IN THE MATTER OF

PAINE, WEBBER, JACKSON & CURTIS

and

WILLIAM P. COWDEN

RALPH MARTIN KLOPP

File No. 3-484. Promulgated January 22, 1969

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

BROKER-DEALER PROCEEDINGS

Fraudulent Representations in Offer and Sale of Securities

Excessive Trading

Where securities salesman induced excessive trading by customers by means of false representations to them concerning the securities activities of another customer, *held*, willful violations of anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 and in the public interest to bar salesman from association with any broker or dealer, with proviso that after one year he may become associated with a broker-dealer in supervised capacity upon appropriate showing.

Inadequate Supervision

Where registered broker-dealer and branch manager failed reasonably to supervise salesman, with a view to preventing his inducement of excessive trading in customers' accounts, *held*, in public interest to censure broker-dealer and manager.

APPEARANCES:

Arthur F. Mathews, Hyman Braham, David A. Tenwick, Burton H. Finkelstein and *Paul Metzinger*, for the Division of Trading and Markets of the Commission.

Arthur E. Petersilge, of Schlitz & Petersilge, and *Milton Weiss*, of Beekman and Bogue, for Paine, Webber, Jackson & Curtis and William P. Cowden.

Jacob I. Rosenbaum and *Bruce J. Bettigole*, of Burke, Haber & Berick, for Ralph Martin Klopp.

FINDINGS AND OPINION OF THE COMMISSION

Following hearings in these private proceedings pursuant to Sections 15(b), 15A and 19(a)(3) of the Securities Exchange Act of 1934 ("Act"), the hearing examiner filed an initial decision in which he concluded, among other things, that Ralph Martin Klopp, who was a salesman in the Union Commerce (Cleveland) branch office of Paine, Webber, Jackson & Curtis ("registrant"), a registered broker-dealer and member of the New York Stock Exchange and other securities exchanges and the National Association of Securities Dealers, Inc., should be suspended from association with any broker or dealer for a period of four months, but that the proceedings against registrant and William P. Cowden, former manager of that office, should be dismissed. Klopp filed a petition for review of the initial decision which we granted, and, pursuant to Rule 17 CFR 201.17(c) of our Rules of Practice, we ordered review with respect to all other issues which were before the examiner concerning all the respondents. Briefs were filed by the respondents and by our Division of Trading and Markets ("Division"), and we heard oral argument. On the basis of an independent review of the record and for the reasons set forth herein and in the initial decision, we make the following findings.

VIOLATIONS BY KLOPP

The examiner found that during the period from about May 1962 through October 1963, Klopp made certain false representations to two of his customers, J. and R. Those customers, who were close friends, opened accounts with Klopp in the spring of 1961 and effected a number of transactions through him during the ensuing year, relying largely on the recommendations of an investment service to which they had subscribed at his suggestion. The examiner found that in May and June 1962 Klopp told those customers that another customer had made substantial trading profits and that he would inform them of the trading by that customer so that they could duplicate his transactions. The examiner further found that as a result of the customers' reliance on false information concerning such trading given them by Klopp, Klopp in effect obtained discretionary power over their accounts and induced them to engage in excessive trading.

The two customers testified as follows: On May 29, 1962, while R. was at registrant's office, Klopp told him that one of his customers had a "huge" account, used the services of an investment adviser and had made large profits by selling his portfolio and selling additional stock short just before a sharp market drop on the preceding day and covering the short sales and purchasing

stock just prior to the market rally on May 29. R. told J. of this conversation and Klopp himself made essentially the same representations to J. He also advised both customers that the other customer was a doctor, although he did not identify him by name, and used the services of a "Chinese chartist." When Klopp and J., in June 1962, reviewed the latter's portfolio, consisting mostly of low priced over-the-counter securities which had depreciated, Klopp stated that he would inform J. about the doctor's transactions after they were executed. In July 1962 Klopp informed J. that the doctor had just sold stock of Cinerama, Inc. short, and J. instructed Klopp to effect a short sale of that stock for his account. This was followed by a series of further transactions, extending to September 1963, which were effected by J. on the basis of Klopp's statements regarding transactions by the doctor.[1] R.'s first transaction based on a transaction reported to have been effected by the doctor took place in August 1962. In about November 1962, R., based on Klopp's statement that it "might be a good idea to follow the doctor," sold many of the securities in his portfolio in order to obtain additional funds to follow the doctor's transactions. He continued to follow those transactions until October 1963 when he ceased dealing with Klopp.

The record shows that there was a significant increase in activity and in the amounts invested in the accounts of the two customers from the time when, according to their testimony, they started to follow the doctor's transactions. In J.'s account an average cumulative monthly investment of $7,475 was turned over 5.5 times during the first half of 1962,[2] but during the next six months which, according to his testimony, was the principal period during which his trades followed those of the purported doctor, an increased average investment of $11,934 was turned over 22 times. In 1963 the pace of his trading declined again, a fact attributed by J. to a shortage of funds because of losses sustained. With respect to R., for the first ten months of 1962 his account

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[1] The customers also testified that in September 1963, after they became suspicious concerning the existence of the doctor, J. made a tape recording of a telephone conversation with Klopp in which references were made to the doctor's transactions and portfolio. Klopp objected to the examiner's admission of the recording and certain expert testimony as to it on various grounds, and asserted that the recording was not authentic and discredited rather than corroborated the customers' testimony. The examiner concluded that the recording was authentic and was important evidence tending to corroborate the customers' testimony but was not decisive as to the charges against Klopp. While we agree with the examiner as to the admissibility of the recording (see order of June 16, 1966 upholding the examiners ruling) and expert testimony relating to it, in view of the conflicting and inconclusive nature of the expert testimony regarding the integrity of the recording we give no weight to the recording in making our findings herein.

[2] Turnover rate has been computed by dividing the aggregate amount of purchases by the average cumulative monthly investment. See *Reynolds & Co.*, 39 S.E.C. 902, 906, n. 10 (1960).

had a turnover rate of 4.2 with an average investment of $22,785, but for the next ten months, when most of the trading purportedly following the doctor's transactions took place, his account had a turnover rate of 17.1 with an average investment of $38,695. During the period under consideration, both customers traded for the first time in stocks selling for more than $100 per share, and the total amounts of many of their transactions far exceeded those of prior transactions.[3] In addition, whereas previously, both in their accounts with registrant and elsewhere, J. had made only one short sale and R. none, during the period in question they effected a substantial number of short sales.

Klopp denied making any representations concerning the nature of and transactions in another account, and testified that, far from inducing J. and R. to increase their trading activity, he advised them to reduce such activity and instead to buy and hold high quality stocks, but that they disregarded his advice.

The examiner, in resolving the credibility issue against Klopp, noted that the probative effect of the testimony of J. and R. was weakened by a lack of specificity and consistency and some contradictory evidence in the record but concluded that "in sum their testimony on salient aspects of the issues involved remains credible and must be accepted." His conclusion in this respect is entitled to considerable weight and is supported by various facts shown by the record which provide strong corroboration for the customers' testimony.

There is a significant correlation between certain of the information which they testified was given to them and the actual activity in the account of a Dr. R., which was also serviced by Klopp and was a large and active one.[4] The record shows that Dr. R. effected a substantial number of sales and short sales shortly prior to May 28, 1962, and the day before Klopp told J. that the "doctor" had sold Cinerama stock short, Dr. R. had effected a short sale of that stock. In addition, in October 1962, the last month in which there was substantial activity in Dr. R.'s account, J. had 8 transactions in stock of International Business Machines, Inc. ("IBM") which were identical in nature and date with transactions effected by Dr. R. These circumstances suggest that Klopp's representations had their genesis in Dr. R.'s account. Klopp testified, however, that as far as he knew Dr. R. did not

[3] For example, J., none of whose purchases in the earlier period had exceeded $6,000, in October 1962 alone paid more than $16,000 in each of four purchase transactions and effected four short sales each of which exceeded that figure.

[4] In terms of amount invested it was Klopp's largest account. The average cumulative monthly investment for the period from January 1, 1962 through January 31, 1963 was about $90,000.

have an investment adviser or a chartist. Further corroboration of the customers' testimony is provided by the fact that in November 1962 J. had 4 transactions and R. 3 transactions in IBM stock which were identical as to nature and date with transactions in the account of Klopp's wife.

We also agree with the examiner that Klopp's testimony regarding an account in the name of "Mark Christian" was "so patently concocted as to create substantial doubt whether credence should be accorded any of his testimony." That account was opened by Klopp in February 1963, about two months after Cowden, the manager of the branch office, had told Klopp that his wife's account was too active, and was used until August 1963, solely to effect transactions for Klopp's wife.[5] The name used was admittedly fictitious, being derived from the first and middle names of one of Klopp's sons, as were the signature, residence and business address, occupation and other information filled in by Klopp on the new account form. Payment for purchases in the account was made by checks drawn on an account which Klopp's wife had opened in the Mark Christian name and signed by her in that name. At no time during its existence did Klopp disclose the true nature of the account to registrant. The examiner rejected Klopp's explanation that this account was to serve as a vehicle for a proposed investment partnership in which his wife was to be one of the partners, and that he did not disclose the nature of the account to registrant because of its assertedly interim character. Under all the circumstances we consider such rejection fully warranted. The manner in which the account was opened, the use of a separate checking account for the use of Klopp's wife as "Mark Christian," and the non-disclosure to registrant indicate that the account was designed to be a secret account for the use of Klopp and his wife. The fact that so far as appears no transactions were executed in the account which could not under registrant's policies have been executed in the account of a member of a salesman's family does not compel a different conclusion.[6]

The inconsistencies and contradictions in the customers' testimony, which Klopp stresses, do not in our view impair the credibility of such testimony in its most significant aspects. To some

[5] Klopp has renewed an earlier objection to the admission of evidence concerning the Mark Christian account and in addition claims that the examiner improperly based substantive findings on such evidence although it was admitted solely on the issues of Klopp's credibility and the public interest. In our view, the evidence is relevant to those issues and therefore was properly admitted. There is no basis for the claim that the examiner made improper use of this evidence.

[6] We can only characterize as frivolous Klopp's contention that the existence of any intent to deceive registrant is refuted by the fact that the new account card lists a post office box number as "Mark Christian's" mail address and the application for that box on file with the post office shows Klopp's home address as the address for "Mark Christian."

extent they are trivial in nature and some appear to be attributable to memory lapses respecting transactions which took place in 1962 and 1963 when the customers engaged in considerable trading. It is not necessarily inconsistent with their testimony as to Klopp's representations that they had a substantial number of transactions which did not follow what Klopp represented to be the doctor's trading, although it does indicate that their reliance on such trading was possibly less complete than some of their testimony would suggest.[7] And the fact that, as Klopp stresses, they had previously engaged in short-term trading through other brokers as well as through him is outweighed by the significant change to which we have referred that took place after the asserted misrepresentations.

We accordingly accept the examiner's conclusion on the credibility issue and concur with his findings as to the misrepresentations made by Klopp. We also agree with his finding that Klopp induced excessive trading in the accounts of the two customers. It is true that these accounts, even prior to the "doctor" period, were in the nature of trading rather than investment accounts. As a result of Klopp's representations, however, the customers' trading was influenced by and in great part directly attributable to the doctor's transactions reported to them by Klopp. As we have noted, there was a significant increase in trading activity when the customers began to follow Klopp's representations as to the doctor's account. Since the increase was attributable to Klopp and represented a substantial departure from the type and amount of trading activity which the customers had previously engaged in on their own initiative, no matter how speculative such activity was, we think it is properly concluded that he induced the customers to engage in trading which was excessive in size and frequency.

In view of the foregoing, we find, as did the examiner, that Klopp willfully violated Section 10(b) of the Act and Rule 10b–5 thereunder, and Section 17(a) of the Securities Act of 1933.

SUPERVISION BY REGISTRANT AND COWDEN

The order for proceedings charged that registrant and Cowden failed to exercise suitable supervision of Klopp and to enforce procedures established by registrant intended to prevent violations, and thereby aided and abetted Klopp's violations.[8] In concluding that the proceedings against registrant and Cowden

[7] R. testified that while his transactions in late 1962 and early 1963 were all influenced by the trading of the doctor, he sometimes relied merely on what Klopp told him as to the prognosis of the doctor and the latter's alleged adviser or chartist as to the market generally.

[8] The Division has not contended that there was supervisory neglect with respect to Klopp's misrepresentations as such.

should be dismissed, the examiner found that the supervisory procedures in effect at the time of the violations, although not above criticism, constituted a "reasonably acceptable system". He further found that while negligence in the enforcement of established procedures had been shown with respect to the adequacy of review of customers' accounts, in view of the "peculiar and unique" nature of the misconduct the record did not establish that absent such negligence Klopp's violations would have been prevented or detected. We have reached a different conclusion.

Registrant and Cowden contend that the supervisory procedures designed to prevent and detect excessive trading and the manner in which such procedures were carried out met the standards of the Act as expressed in Commission decisions and now codified in Section 15(b) (5) (E).[9] That Section requires reasonable supervision with a view to preventing violations of the securities acts, and provides that no person shall be deemed to have failed to meet that requirement if (a) procedures and a system for applying them have been established which would reasonably be expected to prevent and detect, insofar as practicable, any such violation and (b) he has reasonably discharged his duties under such procedures and system without reasonable cause to believe that the procedures and system were not being complied with.

In 1962 and 1963, registrant, whose main office is in New York, had a total of 43 offices in 40 cities and about 1,800 employees. The Union Commerce office had about 70 employees, including 31 salesmen, and about 3,100 accounts as of the end of each of those years. Supervision of customer accounts was the responsibility of regional partners and of the branch managers. The supervisory procedures which were in effect during the period under consideration included the following: Cowden reviewed the daily blotter and order tickets at the end of each day, and every two or three weeks reviewed the daily blotters for that period. The margin clerks who entered transactions in the customers' ledger accounts each day were instructed to report any unusual activity to Robert R. Uhler, supervisor of the branch office's accounting department, and Uhler was also supposed to make spot checks of the customers' accounts and advise Cowden if he noted such activity. Where it appeared that an account might have unusual activity, Cowden discussed it with the salesman, checked the records maintained by the salesman with respect to that customer's holdings, and in the absence of a satisfactory explanation spoke to the customer. The

[9] Although Section 15(b) (5) (E) was not adopted until 1964, as a part of the Securities Acts Amendments of 1964 (Public Law 88-467), the standards of supervision which it prescribes in substance represented a codification of standards which this Commission had established prior to 1964 through administrative adjudication. See *Reynolds & Co.* 39 S.E.C. 902 (1960).

regional partner visited each of his branch offices at least quarterly to discuss supervisory matters with the manager and to observe the salesmen at work.

In our view, these procedures left important gaps. The review of the daily blotter and the underlying order tickets, on which the principal reliance was placed, was not an adequate procedure to prevent or detect excessive trading. Since transactions appear in chronological order on the blotter, the reviewer obtains essentially an overall picture of the transactions handled by the office and is not likely to uncover excessive activity or changes in the nature of the securities traded in a particular account. Uhler's checks of customers' ledger sheets were also an inadequate procedure for the detection of excessive trading. For one thing, this procedure did not entail a systematic review of accounts but only a spot check which Uhler estimated covered only about two-thirds of the accounts in the office each year. Furthermore, the check as carried out generally involved only a review of statements for one month, which would be unlikely to uncover a change in the activity in an account. Moreover, Cowden was given no guidelines by registrant with respect to the types of activity which would require a further check for excessive trading.[10]

In our view registrant's procedures were not adequate to detect churning. We also find that registrant and Cowden did not reasonably discharge their supervisory duties. Although the spot check of customers' ledger accounts was an integral part of the supervisory system, Cowden admitted that he had to prod Uhler to make the check and that he knew it was not being done on a regular basis, and neither he nor the regional partner knew what portion of the customers' accounts was examined during each check or the period of time taken to cover all accounts. Moreover, Cowden had detected unusual activity in the accounts of Dr. R. and Mrs. Klopp and had in fact told Klopp, about December 1, 1962, that the activity in Mrs. Klopp's account should be reduced. That activity should have caused him to examine the accounts of Klopp's other customers. Had such an examination been made by Cowden in December 1962, it would have shown the unusual changes in the accounts of J. and R. and the similarity of the transactions in those accounts to the transactions in the accounts of Dr. R. and Mrs. Klopp for the preceding months, and the fraud on J. and R.

[10] Although registrant's policy manual stated in general terms that those in charge of an office have the responsibility of reviewing all accounts periodically to assure that no account is being churned for the sake of commissions, apparently no specific supervisory procedures were prescribed for branch managers.

might have been stopped in its early stage.[11] As we said in *Reynolds & Co.*,[12] "in large organizations it is especially imperative that the system of internal control be adequate and effective and that those in authority exercise the utmost vigilance whenever even a remote indication of irregularity reaches their attention." And the asserted fact that the supervisory procedures established and carried out in registrant's Union Commerce branch office were equal to and in some respects better than those of other firms of comparable size[13] is not an excuse for the deficiencies we have found.[14]

Registrant and Cowden urge that even if they had been alerted to the possibility of excessive activity in the two customers' accounts and had contacted them, the customers, according to their own testimony, would not have disclosed the "doctor" story. They argue that this shows that there was no causal relationship between any supervisory defect and Klopp's violations, and that the allegation that they aided and abetted those violations has therefore not been sustained. In our opinion, however, the essence of the allegation taken as a whole is a charge of failure to provide appropriate supervision, and a sufficient relationship between the supervisory failures and the violations has been established when it is shown that such failures existed in the very area in which violations occurred.

PUBLIC INTEREST

We cannot agree with the conclusion of the examiner that despite the serious nature of Klopp's violations a four-month suspension is appropriate in the public interest. As we have found, for a period of over one year Klopp persisted in carrying out a scheme which involved misrepresentations to two of his customers and the churning of their accounts in order to serve his own purposes. Moreover, he deceived his own employer through the use of the Mark Christian account. We conclude that notwithstanding the mitigating factors noted by the examiner, including Klopp's previously good record and his public service in civilian life and with the armed forces, his misconduct was such as to require in the

[11] Uhler testified that upon a reexamination of the two customers' accounts, in connection with these proceedings, he detected activity in the account of J. in October and November 1962 and in the account of R. in November 1962 and May 1963 that would have warranted his bringing these accounts to the attention of Cowden.

[12] 39 S.E.C. 902, 911 (1960). See also *Shearson, Hammill & Co.*, 42 S.E.C. 811, 843 (1965).

[13] See, however, the findings of the Special Study of Securities Markets as to the procedures employed by large firms to detect churning, which indicate, contrary to respondents' assertion, that most large firms employed more extensive procedures than registrant in this respect during the period in question. Report of Special Study of Securities Markets, H. Doc. No. 95, Pt. 1, 88th Cong., 1st Sess., 297–298 (1963).

[14] *F. S. Johns & Company, Inc.*, 43 S.E.C. 124, 138 (1966), *aff'd sub nom. Dlugash* v. *S.E.C.*, 373 F.2d 107 (C.A. 2, 1967) and *Winkler* v. *S.E.C.*, 377 F.2d 518 (C.A. 2, 1967).

public interest that a more substantial sanction be imposed. In our opinion, it is appropriate that he be barred from association with any broker or dealer, with the proviso that such bar shall not preclude his association, after a period of one year, with a broker or dealer in a non-supervisory capacity upon a showing that he will be adequately supervised.

Registrant and Cowden, in urging that the public interest does not require the imposition of a sanction against them, point out that the violations found here were isolated in nature and involved a unique and secret scheme to which the two customers, both sophisticated investors, were parties and through which they alone were injured. They state that they have had a long and reputable career in the securities business[15] and urge that they made a conscientious effort to run their offices in compliance with applicable requirements. Registrant further stresses that since 1963 its supervisory procedures have been upgraded significantly. An internal control department in its main office now oversees supervisory procedures and periodically inspects each branch office for compliance, and has provided branch managers and regional partners with check lists for daily and monthly review, which among other things specify a monthly review of all customers' statements and holdings records and a check of such statements for excessive activity, and a comparison of activity in the accounts of employees or their close relatives with that in customers' accounts. In addition, a computer in the main office has been programmed to produce both daily and monthly "runs," grouped by salesmen and customers, which are sent to and reviewed by branch managers and regional partners.

We have taken into account the steps taken by registrant to improve its system of supervision and its indicated intention to seek even further improvement as well as the other factors urged by it and Cowden. Weighing these factors against the deficiencies in the procedures in effect during the period in question and Cowden's laxity in the performance of his supervisory duties, we conclude that it is appropriate in the public interest to censure both registrant and Cowden.

An appropriate order will issue.

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

[15] Registrant has been registered since 1942 and predecessor firms had been in the securities business for many years. Cowden has been associated with registrant or its predecessor firms since 1933.