credibility.

There are two reasons why I think this testimony should be given substantial weight. First, there is ample circumstantial evidence in this case to support the view that the Allied operation was rotten from top to bottom.[8] Stumpf's conduct, the statements of the managers to the investors, the failure to provide any financial information or certificates to the investors, the worthless securities, the sales emphasis on one penny stock at a time, the refusal to buy back the securities in which Allied supposedly made a market, the misleading scripts, the orchestrated sales of all clients' securities at one point in time, the extremely lucrative commissions to the agents--these factors together create the picture of a brokerage firm that views its customers as sheep just waiting to be shorn.

The second reason is that none of those in a position to refute the Masucci statement would do so under oath. Mercaldi failed to testify and Masucci and Baren claimed the Fifth Amendment. Thus, I believe that Mercaldi was the original source of the spurious projections.

Even if the top officials at Allied did not consciously intend to convey a false impression to the public (though I think they did), at a minimum they were reckless in their disregard of the consequences of their actions. Recklessness is generally viewed as the equivalent of scienter in the

---

[8] After reviewing the entire record, I think the evidence so clearly supports that inference that my July 11, 1989 ruling was probably incorrect as to the need for a showing that Masucci and Baren were officers, directors, or controlling persons. Nevertheless, I would have abided by it in the absence of the new evidence as to Mercaldi.

context of securities law. Rolf v. Blyth, Eastman Dillon & Co., Inc., 570 F.2d 38, 44-47 (2d Cir. 1978).

Therefore, I find that Allied violated §7316(a)(7) in connection with each of the 17 sales of securities to Delaware investors. The president of Allied, Peter Mercaldi, provided Allied's agents with recommendations and projected profits for each of the securities without having reasonable grounds to do so.

3. §7304 and §7316(a)(2) violations

Allied has not met its burden of proof with respect to the §7309(b)(13) exemption that it claims. The evidence suggests that Power Securities Corporation and perhaps Allied itself owned more than 10% of the outstanding shares of common stock in CIP Holdings, Inc., around the time that Allied purchased shares of CIP from Power and then sold them in Delaware. (Exhibits 100-105). Exhibits 100, 101 and 103 indicate that Power sold more than 10% of the CIP stock to Allied through an intermediary, E. J. Pittock & Co., whereas Exhibit 104 indicates that the sales were directly between Power and Allied. Allied argues that these exhibits merely show inter-dealer trades, but Allied bears the burden of proof and has not even attempted to show or explain its ownership and Power's ownership of CIP shares during the relevant period. Also, Allied's argument that it had no way of knowing Power's ownership interest is inconsistent with the fact that Rick Marchese, the president of Power, delivered a pep talk to

Allied's agents at Allied's Pompano Beach office. Even if Allied did not know, it should have registered the securities for sale in Delaware.

Each sale of CIP Holdings, Inc., to Delaware investors was in violation of §7304. I find that the sales were willful. At a minimum, there were three separate sales and three violations of §7304 and §7316(a)(2) by Allied and Stumpf.

4. <u>§7315(c) and Rule 14(a)(2) violations</u>

Although it appears that Allied did fail to report the temporary restraining order issued against it by a New York court, I am unable to find a complete copy of the Form BD in the record. Since there was no testimony on this point, I am unable to ascertain the extent of Allied's reporting obligation. Therefore, this charge is dismissed.

X. The Public Interest Determination.

I find that it is in the public interest that the registrations of the respondents be permanently revoked. I further find that it is in the public interest that respondents be fined $1000 for each of their violations of the Delaware Securities Act.

Floyd Stumpf is a person of low character who should never be permitted to work in the securities industry again. His conduct towards his clients in Delaware was flagrantly cynical and dishonest. Testifying, he was asked by counsel for the State what he had learned about suitability through the course of the proceeding. His response: "That used car salesmen aren't good penny stock investors. They shouldn't be in the market." (A-149). Stumpf's flippant remark, which provoked laughter at the hearing, illustrates his lack of remorse and contempt for the individuals whose trust he once had undeservedly obtained.

Allied's managers apparently shared Stumpf's attitude. Relatively worthless securities were recommended to the public without a good faith basis for the recommendation. The public was induced to buy them because the investors were not told of the risks or given any financial information. Rather, they were told of big profits that were likely to be made in a short period of time. All of the broker-dealer's retail sales effort was focused on one or two penny stocks at a time. The salesmen were paid big commissions for foisting the securities on the public, but they were not allowed to buy them back even though the broker-dealer claimed to make a market in the securities and quoted phony bid prices. The salesmen were given misleading scripts to help create the false impression that the securities were a good investment. When the time seemed right to the broker-dealer (presumably for its own financial reasons), all of the clients' securities were sold by its agents on the same day--with or without the client's authorization. The clients never received any money from these sales. They were never sent any of their stock certificates, and when the exaggerated prices of the securities receded along with the broker-dealer's retail sales effort, the victims were told to "hang in there." Even if they requested ten times that their securities be sold, as did, they could not get a dollar back.

An order imposing the above-stated penalties is attached to this opinion. Respondents have 60 days in which to appeal to the Delaware Court of Chancery in and for New Castle County.

RICHARD W. HUBBARD
Securities Commissioner

Date: January 16, 1990

BEFORE THE SECURITIES COMMISSIONER

OF THE STATE OF DELAWARE

IN THE MATTER OF:	)	
	)	
ALLIED CAPITAL GROUP, INC.,	)	
FLOYD J. STUMPF,	)	Case No. 89-02-04
	)	
Respondents.	)	

ORDER

The evidence on the charges having been heard and the arguments of the parties having been considered,

IT IS ORDERED that:

1. The registration of Allied Capital Group, Inc. ("Allied") to sell securities in Delaware as a broker-dealer is hereby permanently revoked on the grounds that it committed 17 violations of 6 Del. C. §7316(a)(7), 17 violations of 6 Del. C. §7316(a)(10), and 3 violations of 6 Del. C. §7304 and §7316(a)(2), and that permanent revocation is in the public interest because the above-stated violations involved pervasive dishonesty and irresponsibility on the part of Allied's management.

2. It is in the public interest that Allied be fined in the amount of $37,000 and it is so ordered.

3. The agent registration of Floyd J. Stumpf to sell securities in Delaware is hereby permanently revoked on the grounds that he committed 17 violations of 6 Del. C. §7303(2) and §7316(a)(2), 24 violations of 6 Del. C. §7316(a)(7), and 3 violations of 6 Del. C. §7304 and §7316(a)(2), and that

permanent revocation is in the public interest because the above-stated violations involved pervasive fraud and dishonesty.

4. It is in the public interest that Floyd J. Stumpf be fined in the amount of $44,000 and it is so ordered.

Richard W. Hubbard

RICHARD W. HUBBARD
Securities Commissioner

Date: January 16, 1990
Wilmington, Delaware