ADMINISTRATIVE PROCEEDING
FILE NO. 3-484

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of

PAINE, WEBBER, JACKSON & CURTIS (8-402)

WILLIAM P. COWDEN
RALPH MARTIN KLOPP

INITIAL DECISION

(Private Proceedings)

Warren E. Blair
Hearing Examiner

Washington, D.C.
November 28, 1967

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Appearances: John W. Vogel, Hyman Braham, and David A. Tenwick, of the Cleveland Branch Office of the Commission, for the Division of Trading and Markets.

Arthur E. Petersilge, of Schlitz & Petersilge, for Paine, Webber, Jackson & Curtis, and William P. Cowden.

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

Before: Warren E. Blair, Hearing Examiner.

These private proceedings were instituted by an order of the Commission dated January 20, 1966 pursuant to Sections 15(b), 15A, and 19(a)(3) of the Securities Exchange Act of 1934 ("Exchange Act") to determine whether Ralph Martin Klopp, wilfully aided and abetted by Paine, Webber, Jackson & Curtis ("registrant") and William P. Cowden, wilfully violated the anti-fraud provisions of the Securities Act of 1933 ("Securities Act") and the Exchange Act as alleged by the Division of Trading and Markets ("Division"), and whether remedial action pursuant to Sections 15(b), 15A, and 19(a)(3) of the Exchange Act is necessary.

The Division alleged, in substance, that during the period from about January 1, 1962 to October 31, 1963, Klopp, then one of registrant's salesmen, wilfully violated Section 17(a) of the Securities Act and Sections 10(b) and 15(c)(1) of the Exchange Act and Rules 10b-5 and 15c1-2 thereunder[1/] by making false and misleading statements of material facts concerning one of his customer accounts. Allegedly, Klopp told customers that he had a large and active doctor's account in which substantial profits

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1/ Since Section 15(c)(1), enacted as part of the regulatory scheme relating to the over-the-counter market, is by its terms concerned only with the misconduct of brokers or dealers, and since Klopp is neither a broker nor a dealer, he cannot be found to have violated Section 15(c)(1) and Rule 15c-1 under the Exchange Act. Accordingly, that charge against him is hereby dismissed. In consequence, the charge that registrant and Cowden wilfully aided and abetted the commission of Klopp's alleged violation of Section 15(c)(1) and Rule 15c1-2 thereunder must also be, and hereby is, dismissed.

had been realized, that the doctor acted on the advice of a New York expert financial adviser and a chartist, and that he, Klopp, was informing the customers about the doctor's trades so that they could also make substantial profits by effecting like transactions. The Division also alleged that after he gained the customers' full trust and confidence, Klopp induced them to engage in excessive trading. Registrant and Cowden, then one of registrant's branch office managers, are alleged to have aided and abetted Klopp's violations by failing to properly supervise Klopp's activities.

General denials of the alleged misconduct or assertions of lack of sufficient information to admit or deny those allegations were filed on behalf of respondents. Counsel appeared on behalf of all respondents and participated throughout the hearing.

As part of the post-hearing procedures, filings of proposed findings, conclusions, and supporting briefs were made by the 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.

Respondents

Registrant, whose principal office is in New York City, has been registered under the Exchange Act as a broker-dealer

since July 19, 1942, and is a member of the National Association of Securities Dealers, Inc. ("NASD") and of the New York Stock Exchange, American Stock Exchange, and other national securities exchanges. Cowden was resident manager of registrant's branch office located in the Union Commerce Building, Cleveland, Ohio during the years 1960 through 1965, and became a limited partner of registrant January 1, 1966. Klopp was employed by registrant as a securities salesman from January, 1958 to July, 1964, and was under Cowden's supervision while so employed. Klopp left registrant to accept his present position as a securities salesman in the Cleveland branch office of another securities firm, Hayden, Stone Incorporated.

During the period in question, respondents used the mails in connection with the securities transactions involved herein.

Violations by Klopp

In the course of effecting securities transactions for two customers, Joseph Kaucnik and Robert Kerzman, during the period from about May, 1962 through October, 1963, and for the purpose of inducing each of them to effect securities transactions, Klopp represented to Kaucnik and Kerzman that he was informing them of the nature of the trades in a highly profitable account he was handling for a doctor. Klopp further represented that the doctor's account had buying power of around $1,000,000,

that the doctor had a financial adviser in New York as well as an investment chartist, and that previous trading losses suffered by Kaucnik and Kerzman could be recovered through their following the doctor's trades. These representations were false in that Klopp, although the account executive for several doctors, did not have an account of the size or nature represented, nor one containing trades based upon the advice of a New York investment adviser and chartist.

Klopp does not contend that he was in fact handling an account of the character that Kaucnik and Kerzman assert led them to effect trades through him. His defense and counter-testimony are that he did not make the representations in question, and that Kaucnik and Kerzman made the trades in their accounts almost entirely upon their own decisions and at times contrary to his recommendations and advice. Klopp's testimony with respect to those matters is not credited.

Kaucnik and Kerzman became acquainted with Klopp in May or June, 1961, introducing themselves while attending investment seminar lectures being conducted by Klopp under sponsorship of registrant. Impressed with Klopp, Kaucnik and Kerzman each opened an account with registrant about June, 1961 and during the ensuing twelve months effected a number of trades in those accounts, following recommendations of Klopp as well as recommendations published by J. S. Herold, whose investment

advisory service met with Klopp's approval.

On May 29, 1962, Kerzman was seated alongside Klopp's desk in registrant's office watching the board reflect the market rally from the previous day's record sell-off. Klopp's remark, "They've pegged it perfectly," caused Kerzman to ask its meaning. Klopp then indicated that he was referring to a "huge account that owned many stocks long before the crash, and just before the crash sold them, turned around and went short and covered their shorts just prior to this rise and went long again and made substantial profits." Klopp also mentioned that the account received advice from a "New York adviser." Kerzman repeated to Kaucnik the conversation he had with Klopp.

In June, 1962, Kaucnik spoke to Klopp about what he had heard from Kerzman, and Klopp reiterated his earlier statements regarding this large account he was handling. During June, Kaucnik had several more conversations with Klopp concerning the account which Klopp referred to as that of "these fellows," at other times, "the doctor," and which he represented as having at times "in excess of $500,000 in it."[2/] Some time later, Klopp told Kaucnik that the account also had the services of a "Chinese chartist" and that at times telephone

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2/ During the period in question the effective margin requirement of 50% allowed an account of such size to purchase securities with a market price of $1,000,000.

conference calls would allow him, the doctor, the investment adviser, and the chartist to discuss the market and the moves that the doctor should make. Kerzman also had conversations with Klopp during the period in question in which Klopp stated that the buying power of the doctor's account was about a million dollars, and that the account utilized the services of a New York investment adviser and a Chinese chartist.

Late in June, 1962, Kaucnik commented to Klopp, in the course of a review of Kaucnik's account which consisted almost entirely of poorly performing over-the-counter stocks, that it would be "nice" to have an investment adviser who would provide guidance on the market's performance. In response to that comment, Klopp said that he could tell Kaucnik what the doctor was buying or selling as long as he did not disclose the name of the account and did not make the information available until after the trade was executed. It was then agreed between them that Klopp would call Kaucnik when the doctor effected a trade.

In July, 1962, Klopp informed Kaucnik that the doctor had sold Cinerama stock short, and Kaucnik thereupon told Klopp to sell short for his account. This was the first in the series of transactions ending in September, 1963 which were effected by Kaucnik because of supposed trades by the fictitious doctor. Kerzman's first transaction on the same basis took place toward the end of August, 1962. About

November, 1962 Kerzman liquidated many of his securities to obtain funds with which to follow the "doctor's" trades and did this pursuant to a discussion with Klopp in which Klopp stated "it might be a good idea to follow the doctor." Kerzman eventually terminated his trading with Klopp in October, 1963.

At the time that Kaucnik and Kerzman opened their accounts, they informed Klopp that they were interested in short-term capital gains, and it appears that such objective was pursued by them throughout the time that Klopp was handling their accounts. During 1961 and through May, 1962, Kaucnik's trading activity was comparatively moderate, but following the market decline of 1962, the tempo of his trading increased dramatically. Where his account had a rate of turnover 3/ of 6.17 times in the first six months of 1962 on an average cumulative monthly investment of $7,475, turnover on an average investment of $11,934 rose to 22.3 times during the second half of the year, before dropping back to 6.2 times on $12,962 for the nine months ending September 30, 1963. Kerzman's

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3/ Rate of turnover is computed by dividing the aggregate amount of the purchases by the average cumulative monthly investment, the latter representing the cumulative total of the net investment in the account at the end of each month, exclusive of loans, divided by the number of months under consideration. Reynolds & Co., 39 S.E.C. 902, 906 n. 10 (1960).

rate of turnover on an average cumulative monthly investment of $24,674 was 6.8 times in the year 1962, and surged to 16.8 times on an average investment of $35,760 in the following ten months of 1963. The earlier upswing in the trading in Kaucnik's account as compared to that in Kerzman's tends to corroborate Kaucnik's testimony that by November, 1962, his losses forced him to reduce his trading. The differences in the rates of turnover in these accounts is also consistent with Kerzman's testimony that it was not until August, 1962 that he began to follow the fictitious doctor's moves, and that it was about November, 1962, that he liquidated previous purchases at Klopp's suggestion to obtain funds to increase the instances in which his trading would reflect that of the "doctor."

One day in August, 1963, while Klopp was absent from his desk, Kaucnik's attention was drawn to an investment advisory bulletin written by M. H. de La Chappelle which registrant circulated to its offices. Upon noting that the bulletin made recommendations on a good number of stocks supposedly owned by the "doctor," Kaucnik became concerned about whether such "doctor" existed, and thereafter made notes on his conversations with Klopp. Because of his aroused suspicion, Kaucnik also recorded a conversation he had with Klopp on September 12, 1963 by means of a tape recorder Kerzman had obtained and connected with the telephone transfer

box in Kaucnik's home. In the recorded conversation Kaucnik initiated, references were made to the alleged commodity and securities trades of the "doctor," to the then supposed existing securities holdings of the "doctor" with an aggregate market value of over $1,300,000, and to Klopp's own transactions.

While the tape recording is an important piece of evidence tending to corroborate the testimony of Kaucnik and Kerzman, it is not decisive as to the charges against Klopp. Aside from the tape, the remaining credible evidence constitutes convincing evidence of Klopp's misconduct in inducing the trading activities of Kaucnik and Kerzman. In addition, Klopp's own trading activities cast doubt upon his denials that he had induced the trading in question and upon his assertions that such trading was contrary to the investment philosophy that he had attempted to instill in Kaucnik and Kerzman.

An analysis of the account Klopp opened with registrant in the name of his wife, Jeanne Ann Klopp,[4/] discloses that for the year 1962 an average cumulative monthly investment of $12,978 was turned over 58 times. During that year, 39 purchases were made, only four of which occurred in the first six months. All of these purchases were either sold in

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4/ Klopp admits to a beneficial interest in this account, and it is obvious that he initiated the trades effected therein.

less than four months, or represented covers of short sales, and twenty-three of the purchases or short positions were held for less than ten days. In December, 1962 Cowden became concerned about the account's activity, particularly because of the large number of trades in the stock of International Business Machines, 5/ and told Klopp that his wife's account was too active. Klopp assured Cowden the trading in the account would be reduced, and it was to the extent that turnover was reduced to 29.8 times on an average investment of about $20,000.

While the trading activity of a salesman in his own account does not by itself lead to the conclusion that he would recommend similar activity to his customers, it may well in any given instance, when considered with all other circumstances, be significant. Here it appears that Klopp believed strongly in his trading ability and, anxious to exploit that potential, chose to practice deception upon his customers in order to induce them to increase their trading, and thereby, his commissions.

In addition, it appears that in February, 1963 Klopp, not content with the amount of trading that Cowden would

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5/ Klopp's initial purchase of IBM in 1962 was on June 21, and by the end of the year, 1,800 shares of IBM had been purchased in 22 transactions, 8 of which covered short sales.

countenance in the Jeanne Ann Klopp account, secretly opened another account with registrant for his wife's use under the fictitious name of Mark Christian.[6/] During the eight months that this new account was active and under Klopp's control, its average investment of close to $10,000 was turned over 8.4 times. The formal closing of the Mark Christian account took place in April, 1964 when Klopp, still without disclosing his interest, appears to have advised registrant that "Mark Christian" had "moved out of town." Such actions raise a question regarding the credibility of Klopp's professions that he attempted to dissuade Kaucnik and Kerzman from active trading.

Further, Klopp's assertions that the trading of Kaucnik and Kerzman after May, 1962 was not induced by his recommendations cannot be accepted in view of certain striking similarities in the three accounts that fall outside the realm of mere coincidence.[7/] Thus in October and November, 1962 when Klopp traded heavily in IBM stock, Kaucnik did the same. Klopp purchased IBM stock on October 5, and 30 and on November 1, 5, 9, and 16; Kaucnik purchased IBM stock, though in lesser amounts, on October 3, 9, 11, 19, and 30, and on November 1, 2, and 5.

6/ The name of Mark Christian was derived from the given names of one of Klopp's sons.

7/ Tr. pp. 2492-93. Klopp specifically denied giving Kaucnik or Kerzman any trading recommendations, denied knowledge of any relationship between his trading in IBM stock and theirs, and testified that if there was any relation, "it would be simply coincidental."

Klopp sold IBM stock in these months on October 25, 30, and 31 and November 2, 9, 14, and 15; Kaucnik sales of that stock were on October 9, 10, 17, 18, 26, and 31 and on November 2, 5, and 9. In those two months Klopp sold IBM short four times and Kaucnik did the same six times, with each of them making one of their short sales on October 31. During the two month period, Klopp held all but two of his purchases or short positions in IBM stock for less than ten days, and Kaucnik held none of his for more than seven days. In 1963, Klopp purchased 1,000 shares of Paddington stock on June 25 in the Jeanne Ann Klopp account and another 100 shares in the Mark Christian account; on the same day Kaucnik bought 50 shares of Paddington. It is also worth noting that in 1963 Klopp had a strong interest in trading in Chrysler, as evidenced by his purchases in the Jeanne Ann Klopp account on April 18 and May 29, 1963 amounting to nearly $50,000 which were sold on June 12, 1963, and his purchase in the Mark Christian account on August 29 which he sold on September 10. Kaucnik's trading interest in Chrysler spanned about the same period in 1963, beginning with a purchase of Chrysler stock on April 17, and continuing until his last sale on September 24.

Kerzman's trading also shows a correlation with that of Klopp. On November 5, 1962 Klopp purchased 100 shares of IBM stock, and purchased another 100 shares to cover a short

position taken on November 2; Kerzman bought 50 shares of IBM stock on November 5, and on the same day also made and covered a short sale of another 50 shares of that stock. On November 9, 1962 Klopp and Kerzman both sold their long purchases of November 5. Between February and May, 1963 Klopp purchased or covered a short position in IBM stock on February 28, March 21, and May 15, and sold IBM stock on February 11, March 5, April 10, and May 15; Kerzman in the same period purchased or covered a short position in IBM stock on February 13 and 28, March 22, May 1, 7 and 14, and made sales of that stock on February 11, March 12, April 16, May 7, 10 and 27. Klopp sold 100 shares of IBM short on February 11, and on that date Kerzman did the same. Klopp's interest in purchasing Chrysler stock on April 18, 1963 also coincides with that of Kerzman, who purchased 100 shares of that stock on April 17, 100 on April 18, and 200 on April 22. A further correlation in the two accounts is observed in the similar interests in the stock of South Puerto Rico Sugar Company. Klopp purchased 100 shares of that stock on April 8, 1963 which he sold on May 27; Kerzman purchased 1,000 shares of the same stock on May 10, 1963 which he sold on May 13 and 14.

Klopp's testimony regarding the investment philosophy he espoused, being inconsistent, becomes suspect. Initially, Klopp testified that at the time Kaucnik and Kerzman opened

their accounts with registrant, he discussed their investment objectives with them and expressed his opinion:

> . . . that the best probability of making money in the market would be to utilize and invest in higher quality, growth stock, and to hold them for a period of time. The minimum was six months, if they were looking for capital gains, and I also mentioned to them that I was primarily a fundamentalist, and I thought that the way to select stock or one of the basic ways to select them was on a basis of earnings and good fundamentals. 8/

Upon cross-examination Klopp testified that Kaucnik and Kerzman agreed with the views he had expressed and then testified:

> Q. Did their investment philosophy agree with yours?
>
> A. My own personal philosophy?
>
> Q. Yes.
>
> A. Yes, sir. 9/

However, when it became apparent that registrant's monthly statements on the Jeanne Ann Klopp account were to become part of the record, Klopp denied that the views he expressed to Kaucnik and Kerzman were those he felt appropriate for himself. Klopp then further testified that the Jeanne Ann Klopp account "was run in an aggressive manner" in an attempt "to generate profit on an annual basis of approximately 15

8/ Tr. pp. 1059-60.

9/ Tr. p. 1343. In fact, it appears that Kaucnik, with a single exception, sold every purchase that he made through Klopp in 1961 in less than 5 months. See Paine, Webber Ex. B-1.

per cent a year,"[10] and that in order to accomplish his purpose he would, if need be, rapidly switch from stock to stock.[11] The amount of activity in the Jeanne Ann Klopp account bears a close resemblance to that engaged in by Kaucnik and Kerzman.

An entirely separate and distinct aspect of Klopp's testimony, so patently concocted as to create substantial doubt whether credence should be accorded any of his testimony, is his explanation of the Mark Christian account, its creation, purpose, and closing.

As noted, the Mark Christian account was opened by Klopp in February, 1963 shortly after Cowden spoke to him about the overly active trading carried on in the Jeanne Ann Klopp account, and was closed out the following year without registrant or Cowden ever knowing of Klopp's interest therein. However, it is apparent that Klopp not only failed to disclose his interest in the Mark Christian account but took care to assure that his interest would not come to the attention of the registrant or Cowden in the ordinary course of business nor be readily susceptible of tracing. On the application for opening that account, Klopp signed the fictitious name "Mark Christian," and included a false residence address and occupation for the purported customer; the margin agreement

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10/ Tr. p. 2487.

11/ Tr. p. 2488.

required by registrant was signed by Mrs. Klopp who assumed the name "Mark Christian"; the address of the account was a post office box number which Mrs. Klopp obtained at her husband's direction; the checking account used in connection with the Mark Christian account was opened by Mrs. Klopp and required her signature of the name "Mark Christian"; the application to open that checking account gave the post office box number as the address of Mark Christian and indicated that the applicant was a student at John Carroll, a private secondary and college level educational institution. When the Mark Christian account with registrant was formally closed in April, 1964 it appears that Klopp again deliberately concealed his interest in the account by falsely stating that Mark Christian had moved out of town.

Klopp's explanation for the opening of the Mark Christian account to the effect that it was intended for use by an investment partnership to be comprised of a number of his customers, and that the plan was discarded after eight months because of legal complexities does not square with the facts nor furnish a plausible reason for its use during that time. Further, his disclaimer of knowledge of the manner and reason for his wife's opening the Mark Christian checking account in the way she did and the use to which it

was put is incredible as well as inconsistent in material respects. 12/

While there have been serious attacks upon the authenticity of the tape recording introduced as a record of a telephone conversation between Kaucnik and Klopp which took place on September 12, 1963, the tape recording is accepted as being an accurate reproduction of such conversation. The affirmative and certain opinion of the Division's expert on voice identification, in which opinion experts testifying at the instance of Klopp tended to agree, was that the recorded voice purporting to be that of Klopp was a recording of Klopp's voice. But over and beyond that identification, with which the Examiner, having heard the recording, concurs, the recorded conversation sounds normal and the topics and references covered in the course of the conversation indicate that the recording was

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12/ Klopp first testified that Mrs. Klopp, signing the name of Mark Christian, drew checks on this account to pay registrant for purchases in the Mark Christian account (Tr. pp. 549-50) and also that after he left registrant an investment organization of the type intended to be covered by the Mark Christian account was formed and was in operation as of May 19, 1966 (Tr. p. 533). Later Klopp denied knowing who drew checks against the Mark Christian checking account or whether such checks were used to pay for purchases of securities in the Mark Christian account (Tr. p. 1330) and also testified that participants in his claimed later venture in fact had individual accounts (Tr. pp. 2473-76). In reality, no organization similar to that referred to by Klopp in his explanation of the Mark Christian account appears to have been intended or in existence either while Klopp was employed by registrant or thereafter.

made as stated by Kaucnik.

That the recorded conversation took place shortly after 10:00 A.M. on September 12, 1963 is apparent from Klopp's knowledge of and reference to certain trades on the New York and American Stock Exchanges which apparently were being reported on the Trans Lux Klopp could see while speaking to Kaucnik. 13/ The coincidence of the market action on various securities referred to by Kaucnik in the course of the conversation with that which actually happened on September 11, 1963, the day previous, also establishes the time of the conversation in question as being September 12, 1963 and tends to add credence to Kaucnik's testimony relating to that conversation.

Illustrative are Kaucnik's and Klopp's comments on Chrysler which begin with Kaucnik's reference to that stock:

> For the amount of stock they traded in on Chrysler you'd expect that they'd have had a larger gain. You know a hundred and 40 some thousand shares you think it would have more up-side potential than a half point or whatever it was for the day. 14/

[Klopp] Yea, yea, that's right.

[Kaucnik] And actually that the gain, it didn't even hold the gain that it had on the opening. 15/

13/ The Trans Lux, a projection on a screen of a portion of the moving ticker tape, could be seen by all of the salesmen in registrant's Cleveland office.

14/ On September 11, 1963, Chrysler stock closed up 1/2 on the NYSE on volume of 146,800 shares.

15/ On September 11, 1963, the opening of Chrysler trading was at a price of 74-1/8, the high was 75-1/4, the low 73-1/2, and the close 74-1/8.

[Klopp] That's right. That's right and a ---

Later in the conversation which had turned to other topics, Klopp interrupts to say:

4,000, 4,500, 73-5/8.

[Kaucnik] Oh boy.

[Klopp] Although, Joe, the rest of the market doesn't look quite like that.

[Kaucnik] No?

[Klopp] No, the few others you know that are open here ---

[Kaucnik] Yea.

[Klopp] don't look too bad.

[Kaucnik] Uhmm

[Klopp] That wasn't a real big opening, it was ---

[Kaucnik] Yea, yea.

[Klopp] 4,000 and 500 behind.[16/]

[Kaucnik] Yea, yea.

[Klopp] 4,500 ---

Klopp also commented that "Telephone's up a little,"[17/] observed that "there's 9½ on Lundy,"[18/] and confirmed Kaucnik's statement

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16/ The "Fitch Sheets" report that Chrysler opened trading on the NYSE with a sale of 4,000 shares and that the second trade was for 500 shares, both at 73-5/8.

17/ American Telephone & Telegraph Company stock closed on September 11, 1963 at 124-3/4 and opened on September 12 at 125, up ¼.

18/ On September 12, 1963 Lundy Electronics & Systems opened trading on the American Stock Exchange at 9½.

that Crown Cork & Seal Co. had lost a point on September 11, as well as the fact that trading in that stock had closed at its low for the day.

The recorded dialogue regarding Klopp's break-even point of roughly 58 on his purchase of Paddington Corp. stock rings true despite Klopp's testimony to the contrary that Kaucnik knew the break-even point wasn't 58, that Kaucnik knew Klopp had paid 60¼ for the stock. The record bears out the fact that Klopp paid 60¼ for 1,000 shares of Paddington Corp. stock purchased on June 25, 1963,[19/] but also discloses that on July 16 he received dividends of $700 on that stock and on July 31 a stock dividend of 20 shares. Considering the cash dividend as a return of capital reduces the cost of the Paddington purchase to $59,550, and makes the average cost of each of the 1,020 shares of Paddington held in the Jeanne Ann Klopp account[20/] as of the date of the recorded conversation "roughly" 58.[21/]

19/ Although Kaucnik refers to 2,000 shares of Paddington in the conversation, such reference is consistent with the statements in his testimony (Tr. p. 198) and his affidavit (Paine Webber Ex. B, p. 7) indicating that his own purchases of Paddington stock were influenced by Klopp's statement that he bought 2,000 shares in his wife's name.

20/ According to Klopp, the reference would not relate to the Mark Christian account (Tr. p. 1093).

21/ In addition, Klopp's comment in the taped conversation that Paddington was down to 56½ reflects the exact price of the closing on September 11, 1963.

Also helpful in reaching the conclusions that the tape is authentic and that the recorded conversation related to previous representations to Kaucnik by Klopp is the discussion relating to cocoa:

[Kaucnik] Does the Doctor ever talk about cocoa any more?

[Klopp] Yea, a---they do once and a while and the only noise I get out of them that it's not doing a damn thing, I mean its bobbing I guess around that 24 level. 22/

[Kaucnik] Uhmmm, uhmmm

[Klopp] Up and down. Up and down.

[Kaucnik] That's a hell of a way from where they owned it, what is it 27½ area?

[Klopp] Yea, yea.

[Kaucnik] Somewhere around there.

[Klopp] Very much, that's right.

[Kaucnik] Boy, if they were still hanging on to that they'd have a hell of a loss, wouldn't they.

[Klopp] Terrific.

[Kaucnik] With the amount they had, you know with a --

[Klopp] I was going to say concerning how they could have gotten killed --

[Kaucnik] Yea.

22/ As of September 11, 1963, futures prices of September, 1963 cocoa contracts closed at 22.97, of December, 1963 contracts at 23.67. Respective highs for the day were 23.35 and 24.15.

[Klopp] They got out damn fast.

[Kaucnik] Yea, because, the hell, they had 100 -- they had 50 contracts of September and 50 contracts in December so hell that was a lot of money.

[Klopp] You said it. They could have really gotten murdered.

Turning to the record of Klopp's commodity trading in 1963, a similarity is again found between what appears to have been represented to Kaucnik as the action of the "doctor" and what was taking place in Klopp's own accounts. Klopp's commodity trading account with registrant reflects a shift of interest in 1963 from wheat in January to cocoa in May, at which time, significantly, his account indicates purchases of December, 1963 cocoa futures at prices of 27.05 and 27.70 and sales of those contracts that resulted in a small profit to him. Further trades in the same cocoa futures were made in June and August, 1963, and his commodity trading then appears to have ceased until a return to trading in wheat futures in January, 1964.

The credibility of Kaucnik and Kerzman is attacked on the basis of the presence of discrepancies in their testimony as well as that of other evidence in the record which respondents contend renders that testimony untrustworthy. The testimony of Kaucnik and Kerzman has been carefully weighed

in the light of that attack, the record references noted by respondents reviewed and their arguments with respect to the inferences to be drawn therefrom considered.

Unquestionably, the probative effect of the testimony is weakened by the failure of Kaucnik and Kerzman to be specific and consistent throughout their stays on the witness stand and by the contradiction of some elements of their testimony which is present in other evidence referred to by respondents, but in sum their testimony on salient aspects of the issues involved remains credible and must be accepted. Further, their demeanor while on the stand indicated that they were without bias against Klopp and were testifying to the best of their knowledge and recollection about the representations that Klopp had made about the "doctor" and the "doctor's account." Granting that the testimony concerning the extent Klopp's representations influenced their trading decisions was more imprecise than would be desired to remove all doubt, it is clear that the thrust of their testimony in that regard is to the effect that they did use the "doctor's" trading as a guide for their own, sometimes effecting trades identical to those assumed to have been made by the "doctor," sometimes using the "doctor's" activity simply as a factor influencing their own decisions. Such testimony is accepted as credible in and of itself, and

acquires conviction from the corroborating evidence found in the Jeanne Ann Klopp account and from the absence of motivation for Kaucnik and Kerzman to testify falsely.[23/]

Klopp renews his objection, initially raised and overruled in the course of the hearing, to the admission of the "Kaucnik-Klopp" tape recording into evidence on the ground that the recording was obtained in a violation of Section 605 of the Federal Communications Act of 1934, 47 U.S.C. §605. Klopp offers no new arguments for his position, relying solely upon his Brief in Support of Inadmissibility in Evidence of Tape Recording, dated May 31, 1966. Full consideration having been given to Klopp's arguments heretofore, and no reason appearing for a reversal of the order overruling Klopp's objection to the tape recording,[24/] the renewed objection is overruled.

Klopp also contends that the testimony of Lawrence G. Kersta, who identified Klopp's voice on the tape recording, should not have been admitted because the identification was

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23/ Though proffering several acknowledged conjectural possibilities on the question of motivation, none of which are accepted, counsel for Klopp concedes that there is no apparent reason for Kaucnik or Kerzman to lie. See Brief, Proposed Findings and Proposed Conclusions on Behalf of Respondent Ralph Martin Klopp, p. 53.

24/ Order on Admissibility in Evidence of Tape Recording, June 8, 1966, aff'd, Order Affirming Ruling of Hearing Examiner, S.E.C. June 16, 1966.

accomplished by means of a "voiceprint" technique that lacks general scientific acceptance. While the same objection on the same grounds was raised and overruled at the time that Kersta testified, it is now raised by Klopp for consideration in the light of later testimony given by speech and acoustics experts called to the stand by Klopp, and of the doubts about "voiceprint" evidence which were expressed by the Supreme Court of New Jersey in State v. Cary, 49 N.J. 343, 230 A. 2d 384 (1967), decided subsequent to the close of the hearings herein.

In the Cary case, the court remanded the trial court's order compelling the defendant to submit to a voice test for the purpose of having the lower court determine "whether the voiceprint technique and equipment are sufficiently accurate to produce results admissible as evidence." In doing so, the court indicated that testimony of experts in addition to Kersta was necessary in order to resolve the question and that the "prosecutor must satisfy the trial judge that identification by voiceprint technique and equipment has a sufficient scientific basis to produce uniform and reasonably reliable results and will contribute materially to the ascertainment of the truth." Assuming arguendo that the criteria laid down by the court would have to be met before Kersta's testimony would be admissible in these proceedings, it is concluded that Klopp's objection should again be overruled and Kersta's testimony admitted.

There can be no question regarding the acceptance by the scientific community of the spectrograph or "voiceprint" machine as a reliable instrument for production of sound spectrograms which are pictorial representations of tape recorded speech or sound. Spectrographs are commonly used by scientists in connection with analyses of a wide variety of acoustic sounds and produce either bar or contour spectrograms depending upon the setting of the machine's controls.

There is more question concerning the reliability of spectrograms as used by Kersta for identification purposes, but the record contains sufficient agreement amongst the acoustic experts to show that the "voiceprint" technique has an adequate scientific basis to make Kersta's testimony admissible. Basically, the technique used by Kersta is nothing more than a matching of the bar spectrogram pattern of an unidentified voice with that of an identified voice, and where sufficient similarity in patterns is noted, concluding that in each instance the same person spoke. The underlying theory is predicated upon Kersta's belief, growing out of four years of experiments, that every human voice has individual characteristics produced by the uniqueness of each person's vocal cavities and of his articulatory pattern, the way in which each person uses his muscles of speech.

The testimony of the other acoustics experts does not, as claimed by Klopp, destroy the validity of Kersta's technique; it does no more than question its infallibility. Dr. Dennis Klatt, an assistant professor of electrical engineering of Massachusetts Institute of Technology working in speech research, testified to the existence of skepticism regarding the high degree of accuracy which Kersta claimed for "voice-prints," but on cross-examination clarified his view concerning the acceptability of Kersta's technique:[25/]

> Q. Would it be correct to say Dr. Klatt that at this state or posture of scientific information that you are aware of from Dr. Kersta and other persons in the field of voice identification, that you do not think that the present technique is refined enough to identify voices, individual voices?
>
> A. It depends entirely on your criterion of how refined it is. If you are willing to accept an occasional misidentification, it certainly is a reasonably good technique already, yes.
>
> Q. So that you would state now that it is a reasonably good technique in the present state of knowledge.
>
> A. Yes.

Dr. Klatt also expressed confidence in the testimony of Kersta a bit later, replying to a question of the extent to which he had attempted to duplicate Kersta's work:[26/]

25/ Tr. p. 2233.

26/ Tr. p. 2244-45.

> Let me just say that I was asked to comment more about voice identification and not to really address myself to the question of whether the voice was Klopp's or not.
>
> I would assume that there is a pretty strong chance that it is Klopp's. But Kersta is reasonably reliable. He has done a thorough job, and there is a pretty good chance that there can be a mistake. It could have been a mimic, there is that possibility.
>
> There is sort of a 10 percent chance, or something like that.

While Dr. Klatt further explained that his conclusion that the Kersta system had a reliability of 90% was based largely upon Kersta's published data,[27] it must be assumed that the published data referred to was scientifically trustworthy for Dr. Klatt to have reached such conclusion.

The testimony of Dr. Martin Young, an associate professor of speech pathology and audiology at Western Reserve University, also indicates that Kersta's technique has an origin in accepted scientific principles. Although unable to replicate Kersta's experiments because of absence of information regarding the exact nature of the eight unique acoustic cues relied upon by Kersta in making spectrogram pattern comparisons, Dr. Young, at Klopp's request, undertook to design a similar experiment based upon cues of his own devising. On the basis of that experiment, Dr. Young felt that he could not "conclude at

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27/ Tr. 2259.

the present time that speakers can be identified with high accuracy on the basis of words spoken in context,[28] but they can be identified with reasonable accuracy on the basis of words spoken in isolation.[29] The results of Dr. Young's experiment do not confirm the accuracy claimed by Kersta for his system with respect to words in context, but they do afford support to Kersta's claims with respect to words in isolation.[30] While not intended for such purposes, Dr. Young's experiment establishes that other experts in acoustics, unfamiliar as they may be with Kersta's system, can readily devise a reasonably accurate system of voice identification based upon the spectrographic patterns of words in isolation, and clearly indicates that Kersta's technique developed over four years of experimentation relies upon accepted scientific principles.[31]

28/ "Words spoken in context" refers to words which form parts of sentences, whereas "words in isolation" are single words voiced separately.

29/ Tr. p. 2139.

30/ Tr. pp. 2091-92. While the rate of accuracy for all observers used in Dr. Young's experiment was 78.4%, a 97% accuracy was achieved in the identification of one voice.

31/ It is noted that a third expert called by Klopp, Dr. Oscar Tosi, professor and supervisor of the Speech and Hearing Laboratories at Michigan State University, volunteered at one point that he had "big respect for Mr. Kersta." Tr. p. 2012. Dr. Tosi is also "working in the voiceprint field." Tr. p. 1527.

Although it is believed that the record is sufficient to meet even the requirements indicated by the Cary case, supra, the later decision of the United States Court of Military Appeals in United States v. Wright, 17 USCMA 183, 37 CMR 447 (1967), is viewed as authority for admitting Kersta's testimony without need for further verification of the "voiceprint" technique. In the Wright case, an appeal from a general court-martial conviction on charges of making obscene and threatening telephone calls to a woman, appellate defense counsel contended, as Klopp does in these proceedings, that the scientific principles underlying the "voiceprints" are so uncertain in theory and practice as to require their exclusion as a matter of law. In rejecting that contention, the court stated:

> Mr. Kersta's testimony established that his system of voice identification had, experimentally and in practical application, demonstrated a high degree of accuracy and, further, that he was personally qualified to testify as an expert on comparisons of sound patterns made by human voices. True, two defense expert witnesses expressed reservations as to the complete reliability of Mr. Kersta's system and procedures. The specifics of their reservations need not detain me. Courts have consistently recognized the admissibility of the testimony of experts in areas where there is neither infallibility of result nor unanimity of opinion as to the existence vel non of a particular condition or fact. For example, the difference of opinion among psychiatrists as to the mental condition of a particular person is very well known. See United States v. Henderson, 11 USCMA 556, 29 CMR 372; United States v. Carey, 11 USCMA 443, 449, 29 CMR 259. Identifying the author of a questioned

> document by comparison of the handwriting of the document with other handwritings made by known persons is commonplace in the courts, but it certainly cannot be said that all experts in the field and all techniques of identification are infallible. United States v. DeLeo, 5 USCMA 148, 153, 17 CMR 148. In fact, visual examination of a questioned document with handwriting exemplars of the accused may lead the fact finders to an opinion different from that of the expert. United States v. Privett, 4 CMR 392. Here, the tape recording of one of the obscene calls and the recording of the test call made by the accused were both before the court-martial. Each was played in open court. Since voice identification by ear is fully acceptable in the courts, the court members could thus determine for themselves the margin of error, if any, in Mr. Kersta's expert opinion. 2/ With the board of review, therefore, I am satisfied that the shortcomings of Mr. Kersta's voiceprint system did not render his opinion inadmissible.

2/ It is interesting to note that one of the defense experts testified that a type of spectogram [sic] he used in certain experiments yielded a sixty percent degree of success; listener identification in the same experiments, however, achieved results that were ten percent better.

As in the Wright case, the record in these proceedings contains Kersta's recital of his qualifications and the results of his experiments, as well as the doubts of two defense expert witnesses regarding the reliability of Kersta's "voiceprints" as a system of identification. But also persuasive on this question is the fact that a federal appellate court, albeit restricted to military law, has found that Kersta's opinion based upon his "voiceprint" system is admissible. Kersta's

testimony is therefore found admissible in evidence as a matter of law, and Klopp's contentions to the contrary are rejected.

Respondents further contend that the tape recording is not in fact a reproduction of a telephone conversation that took place between Kaucnik and Klopp. In support they claim that the recording contains contextual inconsistencies, that the tape was spliced subsequent to the recording thereon, and that the recording could not have been made over the telephone in the manner described by Kaucnik.

The contextual inconsistencies pointed out by Klopp are not impressive. With respect to the telephone call from Barney which preceded the Klopp conversation, Kaucnik may well have been called "Bill" as a result of a simple slip of the tongue on the part of the caller, but regardless, the unexplained misnomer standing alone cannot be considered of material significance. The remainder of the alleged inconsistencies, all involving statements made during the Klopp conversation, are not found to have that character, and Klopp's interpretations and assertions to the contrary cannot be accepted.

Similarly rejected is the claim that the recorded conversation does not sound normal. While the expert witnesses are not in agreement with respect to whether the recorded

conversation sounds "normal," we find, having heard the voices and the manner in which Kaucnik and Klopp spoke not only on the recording but while on the witness stand as well, that the recorded conversation flows in a normal fashion. As to Dr. Klatt's thought that "dubbing" was a "possible explanation" for an audible incongruity he found in Kaucnik's voice, such possibility should not be separated from his qualifying remark that "the chain of events that take place from speaking in a room through a telephone system through a couple of wires onto the recording involves a lot of different things."[32/] Granting the existence of the incongruity, an inference that dubbing actually took place does not thereby appear justified.

Respondents' contention that the tape was spliced after the recording was made is accepted as established in one of the three instances they have indicated. In that one instance, two of Klopp's expert witnesses, Dr. Arthur H. Benade, an associate professor in the Science Department at Case Intitute of Technology, and Dr. Klatt agreed that such splice must have occurred after the recording, the latter's opinion being an interpretation of a spectrogram that showed one letter of the word "sold" was missing. In the two other instances, there is disagreement between these witnesses as to whether a splice at one of the spots occurred before or after the

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32/ Tr. p. 2210.

recording,[33] and only Dr. Benade detected such a splice at the other.[34] However, the presence of one splice or three does not destroy the credibility of the tape. Dr. Benade's views were that the splices "don't prove anything by themselves,"[35] and that he "didn't think that one could make quite this kind of a tape by mechanical splicing anyway."[36] Dr. Klatt also viewed his findings of splices and the audible incongruity as inconclusive, stating, when pressed for his professional opinion on whether the tape recording represents what it purports to be, that "it is impossible to tell, that there is no scientific way possible to tell one way or the other."[37]

The argument to the effect that tampering with the tape has been shown when the testimony of Kaucnik and Kerzman and the proof of splicing are juxtaposed is not accepted.

33/ Following the words "Litton, 1000 . . . ." appearing at the bottom of DX 1, p. 2. Dr. Benade's opinion was that it appeared "to have been made before the tape was recorded." Tr. p. 1120. Dr. Klatt's opinion that such splice occurred afterward was based on the "intonation of how things were said on the tape." Tr. p. 2214.

34/ Following the words, "oh boy" at the bottom of DX 1, p. 2. See Tr. p. 1121.

35/ Tr. p. 1122.

36/ Tr. p. 1977.

37/ Tr. p. 2249.

Neither Kaucnik nor Kerzman testified categorically that no splicing occurred during or after the recording of the conversation with Klopp, their testimony being guarded in that respect as well as in numerous others, as might be expected of witnesses testifying to events three years in the past. Nevertheless the failure of these witnesses to give positive and unequivocal answers to the questions relating to a break in the tape was viewed as militating against acceptance of the recording as authentic, and carefully weighed with all other factors before the recording was found to have probative value.

Respondents' arguments that the recorded conversation could not have taken place over the telephone in the manner testified to by Kaucnik are also rejected. Although the opinions of Dr. Benade and of Dr. Tosi were that the recording could not have been made in that manner, those opinions lose weight and become inconclusive upon analysis of their underlying assumptions and attempted replications of the recording.

Dr. Benade concluded from spectrograms made of the voices of Kaucnik and Klopp appearing on the recording, that Kaucnik's voice spectrum was consistent but Klopp's inconsistent with that to be expected in a telephone voice. The anomaly in Klopp's voice spectrum is supposedly established by the sharp drop-off in the intensity of Klopp's voice at frequencies between 3,000 and 4,000 kilocycles and a leveling off of

intensity beyond the latter frequency.[38] However, Dr. Benade reached that conclusion under the misapprehension that the telephone circuit over which the recorded conversation took place did not utilize loading coils, which characteristically filter out sound frequencies above approximately 3,500 kilocycles. After evidence was introduced by the Division that loading coils had been present in the circuit and that a voice spectrum comparable to Klopp's had been prepared from a voice speaking over a simulated but similarly loaded telephone circuit, Dr. Benade was recalled to the witness stand. Dr. Benade then testified that Klopp's voice could not have been recorded over the telephone because the spectrum of Klopp's recorded voice disclosed the presence of speech above 3,500 kilocycles, a level inconsistent with voice transmission over a loaded circuit. But the force of Dr. Benade's conclusion was again dissipated when Dr. Tosi testified that he found in his attempted replication of the recorded conversation over a loaded telephone circuit that "the circuitry of the telephone allowed" speech frequencies above 3,500 kilocycles to pass.[39]

Dr. Tosi's conclusion that the recorded conversation could not take place over the telephone because of the great

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38/ See, e.g., KXN-10.

39/ Tr. p. 2545.

difference in the intensities of the recorded voices, ranging up to 20 decibels and "consistently the order of 10 to 15 decibels,"[40/] is open to question because it is predicated upon the belief that a 5 decibel difference would be normal. Differing with the latter premise is the testimony of Stephen E. Flocke and Robert J. Koren, both engineers in the employ of the Ohio Bell Telephone Company. Flocke stated that a facility loss difference "on the order of 10 DB's [decibels]"[41/] could be expected in the circuit used by Kaucnik and Klopp as compared with 5 or 6 decibels in the circuit used by Dr. Tosi, and Koren testified that he had experimentally established that the theoretical average loss would be 8.5 decibels. Koren further testified that he could not express an opinion on whether a conversation in which an average loss of 15 to 20 decibels existed was likely to have taken place on the telephone without assuming that "the people talking on the instruments were talking at normal voice levels, the instruments were in good condition, and that the circuit was in good condition."[42/] It appears, therefore, that the intensity difference, although certainly of a suspiciously high degree, could have occurred

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40/ Tr. p. 2013. Klopp's proposed finding (Klopp Brief p. 33) that "the difference in voice intensity present in the alleged conversation was consistently between 10 and 20 decibels" is rejected.

41/ Tr. p. 2349.

42/ Tr. p. 2408.

in the recorded telephone conversation, and that the nature and condition of the telephone facilities used would be important factors in the amount of the intensity difference experienced. As has been observed in connection with the loading coils utilized in telephone systems, the theoretical characteristics of a particular circuit may not hold true when in use.

As indicated before, there are unusual characteristics to be found in the tape and the recording, but these are not inexplicable. When all of the evidence bearing on the question is weighed, the preponderance favors acceptance of the recording as authentic. Contrary arguments by the respondents are found not to be sustained by the record.

Having reached the conclusion that Klopp did cause Kaucnik and Kerzman to effect securities transactions by the alleged misrepresentations, the next question is whether he induced them to engage in excessive trading as charged by the Division. It is concluded that Klopp did induce such excessive trading by Kaucnik and Kerzman.

The record is clear that both Kerzman and Kaucnik opened their accounts with the intent of trading rather than investing in securities, and that they, not Klopp, made the decisions to effect the transactions in their accounts. This being so, the size and frequency of the trading in the Kaucnik and Kerzman accounts, standing alone, do not lead to the

conclusion that Klopp induced excessive trading.[43] However, trading activity cannot be segregated from other factors having a bearing on that activity.[44]

As found herein, the trading in question after May 28, 1962 was influenced and improperly caused by Klopp, upon whom Kaucnik and Kerzman relied for advice regarding the "doctor's" trading. The faith they had in that information as a guide for their own trading in effect gave Klopp practical discretionary power over their accounts, permitting him to dictate or influence their transactions merely by informing them that the "doctor" had effected or was about to effect a particular securities transaction or a series of them. Klopp used the power he gained through his deception to profit himself and displayed little, if any, concern for the welfare of Kaucnik and Kerzman. Viewed in the light of Klopp's misconduct and his relationship with Kaucnik and Kerzman, the transactions in the Kaucnik and Kerzman accounts must be regarded as excessive in size and frequency and Klopp held responsible as the cause of such activity.

In view of the foregoing, it is concluded that Klopp wilfully violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

43/ Cf. Walter S. Grubbs, 28 S.E.C. 323, 328-30 (1948).

44/ Ibid.

Supervision of Klopp

The charge against registrant and Cowden is that by failing to properly supervise Klopp and by neglecting to enforce established procedures designed by registrant to prevent violations of the statutes, rules, and regulations administered by the Commission, registrant and Cowden wilfully aided and abetted Klopp's violations. The concern therefore is the relationship of registrant's and Cowden's supervisory responsibility to the specific violations that Klopp is found to have committed. It is concluded under all of the circumstances, including the peculiar and unique deception that gave rise to a finding that the size and frequency of the transactions in the Kaucnik and Kerzman accounts were excessive, that registrant and Cowden did not wilfully aid and abet Klopp's violations.

During the years 1961 through 1963, registrant was one of the larger broker-dealer firms doing business on a national scale with 43 branch offices in 40 cities in the United States. In those years, registrant followed a practice not unusual at that time amongst the larger broker-dealers of having separate systems of accounting in different parts of the country. Supervision of customer accounts was left in the hands of registrant's regional partners and the branch managers who were directly responsible to the regional partners. The policies of

registrant which were to be followed in the operation of its business were covered in a manual available in the branch offices; these policies were supplemented in the course of briefings in annual meetings attended by branch managers and regional partners.

Registrant's Ohio region geographically included all of the State of Ohio and Western Pennsylvania. During the period in question, the regional partner's responsibility extended over six branch offices in that area whose operations were carried on by about 70 salesmen and 95 other employees. The Union Commerce office Cowden managed had more than 70 employees, of whom about 30 were salesmen. The regional partner had the responsibility for assuring that registrant's policies and the rules and regulations of the regulatory agencies, trade associations, and the New York Stock Exchange were being observed. In discharging those responsibilities the regional partner visited quarterly each office in his area, gave lectures to the managers and employees, and discussed in detail with the managers their respective operations and practices. In cases of difficulties arising with customers, the regional partner would go to the office involved, determine responsibility for any error, and in instances admonish the manager or salesmen.

Direct supervision of the accounts in each office was the responsibility of the office manager, as were branch office sales management, selection and development of personnel, and the overall supervision and control of operations. In the Union Commerce office Cowden was assisted in his supervision of the accounts by a subordinate in charge of the office's accounting services, and another in charge of the office salesmen.

In 1962 and 1963 procedures were in effect which were intended to inhibit and detect improper excessive trading in customer accounts and other deceptive practices. Salesmen were initially familiarized with applicable rules and regulations by means of registrant's six-month training program which included sessions in New York and Cleveland, and their knowledge was kept current by staff meetings and by distribution of educational bulletins received from the NASD and the New York Stock Exchange. In addition, salesmen were required to read registrant's policy manual and a guide for registered representatives published by the Association of Stock Exchanges.

Every two or three weeks, as part of his supervisory routine, Cowden would review the daily blotter sheets covering purchases and sales effected in his office and examine the order tickets upon which the blotter sheets were based. In doing so Cowden became acquainted with the type and extent of

the activity in the individual accounts. This check was supplemented with a spot-check of customers' ledger accounts in the cashier's department, which was required to bring to Cowden's attention any account that reflected unusual activity. Salesmen were also warned in sales meetings against churning customers' accounts and making misrepresentations to effect sales, and were required to inform Cowden immediately concerning any customer's complaint.

While the described supervisory procedures are not above criticism, as was apparently recognized by registrant in 1964 and 1965 when additional safeguards were adopted, registrant and Cowden during the period in question are found to have had a reasonably acceptable system designed to control and supervise salesmen in the Union Commerce office. Whether there was negligence in the enforcement of established procedures is then the next consideration.

Cowden, with the approval of the regional partner, hired Klopp after interviewing him and speaking to Klopp's references. Klopp then entered the customary six months' training program in the course of which he displayed outstanding ability. In addition, he achieved excellent grades in two correspondence courses offered by the New York Institute of Finance.

During the years that Klopp was with registrant, he acquired approximately 400 accounts, of which about 50 were

active in 1962 and 1963, with 10 of those considered trading accounts. One of the latter, the account of Dr. Francis Rigel, came to Cowden's attention from time to time because of its extensive activity, but Klopp was able to satisfy Cowden that Dr. Rigel was interested in trading and that there need be no concern about the account.[45/] During the period in question, no serious complaints about Klopp were received by registrant or Cowden, and neither Kaucnik nor Kerzman informed registrant or Cowden of any doubts regarding Klopp's integrity nor of the representations Klopp had made to induce their trading.

Although the amount of the review that customer accounts received in Cowden's office may not have been adequate to detect and prevent improper excessive trading in those accounts, the record does not indicate that supervisory neglect contributed to the perpetration of the fraud in question or allowed that fraud to continue without detection. The Kaucnik and Kerzman accounts are not of such nature and character that if picked up during a review in the cashier's department would have reasonably led to inquiry beyond discussion with Klopp and review of available office information relating to those

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45/ After Klopp left registrant, Dr. Rigel had occasion to telephone the regional partner, at which time Dr. Rigel was asked if he knew of anything wrong in his account and replied in the negative.

accounts. The likelihood that such inquiry, or even one extended to include questioning of Kaucnik and Kerzman, would have produced early evidence of Klopp's misconduct is extremely remote, if not altogether non-existent. Inadequacy of registrant's account review procedures not being a contributing factor and no other failure to enforce registrant's procedures being shown as contributing to Klopp's violations, it is concluded that neither registrant nor Cowden aided or abetted those violations.

The Division's contentions that registrant's controls were not designed to detect excessive trading, and, in any event, were not effective, are not sustained by the record. In its argument the Division does not specify what it believes to be the shortcomings of registrant's procedures nor indicate the manner in which such procedures could have been improved, and reduces the problem to a statement that "there is an accepted danger that the public will become the victims of unauthorized conduct and representations by salesmen." Implicit in that attempted simplification of the issue, as well as in the thrust of the Division's argument on this question, seems to be the view that proof of misconduct by salesmen ineluctably establishes culpable lack of supervision. Such view is not supported by the Commission's decisions relied upon by the Division.

Bond & Goodwin, Inc., 15 S.E.C. 584 (1944), cited by the Division as early precedent for its position, imputed

responsibility to the respondent firm for the misconduct of its salesman only after finding that supervision over the salesman was "slight, if it existed at all," that "the routine of respondent's office appears to have been very lax" in numerous critical areas, and that the firm had not made the "thoroughgoing investigation" which should have been prompted by an item of correspondence that had come to the attention of its president. In Rudolph H. Deetjen, 18 S.E.C. 64 (1945), the finding was that "the firm knew or should have known what was taking place, and that it blinked" at the misconduct that gave rise to the violations there involved. In like manner, the Commission concluded in E. H. Rollins & Sons, Incorporated, 18 S.E.C. 347, 390 (1945), that the firm "must bear the responsibility for the numerous transactions constituting willful violations" in consequence of evidence that officers in Chicago and New York "were apprised of sufficient facts in connection with such transactions to put them on reasonable notice of their fraudulent character." The Commission also declared that "it is utterly inconceivable that accounts of the size of these funds, especially Woman's Work, did not at intervals receive the security [sic; scrutiny 46/] of one or more of Rollins' officers or senior employees." In deciding Reynolds & Co., 39 S.E.C. 902 (1960), a leading case on supervision, the Commission

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46/ See Securities Exchange Act Release No. 3661, p. 50 (February 22, 1945).

reiterated the principles that it had enunciated before concerning the duty of brokers and dealers to supervise the actions of employees and the imperative need that "the system of internal control be adequate and effective and that those in authority exercise the utmost vigilence whenever even a remote indication of irregularity reaches their attention." However, the circumstances under which the Commission there found a failure to properly supervise branch office operations were such as "demonstrate serious and extensive misconduct by employees in those offices and grave deficiencies in the supervision and internal control exercised by registrant and the individual stipulating respondents over such employees."

There can be no quarrel with these decisions, but they are inapposite unless it is first shown that registrant and Cowden failed in their duty to properly supervise Klopp and thereby to prevent or detect his violations. The Division has not made that requisite showing, proving only negligence in connection with one procedure in an otherwise reasonably adequate supervisory system, but failing to establish that absent such negligence, Klopp's violations would have been prevented or detected.

Accordingly, it is concluded that neither registrant nor Cowden wilfully aided and abetted the violations of Klopp.

Public Interest

While the serious nature of Klopp's violations makes the imposition of a sanction appropriate in the public interest, it does not appear under all the circumstances that a bar from association with a broker or dealer is required.[47/] There is no evidence that Klopp had previous difficulty with any regulatory agency nor of complaints, with one minor exception, against him during the nine years that he has been in the securities business. Moreover, his record of public service in civilian life and with the armed forces during World War II impels the conclusions that the opening of the Mark Christian account and the violations committed were regrettable lapses in conduct and are not indicative of what might be expected of him in the future.

Having given careful consideration to the evidence bearing upon the public interest and to that tending to mitigate the violations, including the fact that unethical conduct of Kaucnik and Kerzman contributed to the commission of Klopp's violations, it is concluded that a suspension of four months would be appropriate in the public interest.[48/]

47/ It is noted that the Division has not proposed a sanction that it considers appropriate.

48/ All proposed findings and conclusions submitted by the parties have been considered, as have their contentions. To the extent such proposals and contentions are consistent with this initial decision, they are accepted.

Accordingly, IT IS ORDERED that Ralph Martin Klopp is suspended from association with a broker-dealer for a period of four months from the effective date of this order; and

IT IS FURTHER ORDERED that these proceedings insofar as they relate to Paine, Webber, Jackson & Curtis and William P. Cowden are dismissed.

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

Pursuant to Rule 17(f) of the Rules of Practice, this initial decision shall become the final decision of the Commission as to each party who has not, within fifteen days after service of this initial decision upon him, filed a petition for review thereof pursuant to Rule 17(b), unless the Commission, pursuant to Rule 17(c), determines on its own initiative to review this initial 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.

--Warren E. Blair, Hearing Examiner

Washington, D.C.
November 28, 1967