ADMINISTRATIVE PROCEEDING
FILE NO. 3-2233

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of
ERNST & ERNST CLARENCE T. ISENSEE JOHN F. MAURER
Rule 2(e) of the Rules of Practice

SUPPLEMENTAL INITIAL DECISION
(Private Proceeding)

Washington, D.C.
October 21, 1975

Ralph Hunter Tracy
Administrative Law Judge

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APPEARANCES: Theodore I. Sonde, Associate Director, Division of Enforcement, James H. Schropp and David J. Romanski, Attorneys, Office of General Counsel, for the Office of the Chief Accountant of the Commission.

Frank C. Heath, Patrick F. McCartan and Marc L. Swartzbaugh of Jones, Day, Reavis & Poque, Cleveland, Ohio, for respondents.

BEFORE: Ralph Hunter Tracy, Administrative Law Judge

On June 12, 1974, the Commission ordered that these proceedings be remanded to the undersigned for additional hearings and post-hearing procedures. Specifically, the Commission ordered that the record be reopened for the limited purpose of allowing further cross-examination of Herbert R. Belcher (Belcher) and Donald M. McGregor (McGregor) when it was brought to its attention that certain prior statements of these witnesses had been discovered and had not previously been made available to respondents during the original hearings in this matter. Reopened hearings were held on July 22, 1974, at which both Belcher and McGregor testified. McGregor was recalled and testified further on March 31, 1975.[1/] Motions by respondents to call additional witnesses were denied.

Upon completion of the reopened hearings, at which all respondents were represented by counsel, briefs were filed by all parties. The findings and conclusions herein are based upon the preponderance of the evidence as determined from the record and upon observation of the witnesses.

McGregor

The prior statements made by McGregor related to the sworn testimony which he gave to SEC investigators on October 24 and 25, 1967, during their investigation of Business Funds, Inc. (BFI). This testimony, consisting

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1/ Pursuant to my direction the testimony of both McGregor and Belcher before the federal grand jury for the Southern District of Texas was obtained by the Office of General Counsel (OGC) and furnished to respondents who elected not to recall Belcher.

of 3 volumes, was introduced into evidence as Respondents' Supplemental Exhibits (RS) 2, 3, 4, and was used to reexamine McGregor on July 22, 1974. RS 2, 3, and 4 refer to numerous papers of McGregor's which were used during the October 24 and 25, 1967 interrogation. Although these documents were not marked as exhibits to his testimony respondents' counsel have made repeated requests that they be produced by the OGC pursuant to 18 U.S.C. 3500 (Jencks Act), and Rule 11.1 of the Commission's Rules of Practice.

The OGC stated that it had made a search for the documents but had not been able to locate them. McGregor testified that they might have been returned to him but he was not certain. Respondents' counsel took the position that it did not have to go to McGregor's files but that it was incumbent upon the OGC to furnish them. In this connection I suggested to counsel that rather than lead to an inconclusive ending to the reopened hearing in which the Respondents would still be asking for more documents, ad infinitum, it might be helpful "to at least utilize the transcript you have before you to demonstrate the points where Mr. McGregor is asked to testify about specific documents and whether or not that might suffice." I also suggested ". . . that I would give you the opportunity to specifically examine him on at least a few examples to either prove or disprove the very point that you are trying to make, that you need these documents."

The response of respondents' counsel to the offer was "I don't think that I can be required to go forward with the witness on the basis of prior testimony which was based upon documentation which has not been made available to me."

A reading of RS 1, 2, and 3 discloses that the documents in question were produced by McGregor and his attorney at the commencement of the testimony, that they were itemized on the record, that they were fully identified when questions were asked and that they were all returned to him at the conclusion of the testimony when they were again identified item by item. Therefore, they have been in McGregor's possession since then and the respondents must have known it when they were making repeated requests of the OGC to produce them. The record discloses that respondents made no effort to obtain the documents from McGregor.

Following his testimony on July 22, 1974, it was learned that McGregor had testified before a Federal grand jury in Houston, Texas, on or about December 1, 1967. Respondents thereupon requested production of this testimony. It was secured by the OGC and made available to respondents and McGregor was recalled for further reexamination on March 31, 1975.

The reexamination of McGregor was based primarily on his testimony before the SEC staff on October 24 and 25, 1967, concerning BFI. This testimony, respondents now argue, adds a new dimension to the concealment of the fraud which prevented E & E from discovering, through the application of generally accepted auditing standards, the situation which brought about the collapse of Westec. In support of this contention respondents cite McGregor's testimony that at the request of BFI he used

various companies he was affiliated with to obtain funds from BFI for Ernest M. Hall, Jr., (Hall) Westec's president, to purchase Westec stock; that the papers evidencing these transactions were sometimes presented to him for his signature after the transaction had occurred; that they were prepared by the law firm of Vinson, Elkins; that Vinson, Elkins at the same time served as counsel for BFI, Westec and McGregor; that therefore Vinson, Elkins had knowledge of these BFI transactions with McGregor and that Vinson, Elkins was under a duty to inform E & E of this fact.

There is nothing in McGregor's testimony to substantiate respondents position. The only thing new is that McGregor engaged in numerous transactions with and on behalf of BFI just as he did with Westec. Accordingly, McGregor's testimony of October 24 and 25, 1967, as reaffirmed on July 22, 1974 and March 31, 1975 fully supports the statement at page 21 of the Initial Decision (I.D.): "In view of the number and nature of the appearances of McGregor up to this time some inquiries should have been made concerning his activities." There is no indication in the record of either the original or the reopened hearings that respondents made any inquiry of McGregor at any time.

Belcher

The prior statements made by Belcher related to unsworn testimony he gave before the United States Attorney in Houston, Texas, on December 1, 1967, at which time SEC staff members were present. During the reopened hearing it was learned that Belcher had appeared before a

grand jury shortly after the December 1, 1967 interrogation, and respondents immediately demanded that it, too, be produced. However, when the grand jury testimony was obtained and furnished to respondents they decided not to recall Belcher for any further examination.

Respondents now seek to use Belcher's prior testimony to place blame on Griffin for not informing Isensee of the conditional nature of the Beco transaction. Although respondents have characterized Belcher as "evasive a witness as one could find" they now claim that he told Griffin of the Beco transaction and its conditional nature on a trip to Washington to visit the SEC and that Griffin failed to tell Isensee about it. They neglect to mention that Isensee was also present on this visit to the SEC which took place on April 12, 1965. However, Griffin's testimony is that he did not learn of the conditional nature of the Beco acquisition until about November 1, 1965, when he was preparing an application for BFI in connection with the Metric acquisition, at which time he brought it to Isensee's attention.[2/]

Griffin testified that on or about April 12, 1965, he learned that the Beco transaction had been consummated; that he was unhappy that his advice that Beco could not be acquired without approval of the Commission had not been followed and that about April 30, 1965, Vinson, Elkins ceased representing Westec.

2/ This was a renewal of the application filed in February 1965 under the Investment Company Act of 1940. (See pages 32 and 36 of the I.D.).

In their brief relating to the reopened hearings respondents state: "The Administrative Law Judge relied upon and reiterated this testimony of Belcher in the course of his Initial Decision. (See I.D., 36, 40, 45)." On page 36 of the I.D. it is stated: "Belcher testified that he discussed this contingent contract with Isensee and Griffin, company counsel, during a trip to Washington for a conference with the Commission concerning the Trak acquisition. This conference took place on April 12, 1965." On page 40 of the I.D. it is stated: "There is also Belcher's testimony that he discussed this condition with Isensee on a trip to Washington on or about April 12, 1965." There is no reference whatsoever to Belcher on page 45 but there is this statement: "Moreover, respondents knew or should have known of the conditional nature of the Beco acquisition, particularly when PW informed them of it." There is no reliance on Belcher's testimony alone as respondents contend.

From the testimony of Belcher and Griffin it appears reasonable to believe that while the Beco acquisition may have been discussed on or about April 12, 1965, the contingency may not have been discussed, as indicated by Griffin's testimony that he was concerned that Westec had not followed his advice and that when he did learn of the condition in the fall he immediately informed E & E. There is nothing in the record to indicate any possible motive for Griffin to withhold information in April,[3/] nor is there reason to believe he deliberately did so at that time.

3/ Since Griffin's concern and the advice he gave in April related to the legality of the acquisition under the Investment Company Act of 1940, it lends credence to the belief that he was unaware of the contingency in April.

However, as noted in the I.D., this does not exculpate E & E since there many other flags which should have alerted them to the situation, specifically the Price Waterhouse report. (I.D. 37).

Belcher, in his capacity as Assistant Secretary and Controller of Westec, signed its Form 10-K for 1965, which was filed on May 24, 1965. The 10-K contained the acquisition of Doliver Corporation (Doliver), Beco and Trak. Respondents brief gives the impression that in his December 1, 1967, testimony Belcher testified that when he signed the 10-K he believed that these were proper poolings(underscoring by respondents). Therefore, respondents argue, such testimony is in conflict with his testimony in this proceeding that he knew of the contingency in the Beco acquisition as early as April 12, 1965. [4/] Accordingly, respondents urge, given the weight accorded the hearing testimony of this witness in the Initial Decision, the importance of the evidence developed on reopening bearing upon Belcher's credibility cannot be stressed too strongly.

A careful reading of Belcher's December 1, 1967, testimony fails to disclose any statement as to his belief that the acquisitions were "proper poolings". What he clearly said was that he depended on the outside accountants, that he relied on Isensee in all pooling matters and that since E & E prepared the 10-K he did not question it.

Overall, Belcher's December 1, 1967, testimony confirms rather than refutes the findings in the I.D. concerning the activities of respondents in structuring pooling of interest acquisitions for Westec. Belcher's testimony emphasises the part played by Isensee who "acted as

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4/ The existence of a contingency would prevent the acquisition in any form.

a corporate consultant on accounting matters, particularly with a view to favorable acquisitions." Belcher stated that he did not have a large background on mergers and acquisitions and that he asked Isensee, who acted as consultant on every acquisition or merger for advice on how to do it and how to reflect it on the books.

Other Matters

In their brief respondents reargue matters which were thoroughly considered in the Initial Decision. Since such matters have no relevancy to the limited nature of the reopened proceedings no further discussion is necessary. However, arguments made concerning expert testimony do require consideration. Respondents have repeatedly insisted that all 6 of the experts they called supported their position and therefore, their testimony should be determinative of this case. In this connection they argue that no expert testimony was produced by the OGC and that the findings entirely disregarded the testimony of their experts.

In their reply brief with respect to the reopened hearing respondents state, at page 8:

> "The short answer to this obvious and improper attempt to shift the burden of proof to the respondents is that, '<u>with the exception of some limited rebuttal, no expert testimony to the contrary was introduced by the OCA</u>' (I.D. 104) to show that the accounting and reporting practices approved by respondents were misleading." (underscoring supplied).

Respondents distortion of the quotation from the I.D. becomes readily apparent upon a reading of the entire paragraph:

> "Expert Testimony
>
> Respondents contend that the issues presented in this proceeding are questions requiring expert guidance to resolve and in support of their position introduced the testimony of a number of members of other firms who testified as experts. Respondents lay great emphasis on this testimony and point out, that with the exception of some limited rebuttal, no expert testimony to the contrary was introduced by the OCA. However, as the Commission has previously stated, while the opinions of qualified experts may be helpful, the Commission must in the last analysis weigh the value of expert testimony against its own judgement of what is sound accounting practice. Interstate Hosiery Mills, Inc., 4 SEC 706, 715 (1939)." (Underscoring supplied).

The testimony of the experts in this proceeding was concerned primarily with interpreting generally accepted accounting principles in support of respondents actions after the facts with no knowledge of the evidence developed during the hearing. The fact that 6 experts appeared on behalf of respondents as opposed to 1 for the OGC is not persuasive. In United States v. Simon, 425 F. 2d 796, the defendants called 8 experts as against 2 for the government, one of whom was the Chief Accountant of the Commission, the Commission expert in this proceeding. In Simon the Court said at 805:

> "The defendants called eight expert independent accountants, an impressive array of leaders of the profession."

* * * *

> "With due respect to the Government's accounting witnesses, an SEC staff accountant, and, in rebuttal, its chief accountant, who took a contrary view, we are bound to say that they hardly compared with defendants' witnesses in aggregate auditing experience or professional eminence."

In rejecting defendants' contention that instruction should have been given which would have made their expert accountants testimony decisive in favor of defendants' position, the Court observed at 806:

> "We think the judge was right in refusing to make the accountants' testimony so nearly a complete defense."

Conclusion

Respondents have continued their efforts to prolong this proceeding and to obfuscate the record. This is illustrated by their demanding the OGC to produce documents which they knew had been returned to McGregor and by characterizing an observation in the I.D. as a finding when it was respondents' own statement of its position. In addition, they have repeatedly requested the calling of additional witnesses and further supplementation of the record which have been denied.

The reexamination of Belcher and McGregor on the basis of the Jencks Act material, which has now been made part of the record, did not discredit their prior testimony in this proceeding in any material respect. If anything, it strengthened it. Accordingly, the reexamination of Belcher and McGregor compels the determination that the findings and conclusions reached in the Initial Decision be affirmed.

Accordingly, IT IS ORDERED that the findings and conclusions reached in the Initial Decision are affirmed.

This order shall become effective in accordance with and subject to Rule 17(f) of the Commission's Rules of Practice.

Pursuant to Rule 17(f), the Initial Decision shall become the final decision of the Commission as to each party who has not within fifteen days after service of this supplemental decision upon him, filed a petition for review of this supplemental decision pursuant to Rule 17(b), unless the Commission, pursuant to Rule 17(c) determines on its own initiative to review this supplemental decision as to him. If a party timely files a petition for review, or the Commission takes action to review as to a party, the Initial Decision shall not become final with respect to that party. 5/

Ralph Hunter Tracy
Administrative Law Judge

Washington, D.C.
October 21, 1975

5/ To the extent that the proposed findings and conclusions submitted by the parties, and the agruments made by them, are in accordance with the view herein they are accepted, and to the extent they are inconsistent therewith they are rejected.