

THE LARGE FIRM PROJECT

*A Review of Hiring, Retention and
Supervisory Practices*



**Division of Market Regulation
Division of Enforcement
United States Securities and Exchange Commission**

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**This is a report of the Division of Market Regulation and the Division of Enforcement.
The Commission has expressed no view regarding the analysis, findings or conclusions herein.**



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EXECUTIVE SUMMARY

This report announces the findings of a review undertaken by the Securities and Exchange Commission ("SEC" or "Commission"), working in conjunction with the New York Stock Exchange, Inc. ("NYSE") and the National Association of Securities Dealers, Inc. ("NASD"), of the hiring, retention and supervisory practices of nine of the largest broker-dealers in the United States. This review was commenced because of increased concerns on the part of the Commission and others regarding the frequency and severity of sales practice abuses perpetrated by some registered representatives employed by broker-dealers doing business with the public.

The nine firms involved in this review (referred to as the "Large Firm Project" or "Project") were selected because these firms account for approximately 49% of all public customer accounts in the United States. As part of this Project, Commission, NYSE and NASD staff conducted 170 examinations in 32 states. The examinations, which began in August 1992 and generally were completed in September 1993, covered the home offices of the nine firms and 161 branch offices. The Project also focussed on 268 registered representatives ("Selected registered representatives") who have been the subject of sales practice related customer complaints, named as defendants or respondents in customer initiated litigation or arbitration, or otherwise been the subject of an enforcement or disciplinary action by a state or federal governmental entity or self-regulatory organization ("SRO").

FINDINGS

- **More Than One Third of Selected Registered Representatives Are No Longer in the Securities Industry**

The review of the Selected registered representatives revealed that as of December 1993, 97 (36%) of the 268 registered representatives identified were not working in the securities industry ("previously registered individuals"). Furthermore, 31 of these previously registered individuals have been barred by either the SEC or an SRO, or have been the subject of a criminal proceeding resulting in incarceration. An additional 52 of the previously registered individuals have been or are currently the subject of regulatory review or enforcement action.

- **Approximately 25% of the Examinations Resulted in Enforcement Referrals**

While many registered representatives already have been identified by the regulatory systems currently in place, the Project's examinations have resulted in approximately 40 referrals for further investigation and possible enforcement action. / These referrals

include 14 of the 268 Selected registered representatives. Additional referrals related to sales practice problems involving other registered representatives and branch offices. Among the types of problems identified were indications of excessive trading, unsuitable recommendations, unauthorized trading, improper mutual fund switching and failure to supervise.

- **Three of the Nine Firms Accounted for 88% of the Enforcement Referrals**

The Project disclosed that 88% of the examinations referred for further investigation and possible enforcement action involved three of the nine firms reviewed. These three firms also accounted for over half of the examinations conducted, and had employed 71 (73%) of the 97 previously registered individuals during the time period reviewed. These findings indicate that some firms, at the time of the examinations, were not as diligent in the implementation of their recruitment and hiring practices, and in carrying out their supervisory and compliance procedures on an individual branch office basis.

- **Some Branch Office Managers Are Not Enforcing Supervisory and Compliance Systems**

The supervisory and compliance systems in place at most of the nine firms were found to be adequate. The examinations found that the diligence with which individuals with direct responsibility for the supervision of registered representatives pursued their responsibilities had a significant effect on the overall quality of each firm's compliance and supervisory system. The examinations indicated that some branch office managers were not implementing firm procedures adequately.

- **Registered Representatives Able to Move When Customer Complaints Exist**

Of the 97 individuals who are no longer in the securities industry, 42 (43%) had changed firms one time before becoming non-registered. For the 171 registered representatives currently employed by a broker dealer, 111 (65%) had changed jobs, at least once, from one of the nine firms. Thirty-two of those 111 registered representatives had changed employment between two and five times. Significantly, 17 (56%) of these 32 individuals had two or more complaints at the time of their first employment change and all 32 individuals had at least three complaints by the time of their second employment change. Although there did not appear to be any pattern of movement between the nine firms, the frequency of employment changes of these 32 registered representatives suggests that some firms are willing to employ individuals with a past history of customer complaints, but where no formal disciplinary measures have been taken.

- **Largest Revenue Producing Brokers Generally Not the Subject of Investor Complaints**

The examinations revealed that the Selected registered representatives generally were not among the 50 largest revenue producers at these firms.²⁷ Examiners found that only 15 (6%) of the 268 Selected registered representatives were identified by the firms as being among such producers.

RECOMMENDATIONS

The Project reviewed a small portion of the branch offices and registered representatives from the nine firms, and yet a disproportionate number of referrals for further investigation and enforcement consideration were made. These findings suggest, in our view, that there is a need to devote additional resources at the firm, SRO and Commission level to the detection and prosecution of registered representatives who have a history of sales practice problems or who commit sales practice violations.

In addition, based on the results of the Project as well as the Commission's oversight examination program generally, a number of areas relating to the detection and enforcement of sales practice violations are in need of improvement. In particular, the Commission Staff ("Staff") has found deficiencies with respect to (a) compliance with SRO reporting requirements, (b) tracking systems for SRO handling of investigations relating to Form U-4 and U-5 filings, and (c) the level of disclosure by firms on Form U-5. Moreover, based on the results of our overall sales practice examination efforts, the Staff is concerned that the present level of sanctions may not provide sufficient deterrence against sales practice misconduct by registered representatives, and that existing disclosure regarding SRO disciplinary actions is inadequate.

Based on these factors, the Staff proposes the following recommendations.

1. Increased Examination Efforts and Sanctions in all Sales Practice Matters

Sanctions against registered representatives who engage in serious sales practice abuses should be significant (e.g., permanent bars without a right of re-entry, extended suspensions and increased fines, re-training and probationary programs, re-qualification, and limitations on sales activities). Additionally, SROs should increase the emphasis on sales practice abuses in their examination programs. The Division of Market Regulation likewise will commit resources to the examination of sales practice abuses.

2. Improved Broker-Dealer Compliance Systems for Identifying Problem Brokers

Firms should be required to improve compliance systems designed to oversee and review employee conduct. Improvements would include the ability to identify individuals, before hiring, whose disciplinary history indicates a pattern of sales practice abuse. Additionally, firms should be able to identify registered representatives generating large numbers of sales practice related customer complaints, arbitrations and settlements, and develop the technical capability in the main office to conduct account reviews for suitability on a regular basis.

3. Enhanced Compliance by Firms and Registered Representatives with all SRO Reporting Requirements

The SROs should continue their efforts to monitor the timeliness of required filings, such as the Forms U-4, U-5 and RE-3, through examinations and otherwise. The SROs should increase the sanctions against both firms and individuals where instances of noncompliance with SRO reporting requirements are discovered. The NASD should

require member firms to report to its customer complaint data on a quarterly basis similar to the requirements of NYSE Rule 351. ⁴

4. Qualified Immunity for Firms on Form U-5

The Commission should consider rule-making or, if necessary, legislative changes, to implement uniform policies governing the liability and immunity of broker-dealers and their associated persons with respect to state law defamation actions in connection with statements made in regulatory filings required by the Commission and SROs (e.g., statements in a Form U-5 setting forth the basis for termination of a registered representative).

5. Enhanced Role for Legal and Compliance Departments

Broker-dealers should increase involvement of their compliance and legal staff in registered representative hiring, retention and termination decisions, and branch office visit programs.

6. Additional Regulatory Action

The Commission should consider whether additional regulatory action is needed to address the problem of registered representatives with a history of customer complaints, arbitration awards, judgements in private litigation, and disciplinary actions and fines. The Staff recommends that a firm should be required to designate, above the branch office manager level, an individual or committee to approve the hiring of any registered representative with a history of compliance problems.

7. Continuing Education

The Staff believes that continuing education requirements for the securities industry act as a preventive device to avoid customer complaints and recommends that the Commission continue to emphasize the need to expand investor protection through increased knowledge and heightened awareness of regulatory and ethical standards among securities industry professionals.

8. Development and Implementation of Tracking Systems for SRO Handling of Investigations Relating to Form U-4 and U-5 Filings

The SROs should develop and implement a system for tracking which SRO is investigating a registered representative's termination for cause or amendments to Form U-4 and U-5, and the current status of such investigations.

9. Disclosures When Opening New Accounts

The SROs should adopt a rule requiring their member firms to disclose to investors opening new accounts, prior to effecting any transaction in that account, the availability of information concerning the disciplinary history of registered representatives through the NASD's toll free number.

10. Public Disclosure by All SROs of Initiated Disciplinary Actions

The SROs should make available to the public all formal disciplinary proceedings when initiated against member firms and registered representatives.

CONCLUSION

Ultimately the question of how to deal effectively with problem, or "rogue," brokers is only one of many issues confronting the Commission and the SROs in the area of sales practices. Completion of this Project, therefore, is only one part of an overall program to increase the emphasis on identifying and prosecuting sales practice violations. The Staff intends to continue to identify and target so-called "rogue brokers" in its examination and enforcement programs.

The recommendations contained in this report deal primarily with the issues relating to uncovering abusive sales practices and dealing with them once they occur. Equally important, in our view, is the need to develop means to reduce the likelihood of violative conduct in the first place through appropriate training and incentives. To that end, consideration should be given to, among other things, redefining the role of branch managers and how they are compensated, and educating consumers so that they can better protect themselves from sales practice abuse. Similarly, the industry needs to develop a comprehensive continuing education program to increase the knowledge and professionalism of the sales force thereby deterring sales practice abuse. Finally, prevention of sales practice problems can be greatly enhanced through effective supervisory systems at all levels of the firm.

REPORT ON THE LARGE FIRM PROJECT



Prepared by the Staff of the United States Securities and Exchange Commission

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REPORT ON THE LARGE FIRM PROJECT

Federal securities regulation of broker-dealers rests on the principle of self-regulation. First and foremost, effective self-regulation requires broker-dealers to monitor the trading and sales activities of their associated persons and to establish effective compliance and supervisory procedures to detect possible violations of firm policies, SRO rules and federal and state securities laws. At the next level of the regulatory structure, the SROs, which are membership organizations overseen by the Commission, must establish rules that govern the conduct of member firms and enforce compliance with those rules and with the federal securities laws. To accomplish these responsibilities, which are mandated by statute, the SROs examine their member firms on a routine basis, and initiate disciplinary actions where member firms or their associated persons violate SRO rules or the federal securities laws.

Recognizing the inherent limitations and conflicts associated with any system of self-regulation, Congress gave the Commission direct regulatory authority over the activities of broker-dealers and SROs. The Commission exercises this authority, consistent with its principal statutory mandates of investor protection and the public interest, through its rule-making authority, its examinations of broker-dealers and inspections of SROs, and ultimately through enforcement actions against persons who violate the securities laws.

These statutory purposes are best served when effective compliance mechanisms are in place within broker-dealers, SROs routinely examine for and enforce compliance with the securities laws and their own rules, and, the Commission implements an effective and comprehensive SRO oversight and enforcement program.

I. BACKGROUND ON THE LARGE FIRM PROJECT

Concerns regarding the hiring, retention and supervisory practices of large broker-dealers increased as a result of Commission examination findings in 1991-92. On July 16, 1992, the Divisions of Market Regulation and Enforcement ("Divisions") requested that nine of the largest NYSE member firms provide the Commission with information concerning their hiring and termination practices, customer complaints, and arbitration and civil litigation brought against the firm or its registered representatives. The letter asked for information regarding individuals associated with the broker-dealers as registered representatives who have been disciplined previously by the Commission (or other federal governmental agency), an SRO or a state securities agency; or have been or are the subject of multiple customer complaints, lawsuits or arbitrations alleging various sales practice abuses, such as churning, unsuitable recommendations, unauthorized trading, or misappropriation of funds or securities. ^{1/} The Divisions selected these nine firms because they have approximately 49% of all public customer accounts in the United States.

A. Special August 1992 Sales Practice Examinations

Before the nine firms responded to the data request of July 16, 1992, the Division of Market Regulation requested that the Commission's Regional and District offices conduct special sales practice examinations of 14 branch offices of one of the nine firms. The branch offices were chosen based on the number of customer complaints the firm received in 1991 and 1992 (through June 30). Division staff analyzed the data for purposes of selecting branch offices where there appeared to be the highest probability of sales practice and supervisory abuses. The examinations were conducted between August and November 1992; enforcement referrals were made regarding eight of these branch offices.

The examinations revealed multiple potential sales practice abuses. Registered representatives in several branch offices appeared to have engaged in numerous instances of excessive and unsuitable trading, and in mutual fund switching in accounts of elderly clients to generate substantial commissions for themselves. These examinations heightened concerns that systemic supervisory problems existed at this firm.

B. Joint SEC, NYSE, NASD Meeting

On September 10, 1992, senior staff of the Divisions met with NYSE and NASD staff to discuss the Commission's concerns about the adequacy of sanctions within the regulatory structure that currently exists, and a proposed joint SEC and SRO regulatory effort to analyze the data from the nine firms and to select the branch offices and individual registered representatives for examination.

Participants reviewed the current SRO regulatory, investigative and enforcement programs and discussed the adequacy of current Commission and SRO sanctions for sales practice abuses, whether the SEC and SROs should specify stronger sanctions for serious sales practice abuses, and possible legislative amendments to protect investors from abusive registered representatives. Commission and SRO staff also focused on what SRO regulatory or disciplinary information should be made available to the general public. Finally, Commission and SRO staff discussed a joint examination effort in connection with the Large Firm Project.

II. THE EXAMINATION PROCESS

A. Compilation of Information from Letters

The nine member firms submitted their responses to the Division of Market Regulation, which reviewed and summarized the information. The review found that not all the firms were able to provide a list of 50 registered representatives with the largest number of complaints for each of the years 1990, 1991, or 1992, because of the limited number of individuals with large numbers of complaints. Consequently, the Division of Market Regulation further requested that the firms, in order to provide a list of 50 registered representatives for each of the requested years, provide the names of all registered representatives named in a written sales practice complaint more than once during the entire three year period.

B. Utilization of NYSE Rule 351 Data

In November 1992, the Division of Market Regulation requested from the NYSE its Rule 351 computerized database ("351 data") of customer complaints and Form RE-3 information for the period January 1990 to September 1992.⁷ The nine firms reported more than 30,000 sales practice related complaints and over 60% of those complaints were related to three of the nine firms. Approximately two-thirds of the complaints were against registered representatives with less than 3 complaints submitted during the entire period reviewed. The Staff utilized the 351 data to determine the branch offices and registered representatives with the largest number of complaints, and identified the specific allegations associated with each complaint for the three year period.

The 268 Selected registered representatives were chosen on the basis of recently filed complaints and the total number of written sales practice complaints. The Selected registered representatives had approximately 2,400 complaints. The actual number of complaints that the 268 registered representatives incurred individually varied from a low of three to a high of 89, with an average of 9. Of the Selected registered representatives, 73% had between 3 and 9 total complaints for the three year period.

On January 23, 1993, the Division of Market Regulation provided to the Commission's Northeast Regional Office and Midwest Regional Office, the NYSE and the NASD, a package of material for each of the nine firms which they were assigned. The packages contained (a) a list of branch offices that were the subject of the most sales practice related customer complaints during the period January 1990 through September 1992, (b) a list of Selected registered representatives and a summary of the specific sales practice complaints and RE-3 information, (c) a list of Selected registered representatives who had been employed at one of nine firms involved in this Project before becoming associated with another of the nine firms, and, (d) complete copies of the documentation submitted by the nine firms in response to the July 1992 request.

C. Objectives and Scheduling

The examinations, which began in early February 1993 and generally were completed in September 1993, involved both the field work and a review of the firm's initial submission to the SEC. The primary objectives of the Project were (a) the identification of sales practice abuses, (b) a review and assessment of each firm's main office and branch office supervisory procedures, and (c) a review and assessment of each firm's hiring and termination procedures.

The examination field work consisted of main office examinations of the nine firms, branch office examinations of the nine firms, and, examinations of other broker-dealers where a Selected registered representative may have become employed. The objectives of the home office examinations were to review the data submitted in the responses to the July 16, 1992 letter, review supervisory and compliance procedures, review the top 50 "large producer" lists, and review the securities trading and commission activity of the registered representatives and branch offices selected for further review. The branch office examinations were classified into two categories (a) branches that were examined based on apparent excessive customer complaints, arbitration and litigation matters and other factors identified while examining the firm's main office, and, (b) branch offices that were

examined because one or more of the Selected registered representatives were working at the branch office.

III. THE EXAMINATION FINDINGS

A. Summary Findings

1. More Than One Third of Selected Registered Representatives Are No Longer In the Securities Industry

At the end of 1993, approximately 460,000 registered representatives were associated with registered broker-dealers doing business with the public. The nine firms involved in the Large Firm Project employed 50,762 (11% of active) registered representatives at the end of 1993. Out of the 50,762 registered representatives working for these firms, the Division of Market Regulation identified 268 (.5%) for special examination because of the existence of sales practice-related customer complaints, arbitrations or litigation. The selection of the registered representatives was based on information provided by the firms and an analysis of the Rule 351 data.

The review of the Selected registered representatives revealed that 97 (36%) of the 268 Selected registered representatives were not registered with a broker-dealer as of December 1993. Furthermore, of those 97 registered representatives who were not employed with a broker-dealer, 31 have been barred by either the SEC, an SRO or were involved in a criminal proceeding which resulted in a statutory disqualification. An additional 52 previously registered individuals have been or are currently the subject of regulatory review or enforcement action.

2. Approximately 25% of the Examinations Resulted in Enforcement Referrals

The examinations established that sales practice abuses by registered representatives continue to be a problem which requires regulatory attention. Approximately 40 of the 161 branch office examinations conducted in connection with the Project identified sales practice problems to be referred for further investigation and possible enforcement action. These examinations did not find systemic supervisory or pervasive sales practice problems at the main office level. However, there were indications of excessive trading, unsuitable recommendations, unauthorized trading, improper mutual fund switching and failure to supervise in some of the branch office examinations.

3. Three of the Nine Firms Accounted for 88% of the Enforcement Referrals

The Project disclosed that 88% of the examinations which were referred for further investigation and possible enforcement action were from three of the nine firms. These three firms also accounted for over 50% of the examinations conducted. Furthermore, 71 of the 97 previously registered individuals had been employed by one of these three firms during the time period reviewed. These findings indicate that, at the time of the examinations, some firms had failed to adequately implement their recruitment and hiring practices and their supervisory and compliance procedures on an individual branch office basis.

4. Some Branch Office Managers Are Not Enforcing Supervisory and Compliance Systems

The supervisory and compliance systems in most of the nine firms examined were found to be adequate. The examinations found, however, that the diligence with which individuals implemented their systems and policies had a significant effect on the overall quality of any compliance and supervisory system. The examinations also revealed that some branch office managers were not implementing firm procedures adequately. For example, some branch managers did not comply with written firm procedures by failing to contact customers in a timely manner about their account activity and their satisfaction with a registered representative's handling of their account, to periodically review registered representative trading in customer accounts for suitability, and to obtain authorization letters from customers in incidents where the customers switched mutual funds.

5. Registered Representatives Able to Move When Customer Complaints Exist

The Staff studied the employment patterns of the Selected registered representatives up to December 1993 to identify any possible trends. Of the 97 individuals who are no longer in the securities industry, 42 (43%) had changed firms one time before becoming non-registered. For the 171 registered representatives currently employed by a broker dealer, 111 (65%) had changed jobs at least once from one of the nine firms. Thirty-two of those 111 registered representatives had changed employment between two and five times.

The Staff reviewed the filing dates of the customer complaints and compared them to the employment termination and registration dates. Significantly, 17 (56%) of these 32 individuals had two or more complaints at the time they made their first employment change from one of the nine firms. By the time of their second employment change, all 32 individuals had at least three complaints filed against them at their former firm (total complaints ranged from 3 to 17). Although there did not appear to be any pattern of movement between the nine firms, the frequency of employment changes of the 32 registered representatives who had multiple employment changes suggests that some firms are willing to employ individuals with a past history of customer complaints, but where no formal disciplinary measures have been taken.

6. Largest Revenue Producing Brokers Generally Not the Subject of Investor Complaints

The examinations and registered representative reviews revealed that the registered representatives who were the subject of sales practice related investor complaints, arbitration and litigation or SRO disciplinary actions generally were not the largest revenue producers at these firms. In fact, examiners found that only 15 (6%) of the 268 Selected registered representatives reviewed in connection with this Project were identified by the firms as being among the 50 largest revenue producers.

B. Enforcement Matters

1. Enforcement Referrals Generally Did Not Involve the Selected Registered Representatives or Previously Known Types of Sales Abuses

Of the 40 examinations that resulted in enforcement referrals, only 14 involved a Selected registered representative. The remaining 26 enforcement referrals involved firms or other registered representatives whose sales practice abuses were detected by analysis of firm exception reports, commission runs and other examination techniques. In addition, although examiners might have selected a particular branch office for review because of multiple customer complaints involving a Selected registered representative or a particular type of sales abuse such as excessive trading, examiners often found sales practice problems involving a registered representative who was not identified from customer complaint information and which involved other types of sales abuses including improper mutual fund switching, unauthorized trading or unsuitable securities transactions.

2. Commission Brings Sales Practice Action Against Prudential

During the period in which the Large Firm Project was underway, the Commission filed civil injunctive and administrative proceedings against Prudential Securities Inc. ("Prudential") that, in part, related to the findings from several examinations conducted as part of the Large Firm Project. This case, brought on October 21, 1993, resulted in Prudential agreeing to make an initial payment of \$330 million to a fund for compensatory damages to customers who had purchased limited partnership interests from Prudential during the 1980's, and to pay \$41 million in fines to the SEC, NASD and state securities administrators. Prudential also was required to establish a claim resolution process, under supervision of a court appointed Claims Administrator, and to pay compensatory damages to aggrieved investors without regard to statute of limitations defenses. In addition, Prudential must review its current compliance policies and procedures, and implement any new or revised procedures. Prudential specifically was required to implement new policies and procedures to prohibit excessive trading in customer accounts, sales of unsuitable securities, the hiring and retention of registered representatives with significant disciplinary histories and customer complaints, and, to review mutual fund transactions to prevent sales abuses.

The Commission found that Prudential failed to reasonably supervise ten former registered representatives in nine separate branch offices whose conduct violated the anti-fraud provisions of the federal securities laws, particularly by churning customer accounts and engaging in unauthorized transactions. The Commission also found that Prudential failed to reasonably supervise two of the firm's top producers who were employed in the firm's Dallas branch office. One registered representative in particular operated his own department within the Dallas branch office and, among other things, engaged in unauthorized trading in customer accounts. Although the settlement resolved all current Commission investigations involving Prudential, the Commission stated in its order that the investigation concerning the matters that were the subject of its injunctive and administrative actions continues as to individual liability for the conduct in question.

IV. RECOMMENDATIONS

The examination findings, in our view, demonstrate a need to devote additional resources at the firm, SRO and Commission level to the detection and prosecution of registered representatives who have a history of sales practice problems or who commit serious sales practice violations. Although the number of registered representatives who have a significant number of sales practice complaints is relatively small compared to the industry in general, continued vigilance by the firms in the implementation of their supervisory and compliance procedures is necessary. Over the past five years, the SROs have increased substantially their staff resources devoted to enforcement matters, have brought more sales practice and failure to supervise cases, and have increased sanctions for violative conduct. Nevertheless, the fact that 25% of the branch office examinations conducted in this Project resulted in referrals for enforcement investigation and possible disciplinary action suggests that existing supervisory and compliance systems are not enough to detect problem brokers promptly, and that existing sanctions for sales practice violations at both the SRO and Commission level need to be strengthened.

The Staff believes that it is necessary for broker-dealers, the SROs and the Commission to work together in identifying problem registered representatives, and once identified, to take steps to protect the interests of the customers through aggressive enforcement action or through close supervision of their conduct. Firms should be more aggressive in scrutinizing the past history of registered representatives, establishing policies and procedures designed to prevent and ensure that registered representatives who have a history of customer complaints are more closely supervised and that such supervision is carried out, and responding quickly to indications of sales practice abuses in their sales force. Additionally, the SROs and the Commission should develop better means of identifying sales practice problems at an earlier stage and increase examinations and enforcement resources devoted to individual sales practice cases.

The Staff has developed a series of recommendations that it believes will strengthen the compliance mechanisms in place within broker-dealers, enhance the efforts by the SROs in the detection of sales practice abuses and enforcement of compliance with their rules, and reinforce the Commission's principal mandate of investor protection. We recommend that the Commission consider prompt implementation of the following recommendations.

1. Increased Examination Efforts and Sanctions in Sales Practice Matters

The joint examination sweep by the Commission, the NYSE and the NASD highlighted the necessity of continuing to emphasize sales practice matters in on-site examinations. The NASD routinely reviews sales practice activities through the regulatory programs administered by its 14 District Offices. The NYSE conducts a specialized sales practice examination annually of its largest member firms and in 1994, expanded its program to review all other firms on a four year cycle. Similarly, the Commission has focussed significant attention on sales practice examinations in recent years. The Staff is of the view, however, that more should be done in targeting examinations and identifying problem brokers in each sales practice examination.

The SEC, NYSE and NASD must continue to work together to ensure that registered representatives who are the subject of sales practice related complaints or named as respondents in customer initiated arbitration claims are identified promptly. The Commission has instructed its Regional and District Offices to give particular emphasis to identifying and targeting problem brokers in examinations conducted by SEC examiners. In addition, the Commission plans to conduct additional examination sweeps in cooperation with other regulators and to focus additional examination resources on brokers with large numbers of customer complaints, arbitration awards, and/or disciplinary actions. The Commission will continue to inspect the regulatory programs of the SROs, and to conduct oversight with respect to the sales practice examinations conducted by the SROs.

On the enforcement side, the Staff recommends that additional resources be devoted, both at the Commission and the SRO level, to prosecuting sales practice cases against problem brokers who have violated Commission or SRO rules. Increased emphasis should be given, in this regard, to developing better tools for identifying sales practice problems at an earlier stage. This would include greater use of the customer complaint information available from NYSE member firms pursuant to Rule 351 and increased efforts to review arbitration cases when they are filed rather than at completion. As an additional tool to aid in the identification of problem brokers, the Staff recommends that the NASD adopt a rule based on NYSE Rule 351 and require its members to report customer complaints on a quarterly basis.

Disciplinary sanctions against broker-dealers and registered representatives who engage in abusive sales and trading practices should be severe. The investing public must be assured that the Commission and SROs are attempting to identify these abuses and will investigate and quickly prosecute abuses when discovered. The SROs also must take appropriate disciplinary action against broker-dealers and their associated persons for non-compliance with SRO reporting requirements. While the appropriate sanction in any individual case should depend on the facts and circumstances of that particular case, the Staff recommends that for serious sales practice violations or for recidivists, greater consideration be given to bars (without a right to reapply) or significant suspensions, such as five years or more. The Commission may want to consider a policy that, absent extraordinary circumstances, views negatively reentry applications from persons that have received permanent bars.

For less serious sales practice violations, consideration should be given to additional remedial sanctions, such as extended suspensions, a requirement to complete appropriate financial courses, minimum six month on-job training on a fixed salary (with no commissions or bonus), the retaking of all necessary qualification examinations and a minimum probationary period during which time a person would be severely restricted in their sales activities.

2. Improved Broker-Dealer Systems for Identifying Problem Brokers

Although the examination sweep generally found adequate home office procedures and supervisory structures at most of the firms examined, the Staff believes that firms need to do additional work in terms of reviewing and amending firm procedures to increase the identification of registered representatives generating large numbers of sales practice related customer complaints, arbitrations and settlements. Although the firms produce quarterly customer complaint information in compliance with NYSE Rule 351, it is not

clear that the firms are using any of this valuable information internally for purposes of targeting their own internal audit or branch office visitation programs, or that the firms are adequately tracking customer complaints by product, individual or branch office. In addition, some of the on-site branch office examinations raised questions as to whether the branch managers were following established supervisory procedures or whether the home office or regional legal and compliance departments were fully aware of possible supervisory deficiencies at the branch office level.

The Staff recommends that securities firms review their data processing and computer capabilities to better assist branch office managers in performing their supervisory functions. Firms should move to develop sophisticated computer systems to provide branch office managers with automated tools to better monitor what is happening within a branch, as well as to complete supervisory tasks and reports. The systems should have the capability of permitting more effective oversight of the branch office by the firm's senior management and compliance personnel.

3. Enhanced Compliance by Firms and Registered Representatives with all SRO Reporting Requirements

Historically the most fruitful source for the identification of possible sales practice problems has been reports that broker-dealers and registered representatives have been required to file with SROs. ⁷ Forms U-4 and U-5, which are the uniform forms for registering and terminating salespersons respectively, require, among other things, disclosure of criminal charges and convictions, disciplinary actions brought by domestic and foreign regulators, customer complaints that exceed certain thresholds, and investigations by the firm, an SRO or a foreign or domestic entity. Separately, the NYSE requires the filing of Form RE-3 which discloses, among other things, disciplinary actions taken by the member firm against any of its associated persons, judgements, awards or settlements involving customer initiated litigation and arbitration, and, written customer complaints involving allegations of theft or misappropriation of funds or securities or of forgery.

These required filings form the backbone of the SRO systems for identifying problem registered representatives. For example, when the NYSE receives notification on Form RE-3 involving a registered representative, its procedures require a preliminary investigation to determine the facts of the matter and whether or not the conduct appears to be isolated or involves other customers of the same registered representative. Failure by firms to make prompt filings of these Forms U-4, U-5 and RE-3 can impede substantially the ability of the regulators to address possible sales practice violations in a timely way. During the Project, examiners found one firm did not timely file Forms U-4, U-5 and subsequent amendments.

Registered representatives and their associated firms must submit on a timely basis all filings and amendments required by SRO rules in connection with customer complaints, and adjudicated, resolved or settled disputes. The Staff, therefore, recommends that the SROs continue their efforts to monitor the timeliness of required filings through examinations and otherwise, and to sanction firms for failure to make filings promptly and accurately. Similarly, the Staff recommends that the NASD coordinate with the NYSE to establish a reporting protocol similar to Form RE-3. The NASD is currently considering such a proposal.

4. Qualified Immunity for Firms on Form U-5

In addition to the Staff's general concern regarding the need for timely filing of Forms U-4 and U-5 with respect to registered personnel, there are additional issues presented in the case of the Uniform Notice of Termination, Form U-5. These issues relate to the circumstances under which a registered representative leaves a particular firm.

Form U-5 requires a firm to disclose whether a termination is voluntary or not, and whether or not the salesman is the subject of customer complaints or an investigation. Registered representatives have complained they have been libeled by statements made on Form U-5 regarding the characterization of their termination. Furthermore these complaints, as well as other disclosures made on the form, have been the subject of litigation and/or arbitration and substantial awards have been made in some cases. Regulators have raised concerns that the fear of litigation has led firms to be less candid in their filings and has reduced the value of the Form U-5 as a "red flag" in sales practice cases.

Improved disclosure by firms on Form U-5 could substantially assist regulators in policing for serious sales practice violations. Although some states afford some form of immunity from liability for defamation in these circumstances, the Staff believes that concerns of firms and supervisory personnel regarding civil liability for statements made in regulatory filings required by the Commission or SROs warrant further examination. Such concerns may inhibit full and adequate disclosure of the facts and circumstances surrounding the reasons for termination of registered representatives. The Staff, however, is also cognizant that false statements by firms about registered representatives in filings can be professionally damaging and a source of possible abuse. Accordingly, the Staff intends to recommend rule-making by the Commission, or if necessary, legislative changes, to implement uniform policies governing the liability and immunity of broker-dealers and their associated persons with respect to state law defamation actions in connection with statements made in regulatory filings required by the Commission or SROs.

5. Enhanced Role for Legal and Compliance Departments

The Staff has concerns regarding broker-dealers and managers who disregard cautionary warnings from the firm's legal and compliance staffs with respect to decisions to hire individuals with a history of regulatory problems. Similarly, when a regulatory problem arises at a firm, the final decision to retain a particular registered representative rests with the business interests, who can disregard a recommendation from the legal and compliance department that the representative be terminated, disciplined or subjected to special supervision.

Firms should be encouraged to improve their compliance and supervisory infrastructures and take action so that legal and compliance officials have a substantial voice in hiring and retention decisions regarding registered representatives; particularly where the prospective registered representative, or the registered representative whose current conduct at the firm is at issue, has a history of regulatory problems. This will require greater communication and cooperation among firms regarding potential hires. Although the Staff does not recommend that compliance and legal officials within a firm

have veto power, management should be held responsible for its decisions to hire or retain a registered representative against the recommendation of legal and compliance staff and be required to document the basis for doing so.

In the recent administrative proceedings regarding Prudential, the Commission sought to address that problem at Prudential through agreements requiring the firm to justify the hiring and retention of any salesmen where the legal and compliance department has recommended that the salesman either not be hired or be terminated. The Staff believes that the undertakings with respect to hiring and retention practices contained in the Prudential administrative proceeding should be adopted throughout the securities industry.

6. Additional Regulatory Action

The Staff recommends that the Commission consider whether additional regulatory action is needed to address the problem of registered representatives with a history of sales-practice related customer complaints, arbitration awards, judgements in private litigation, and disciplinary actions and fines. The Staff's concerns stem from situations in which a broker-dealer, or its managers and supervisors, knows or should have known that a registered representative presented a serious potential risk to investors based on a history of regulatory problems.

The Staff believes that a broker-dealer that hires a registered representative with a history of disciplinary problems, awards or customer complaints could be subject to sanctions if, subsequent to the time the registered representative is hired, he or she commits a sales practice violation. Moreover, a firm should be required to designate, above the branch office manager level, an individual or committee to approve the hiring of any registered representative with a history of compliance problems. In this regard, the Staff believes it may be appropriate to take regulatory action to create higher standards, than those currently existing, which more clearly reflect increased liability for firms and their managers with respect to hiring and supervising registered representatives who have a history of regulatory problems.

7. Continuing Education

In addition to concerns regarding the incidence of traditional sales practice problems, the Staff is also troubled by the proliferation of new and exotic investment products without assurances that the training and knowledge bases of the securities industry sales force has kept pace. In this regard, the Staff believes that continuing education requirements for the securities industry can prevent sales practice abuses from occurring in the first place. The Staff therefore recommends that the Commission continue to emphasize the need to expand investor protection through increased knowledge and heightened awareness of regulatory and ethical standards among securities industry professionals.

In May 1993, under the sponsorship of the SROs, an industry task force was established to study the issue of continuing education for persons in the securities industry. This task force, which consisted of twelve individuals from national full-service retail firms, regional firms, investment banks, investment companies, insurance companies and investment planning firms, concluded that there should be mandatory continuing education in the securities industry. The task force was of the view that there should be a two-

element structure to such a program (a regulatory component and a firm component) and that all registered personnel should participate. A separate standing Industry/Regulatory Council on Continuing Education ("Council") was established whose purpose is to (a) determine the specific content of the regulatory component, and (b) mandate specific minimum core curriculum for inclusion in the firm component. The Council is actively pursuing development of a comprehensive program of continuing education and is working on an accelerated timetable to adopt and implement SRO rules by year-end.

Adoption of a mandatory continuing education program is, in our view, a critical element in preventing sales practice abuses and protecting individual investors. The Staff believes the Commission should continue to support the efforts of the Council to work cooperatively with the industry and SROs to implement a program that accomplishes the goal of assuring more knowledgeable sales professionals. The Staff also believes that firms should regularly reassess their own training programs to make sure that sales professionals are knowledgeable about the products they sell -- their structure, their pricing, their risk profile and, most importantly, to what customer base are they suitable.

8. Development and Implementation of Tracking Systems for SRO Handling of Investigations Relating to Form U-4 and U-5 Filings

The examination sweep also revealed deficiencies in the regulators' existing capability to identify and track problem brokers on an integrated basis. The NYSE's Rule 351 data base, which contains customer complaint information for NYSE members going back nearly four years, is extremely useful and was of significant help to the Staff. The Central Registration Depository ("CRD"), however, which contains records on more than 450,000 individual registered representatives, is capable of providing detailed information on an individual basis, but is incapable of the type of regulatory inquiries which are necessary to target problem brokers as a group. It should be noted that the CRD originally was designed as a registration system to facilitate the licensing process with the states and the SROs.

The NASD has recognized this problem and is currently embarked on a multi-million dollar rewrite of the CRD system. When completed in 1995, the state-of-the-art, user-friendly system should provide regulators with the ability to search through hundreds of thousands of records to identify problem brokers, to flag problem brokers who have left the industry so that they can be reviewed should they try to return to the business, and to target firms and branches for examination in a more effective way. The Staff has been working closely with the NASD redesign team and fully supports the new CRD as a critical element in the effort against problem brokers.

The Staff recommends that the SROs should enhance their coordination and tracking systems for investigations relating to Form U-4 and U-5 filings. During the Project, the Staff had difficulty specifically identifying which SRO was investigating a certain registered representative or firm for particular conduct. In some cases, one SRO would initiate an investigation only to find out that another SRO already was reviewing the conduct of that registered representative. In an effort to avoid unnecessary duplication, the first SRO would defer the matter to the SRO with the on-going investigation. Once deferred, however, the conduct giving rise to the deferral was not always fully investigated, as it might not directly relate to the scope of the other investigation.

The Staff believes that the NASD's ongoing project to restructure the CRD system to provide a data base that is more flexible and useful for regulatory purposes will facilitate this coordination and tracking. The Staff recommends, meanwhile, that the SROs review their existing coordination protocols and tracking systems to ensure that matters are fully investigated and that there is no duplication of effort. In addition, the Staff recommends that the Commission's Regional and District Offices monitor more closely referrals to SROs to ensure that investigations are proceeding promptly.

9. Disclosures When Opening New Accounts

Information concerning the disciplinary history of registered representatives is another means of protecting investors from abusive sales practices. To accomplish this goal, the NASD has established, in accordance with the requirements of the Securities Enforcement Remedies and Penny Stock Enforcement Act of 1990, a toll free telephone number (1-800-289-9999) to respond to customer inquiries concerning NASD members and their salespersons. Under this 800 number program, customers can receive, with respect to any registered representative's employment history, final disciplinary actions taken by federal, state and foreign regulators and by SROs, criminal indictments and convictions, pending NASD disciplinary actions and arbitration awards.

The Staff believes that information concerning a broker's disciplinary history is particularly important to investors at the time they open an account or establish a relationship with a particular registered representative. The selection of a registered representative that meets the financial needs, goals and objectives of an investor is a critically important decision. Often an unknown salesperson's pitch is an attempt to pressure the investor to open an account immediately in order to take advantage of a "good deal." The Staff believes that to better protect the interests of investors, customers should be made aware of the availability of disciplinary history information regarding the firm and the registered representative through the toll free hot-line operated by the NASD.

Accordingly, the Staff recommends that the SROs adopt necessary rules requiring their member firms to disclose to investors, prior to effecting any transaction in a new account, information relating to the availability and scope of the NASD 800 number.

10. Public Disclosure by all SROs of Initiated Disciplinary Actions

Historically, in contrast to the practice at the Commission, initiated disciplinary actions at the various SROs have not been made public. The SROs have not made public the filing of charges against member firms or registered representatives, and information concerning the disciplinary process is generally not made public until the process is completed, in the case of a settled matter, or until administrative appeals at the SRO have been exhausted.

The Staff believes that the lack of disclosure with respect to SRO disciplinary proceedings is no longer consistent with the public interest and should be changed. By not disclosing disciplinary actions when charges are brought, investors may be unaware that a registered representative with whom he or she is dealing, or is planning to deal, is currently charged with a significant sales practice violation. Moreover, keeping SRO disciplinary proceedings private encourages proposed respondents to prolong the proceedings to delay the disclosure of the matter. In contrast, the Commission's

procedures provide for disclosure of enforcement actions brought in court and administrative proceedings at their inception, which provides investors with timely information regarding the disciplinary histories of brokers.

The Staff recommends that all SROs should make public disciplinary actions against member firms and individuals when the SRO initiates the disciplinary action by filing formal charges. The NASD began disclosing its initiated disciplinary actions in July 1993. The NYSE's Board of Directors approved a proposal to make its statements of charges public by having them available through the CRD. The disciplinary filings to the CRD from the NYSE commenced on April 25, 1994. Other exchanges, however, do not publicly disclose their disciplinary actions until the matter has been resolved or action completed by the SRO. The Division believes that, once an SRO has made a determination that there is probable cause for believing the securities laws or the rules of the SRO have been violated and has actually initiated a disciplinary action, this information should be publicly available through inclusion in the CRD maintained by the NASD on behalf of the states and the SROs. In addition to the benefits to investors of inclusion of this information in the CRD, such disclosure will remove existing benefits firms receive from dilatory tactics that delay resolution of the disciplinary proceeding.

V. CONCLUSION

The protection of customers from sales practice abuse is critical to the objectives of the Commission and the SROs. The Large Firm Project disclosed that the efforts to combat sales practice abuse need to be improved and strengthened by the securities industry, the SROs and the Commission.

The Project involved only a small sample of the total number of securities firms and, of the firms selected, only a small portion of the branch offices and registered representatives at those firms. As a result, it is not possible to draw general conclusions regarding the securities industry as a whole with respect to its hiring, retention and supervisory practices. However, in the small sample selected for examination, a disproportionate number of referrals for further investigation and enforcement consideration were made which suggests that existing supervisory and compliance systems need improvement and that existing levels of sanctions for sales practice violations at both the Commission and SRO level need to be strengthened.

The Staff believes that the Commission, the SROs and the securities industry should work together to identify problem registered representatives at an early stage. Once identified, steps should be taken to reduce the potential for future sales practice abuse through aggressive enforcement action and close scrutiny at the time that hiring and retention decisions are made. The Staff recommends that the Commission and the SROs consider prompt implementation of the recommendations contained in this report, which are designed to build on and improve existing supervisory and regulatory systems.

The Large Firm Project did reveal some encouraging signs with respect to large firm handling of salespersons with histories of customer complaints. Approximately 36% of the registered representatives identified for examination are no longer employed in the securities industry, and most of the departures were due to bars, criminal proceedings, or other regulatory review or enforcement proceedings. This suggests that, to some extent,

brokers who engage in abusive sales practices are being identified and terminated. Moreover, the fact that most of the enforcement referrals coming out of the Project involved three of the nine firms suggests that, at least in that universe of firms, sales practice problems involving "rogue" brokers are not systemic.

Ultimately the question of how to deal effectively with problem, or "rogue," brokers is only one of many issues confronting the Commission and the SROs in the area of sales practices. Completion of this Project, therefore, is only one part of an overall program to increase the emphasis on identifying and prosecuting sales practice violations. The Staff intends to continue to identify and target so-called "rogue brokers" in its examination and enforcement programs. The Staff also intends to look closely at other sales practice issues, such as bank-affiliated sales activities, mutual fund sales and advertising, and "cold calling" practices at broker-dealers.

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- 3/ An enforcement referral is an examination which the staff deems to be of sufficient concern to warrant further investigation and possible enforcement action. The fact that an examination has been referred to enforcement staff does not necessarily mean that a violation of the sales practice rules or the anti-fraud provisions of the securities laws has occurred, or that an enforcement case will be brought involving the branch or registered representative whose conduct is the subject of the referral.
 - 3/ The July 16, 1992 letter requested that the firm provide a list of the fifty largest revenue producing registered representatives in each of the last three years (1990, 1991, 1992 year-to-date) for both options products and all securities products.
 - 3/ See page 2 and page 4 of Appendix A for a complete description of Form U-4 and Form U-5, respectively.
 - 3/ NYSE Rule 351, among other things, requires its member firms to submit to the Exchange, on a quarterly basis, summary information concerning all customer complaints the member firm received during that quarter.
 - 3/ The letter requested information regarding individuals who were not necessarily subject to a statutory disqualification. Generally speaking, a person is subject to a statutory disqualification if that person has been convicted of any felony or certain enumerated misdemeanors within the last ten years; is enjoined temporarily or permanently from violating the securities laws by a court of competent jurisdiction, or has been and is barred from association with a broker-dealer by the Commission, the Commodity Futures Trading Commission, an SRO or the foreign equivalent thereof. See Section 3(a)(39) of the Securities Exchange Act of 1934.
 - 3/ The July 16, 1992 letter requested that the firms identify 50 registered representatives with the largest number of written sales practice related customer complaints in each of the last three calendar years, 1990, 1991, or 1992 (through June 30).
 - 3/ As noted in the discussion contained in Appendix A, NYSE Rule 351, among other things, requires its member firms to submit to the Exchange, on a quarterly basis, summary information concerning all customer complaints the member firm received during that quarter.
 - 3/ Appendix A contains a detailed description of current SRO investigation and enforcement programs.
 - 3/ Appendix A contains a detailed description of current SRO reporting obligations and the NYSE and NASD investigative processes that certain of these reports trigger.

APPENDIX A

APPENDIX A

This appendix discusses information that the SEC and/or SROs require broker-dealers and persons seeking to become associated with broker-dealers to provide to the SEC and/or SROs. The appendix also discusses the continuing reporting obligations of firms and their associated persons. Lastly, the appendix describes the SROs' investigatory process after the SROs receive the information described above.

I. Current Reporting Requirements

The Securities Exchange of 1934 ("Exchange Act") and SRO rules^{1/} require that broker-dealers and their associated persons disclose specific relevant information during the initial licensing and registration process. Regulators consider this information in determining whether to register or license a firm or individual. Individuals and entities seeking broker-dealer registration must disclose information relating to criminal convictions, civil litigation and administrative proceedings if applicable. In addition, after a broker-dealer or associated person is registered or licensed with the SEC and/or a SRO, the broker-dealers and their associated persons are required to report to the SROs if they have been the subject of regulatory or disciplinary actions, customer complaints or other specifically identified activities or occurrences.^{2/} Upon submission to an SRO of such information, SRO staff generally investigate to determine whether the broker-dealer or associated person has violated securities laws or SRO rules.

A. The Initial Application

1. Broker-Dealers

Pursuant to SEC Rule 15b1-1, an entity initially registering with the Commission as a broker-dealer must complete Form BD. In addition, since January 1993, registrants must file the application with the NASD's CRD system.^{3/} Applicants must disclose on Form BD felonies and misdemeanors involving investments or investment-related business, fraud, false statements or omissions, wrongful taking of property, bribery, forgery, counterfeiting or extortion during the past ten years, and injunctions or findings by a domestic or foreign court in connection with violations of investment-related statutes or regulations during the past ten years. Applicants also must disclose certain sanctions, findings or disciplinary actions by the SEC, Commodity Futures Trading Commission ("CFTC"), federal, state or foreign regulatory authorities and any self-regulatory organization or commodities exchange. After SRO membership is granted, SEC Rule 15b2-2 requires SROs to conduct examinations of new members for compliance with applicable financial responsibility requirements within six months of the effective date of their SEC broker-dealer registration, and for compliance with other applicable provisions of the Exchange Act and rules thereunder within twelve months of the effective date.

2. Registered Representatives

Registered representatives are required to complete a Uniform Application for Securities Industry Registration or Transfer Form (Form U-4) before becoming associated with a broker-dealer. ⁷ Form U-4 requires that firms and individuals report findings and adjudications by domestic and foreign courts, the SEC, the CFTC, federal, state and foreign regulatory agencies, SROs and commodities exchanges involving felony convictions, certain misdemeanors, false statements and omissions and violations of applicable rules. Applicants must also report customer initiated complaints involving; allegations of fraud or wrongful taking of property; allegations of compensatory damages of \$10,000 or more; awards of damages of \$5,000 or more; or settlements of \$5,000 or more. Form U-4 also requires disclosure of unsatisfied judgments or liens, petitions in bankruptcy and any discharges or resignations resulting from accusations involving investment related rules, regulations or statutes, wrongful taking of property or failure to supervise in an investment context.

a. Disciplinary History/Criminal Record

The NASD's Qualifications Section and the NYSE's Qualifications and Registration Section of the Department of Member Firm Regulation review information contained on Form U-4 as part of the registration process for individuals seeking to sell securities. The NASD and NYSE also review Form U-4 in conjunction with reports received from law enforcement officials for fingerprints submitted pursuant to SEC Rule 17f-2, which requires that all broker-dealer employees be fingerprinted. The principal purpose of this review is to identify individuals subject to statutory disqualification who may be ineligible for registration or whose applications may require additional levels of approval under the Exchange Act.

b. Statutory Disqualification

Section 3(a)(39) of the Exchange Act defines "statutory disqualification." Generally speaking, a person is subject to a statutory disqualification if that person has been convicted of any felony or certain enumerated misdemeanors within the last ten years, is enjoined temporarily or permanently from violating the securities laws by a court of competent jurisdiction, or has been and is barred from association with a broker-dealer by the Commission, the CFTC, an SRO or the foreign equivalent thereof.

Any broker-dealer wishing to employ an individual subject to statutory disqualification must first seek approval of an SRO, setting forth any terms and conditions under which the individual would be employed or supervised. The SRO may either deny or consent to the member's request. Sections 6(c)(2), 15A(g)(2) and 17A(b)(4)(A) of the Exchange Act require that SROs give notice to the Commission before admitting to membership any person subject to statutory disqualification or permitting such person to become associated with a member. The form and content of the SROs' notice is prescribed in Rule 19h-1 of the Exchange Act. Should it disagree with the SRO's recommendation to allow the proposed association, the Commission may issue an order directing an SRO to bar the person subject to the disqualification from becoming associated with the member firm. Should an SRO deny the member's request to employ an individual subject to a statutory disqualification, the SRO must notify the Commission of its decision pursuant to Exchange Act Rule 19d-1.

B. Continuing Reporting Obligations

1. Broker-Dealers\Registered Representatives

Once a broker-dealer has become registered with the Commission (and presumably with an SRO), certain events precipitate amended filings of information. Under SEC Rule 15b3-1 broker-dealers are required to amend Form BD if information contained in the application for registration as a broker-dealer becomes inaccurate for any reason. Broker-dealers must also file amendments to Form BD with the NASD's CRD system.

NYSE Rule 351 generally provides that a member firm must report certain occurrences to the Exchange on Form RE-3. Rule 351(a) specifically identifies ten different circumstances where broker-dealers must file a report with the Exchange. See Exhibit 1. These circumstances vary significantly, ranging from situations where a court, government agency or SRO has determined there has been a violation of the securities laws, to circumstances where a firm has received a written customer complaint alleging theft or misappropriation of funds or securities or of forgery.

The spirit of Rule 351 is premised on the NYSE receiving notice of certain events involving member firms or their associated persons so that the Exchange, where appropriate, can investigate. Some of the particular subparagraphs of Rule 351 require specific findings of violations made by a governmental entity or SRO or the initiation of disciplinary action by an SRO against the firm or its employees. At the same time, however, other subparagraphs of Rule 351 require reporting of certain events even though there has been no finding or admission of guilt or a violation.^{2/} Thus, while Form BD requires that firms file a report where there has been a finding of some violation or other improper conduct, the NYSE's RE-3 also requires firms to file reports in instances where there may not be a specific finding of a violation. Although NYSE members are not required to file a Form RE-3 when a written customer complaint is received alleging damages in excess of \$10,000^{3/}, Rule 351(d) nevertheless requires members to provide the Exchange, on a quarterly basis, with summary statistics regarding customer complaints received by the member firms relating to the firm or any associated person.

Schedule C, Part V of the NASD By-Laws and NYSE Rule 351 require that members promptly notify the NASD and the Exchange of any disciplinary action taken by any national securities exchange or association, clearing corporation, commodity futures market or government regulatory body against itself or its associated persons. The rules also require that firms notify the NASD of any disciplinary action taken by the member itself against any of its associated persons involving suspension, termination, the withholding of commissions or imposition of fines in excess of \$2,500, or any other significant limitation on activities. Article IV, Section 2 of the NASD By-Laws requires that registered representative applications for registration with the NASD be kept current at all times by supplemental amendments to the original application.

C. Terminations

1. Broker-Dealers (Form BDW)

SEC Rule 15b6-1 requires that broker-dealers give notice of withdrawal of registration on Form BDW which, since January 1993, broker-dealers must file with the NASD's CRD system. Form BDW requires disclosure of any proceedings and unsatisfied judgments or liens not disclosed on Form BD, as well as unsatisfied customer claims not disclosed elsewhere on Form BDW.

2. Registered Representatives

Under Article IV, Section 3 of the NASD By-Laws and NYSE Rule 345.17, members must provide the NASD and NYSE, respectively, with written notice of termination of any registered person. In addition to notifying the SROs of the termination of association between the broker-dealer and registered representative, the Form U-5 ("Uniform Termination Notice for Securities Industry Registration") requires that firms report: any disciplinary action, investigation or proceeding by a domestic or foreign governmental body or SRO with jurisdiction over investment related business; convictions or guilty pleas in a foreign or domestic court involving felonies or certain misdemeanors; internal investigations involving fraud or wrongful taking of property or violations of investment related statutes or regulations; investment related consumer initiated complaints that alleged compensatory damages of \$10,000 or more, that alleged fraud or the wrongful taking of property, that were settled or decided against the individual for \$5,000 or more, or where the broker-dealer found fraud in the wrongful taking of property. / The purpose of the timely filing of the termination notice is to provide the SROs with a mechanism for reviewing past conduct of terminated registered representatives before the SROs lose jurisdiction over the registered representatives.

II. SRO Investigation and Enforcement Programs

The NYSE and NASD differ in their investigatory and enforcement processes. These differences, in part, relate to the NYSE's centralized location in New York City, and the NASD's eleven district offices. While the NYSE's regulatory and enforcement programs are located in New York, the NASD primarily operates its routine examination, investigation and enforcement programs from its district offices.

A. Enforcement Programs

1. NYSE

The NYSE's Enforcement Division contains a Preliminary Investigation Unit ("P.I. Unit") whose responsibility is to conduct a preliminary investigation concerning all matters that come to the Enforcement Division. For example, the P.I. Unit will preliminarily investigate Form RE-3 filings, Form U-5 filings, and referrals from other SROs or the SEC. The P.I. Unit handles the initial review of the specific items to determine if the Enforcement Division should open a formal investigation. Before making any decisions to proceed further or to discontinue an investigation, the P.I. Unit

gathers certain information, commonly known as the P.I. protocol, which requires that the unit obtain certain information before making any decision to open a formal investigation. For typical allegations of sales practice abuses, the Enforcement staff generally obtains statements from the customer, the registered representative and the firm involved, reviews the customer's new account information and relevant account statements and reviews other customer complaints involving the registered representative.^{8/}

The NYSE has increased its enforcement staff from 42 in 1985 to 111 at the end of 1993. Along with this increase in staffing, the Exchange in recent years has brought many more disciplinary actions against member firms and their associated persons.^{9/} Many of these matters, such as the Shearson and PaineWebber cases, involved significant sales practice abuses and resulted in significant fines and other sanctions against the member firms.^{10/} Moreover, because much of the current regulatory review of abusive sales practices is linked to member firms and/or their associated persons filing required reports with an SRO, the NYSE in recent years has taken steps to assure that member firms and their associated persons follow their reporting obligations and timely submit reports for regulatory review. In this regard, the NYSE's ability and commitment to ensuring that member firms promptly file reports of events such as settlements of civil lawsuits or arbitrations and terminations from employment, has improved substantially. The Exchange notified its membership in early 1990 of the importance of complying with its reporting requirements, warning that non-compliance may subject them to "appropriate disciplinary action."^{11/}

At the same time that the NYSE aggressively attempted to educate its member firms with regard to their reporting obligations, it also brought a number of formal and informal disciplinary actions against member firms for failure to file required reports or for failing to file such reports in a timely manner. The appropriate disciplinary actions that the Exchange can and has taken against member firms for non-compliance ranges from informal action,^{12/} intermediate sanction under NYSE Rule 476A^{13/} and finally, when the member is especially recalcitrant, the Exchange will bring a formal disciplinary action against the member. The combination of an effective educational campaign and aggressive enforcement activity with regard to the reporting rules has been effective.

2. NASD

The NASD carries out its regulatory and enforcement responsibilities through several committees reporting to the NASD's Board of Governors. The general review of sales practice related problems, whether a customer complaint, termination for cause, amendment to a Form U-4 or notice of disciplinary action taken by a member firm against a registered representative, occurs in the NASD district office where the particular registered representative is located.

The NASD has increased resources devoted to regulatory and enforcement programs in its headquarters office and in fourteen District Offices across the country during the past ten years. In particular, the two groups most involved in investigating the types of issues addressed in this Report have both experienced significant expansions. These are the Enforcement Department and the fourteen District Offices.

a. Enforcement Department

The NASD's Enforcement Department investigates and prosecutes many of the NASD's most complex cases, many of which include market manipulation activities involving member firms or their employees. The Department's origins date to the mid-1970's when the Department was then known as the Anti-Fraud Unit. Since that time, the Anti-Fraud Unit has expanded from four examiners, each located within a separate district office, to a centralized enforcement unit of 43 persons within NASD headquarters. Because of the nature of the alleged violations investigated by the Enforcement Department, many cases are often considered by the NASD's Market Surveillance Committee rather than a District Business Conduct Committee ("DBCC").

b. District Offices

The NASD routinely reviews sales practice activities of member firms through examination and regulatory programs administered by the NASD's fourteen District Offices. Possible material violations of the federal securities laws, Municipal Securities Rulemaking Board ("MSRB") or NASD rules are presented to a DBCC for possible formal disciplinary action, if appropriate. In the last ten years, the NASD District Office staff has increased from 363 to 578 employees.

B. SRO Investigation Programs

The SRO investigation programs involve the review of customer complaints, members' notices of disciplinary action, judgments, awards and settlements, and terminations. In regard to customer complaints, in cases where SROs directly receive customer complaints involving the SROs' members and their employees, the SROs review the complaints as part of the SROs' regulatory or compliance programs. At the NASD, the district offices review customer complaints; at the NYSE, the Division of Member Firm Regulation reviews such complaints. When an initial investigation reveals evidence of a violation of federal securities laws or SRO rules, NYSE and NASD staff refer the customer complaint to the SRO's enforcement program for possible disciplinary action against the member or its associated persons.

As discussed in the enforcement program section of this appendix, the NASD and NYSE also routinely review customer complaints received by member firms and reported on Forms U-4, U-5 and RE-3. The SROs also utilize customer complaint information in both the planning and on-site review stages of their broker-dealer examination programs.

In regard to members' notices of disciplinary actions, the NASD district offices review such notices. Similarly, the NYSE Enforcement Division reviews the members' notices filed with the NYSE on Form RE-3, applying the same preliminary investigation protocol applied to Form U-5. The NASD Qualifications Section reviews judgments, awards and settlements, reported on Forms U-4 and U-5, and the NYSE Enforcement Division reviews the same information reported to that Exchange on Form RE-3 pursuant to NYSE Rule 351.

Finally, in regard to terminations for cause, the NASD's Qualification Section reviews information contained in Form U-5 relating to the termination of registered

representatives for cause. The Qualifications Section refers this information for investigation to the NASD's district offices. Pursuant to Article IV, Section 4 of the NASD By-Laws, the Association retains jurisdiction over a registered representative for two years after termination of registration with the NASD; the By-Laws, however, allow additional time for the NASD to begin formal disciplinary action when actionable conduct is disclosed on an amended Form U-5 within two years of the original filing.

The NYSE's Enforcement Division reviews information related to terminations for cause contained on Form U-5 and filed with the Exchange. This information is subject to the same preliminary investigation protocol procedures applied to information contained on Form RE-3. The NYSE retains jurisdiction over the registered representative for one year following termination of registration with the NYSE.

III. SRO Reporting & Availability to the Public

A. SEC Rule 19d-1

SEC Rule 19d-1 requires that SROs provide to the Commission notice of final disciplinary action taken against member firms and associated persons. Decisions in SRO disciplinary actions are referenced in securities violations bulletins and are available for review in the Commission's public reference rooms. In some instances, SROs provide decisions of formal disciplinary actions directly to public organizations such as research libraries or the press.

B. Uniform Disciplinary Act Reporting Form (Form U-6)

Form U-6 is a uniform form for reporting, to the Commission and the NASD, disciplinary actions involving broker-dealers and associated persons. State and federal law enforcement and regulatory agencies, securities and commodities exchanges and self-regulatory organizations in the United States and foreign countries use this form. It is designed for the reporting of a broad range of actions such as indictments, criminal convictions, temporary and permanent injunctions, fines, liquidations and censures.

C. NASD Public Disclosure Program

In 1988, the Commission approved the implementation of a Public Disclosure Program by the NASD.^{12/} The purpose of this program was to permit members of the public to have access to information to help them to determine whether to conduct, or to continue to conduct, business with an NASD member or any of the member's associated persons. Through the Public Disclosure Program, the NASD released certain information about the employment and disciplinary history of its members and their associated persons in response to written inquires from the public.

In October 1990, Congress enacted the Securities Enforcement Remedies and Penny Stock Reform Act of 1990^{13/} ("Penny Stock Reform Act"). Among other things, the Penny Stock Reform Act mandated that the NASD establish a toll-free telephone number to receive customer inquiries concerning the disciplinary history of its members and their associated persons.^{14/} The NASD enhanced its Public Disclosure Program with the introduction of an 800 number service ("800 Service") on October 1, 1991.^{15/}

Through this service the NASD reported: (1) past and present employment history of associated persons of NASD members; (2) all final disciplinary actions ^{18/} taken by federal, state, or SROs against NASD members and their associated persons that relate to securities or commodities transactions; and (3) all criminal convictions reported on Form BD or Form U-4.

In July 1992, the House Subcommittee on Telecommunications and Finance requested that the General Accounting Office ("GAO") conduct a review of the rules, procedures, facilities, and oversight and enforcement activities with respect to the Penny Stock Reform Act. Congress specifically asked the GAO to review the operation of the NASD's 800 Service. ^{19/} The GAO undertook a study of the implementation of the Penny Stock Reform Act and recommended, among other things, that the NASD "provide public investors who request information via the NASD's toll-free service with information on final arbitration awards." ^{20/} Both the Commission and the NASD concurred in this recommendation. ^{21/}

On July 1, 1993, the Commission approved an NASD rule change to permit the NASD to release certain additional information contained in the CRD system regarding the disciplinary history of its members and their associated persons through the 800 Service. The rule change expanded the scope of the information that is reportable to include: (1) pending formal disciplinary proceedings initiated by federal or state securities agencies and SROs, ^{22/} as well as pending and final disciplinary actions taken by foreign governments or foreign regulatory authorities; (2) criminal indictments or information; (3) civil judgments; and (4) arbitration decisions in securities and commodities disputes involving public customers. ^{23/} The NASD discloses final arbitration decisions involving only public customers that are reported on Form U-4 or that are available through the NASD's existing arbitration data base. The NASD data base captures all member and associated person arbitration decisions issued by the NASD arbitrators after May 10, 1989. ^{24/}

The NASD procedures call for a copy of the information requested to be sent to the person requesting it and to the subject of the request, *i.e.*, the member firm or an associated person. Each NASD member firm receives a monthly print-out with the number of requests made concerning the firm and its associated persons, as well as the names of those associated persons about whom customers have made requests. In addition, each such associated person receives a report with all the information that the NASD sent to the requestor. The NASD removes the name and address of the requestor from these reports and does not reveal that information to either the member firm or its associated person. The NASD does not charge a fee for responding to inquiries from callers planning to use the information for their personal investments. Callers, however, who are planning to use the information in their capacity as an agent for an investor or for other business or commercial uses are charged a \$30 fee per inquiry.

When the NASD first introduced the 800 Service they received approximately 140 calls per day. In January 1993, when the NASD announced the expansion of the information disclosed through the 800 Service, the average daily call volume was approximately 200 calls per day. During the first week after the NASD expanded the 800 Service, the NASD received about 1,600 requests for information each day. During July and August 1993, the NASD received about 800 calls a day and in September 1993, received about 600 calls a day. Since September the number of calls to the 800 Service

has declined. Between approximately the end of November 1993 and February 1994, the number of calls to the NASD's 800 Service has leveled off to about 250 calls a day.

Finally, the Division of Market Regulation has requested that all SROs operating arbitration programs forward information concerning arbitration decisions rendered in their forum directly to the CRD system so that this information is consistently disclosed to the public regardless of the arbitration forum and regardless of whether the registered representative timely files or amends a Form U-4 or RE-3.

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- ^{1/} Federal legislation and SRO rules require broker-dealer registration. See 15 USC § 78o. Associated persons of broker-dealers, including registered representatives, are required to pass SRO qualification examinations and must be licensed by the states. The federal government does not require the licensing and registration of associated persons. The Commission, however, recently adopted Rule 15b7-1, which makes it a violation of the Exchange Act for a broker-dealer to have an associated person who has not complied with SRO registration requirements.
- ^{2/} See Securities Exchange Act Rule 15b3-1, 17 C.F.R. § 240.15b3-1 (requires broker-dealers to amend promptly their Form BD); NYSE Rule 351 (requires firms to file Form RE-3 when certain events occur); Article II, Section 2, NASD By-Laws (enables the NASD to adopt qualification requirements for persons associated with member firms, i.e., Form U-4); Article IV, Section 3, NASD By-Laws (requires members to notify the NASD if the member terminates any persons associated with the member).
- ^{3/} Developed jointly by the North American Securities Administrators Association ("NASAA") and the NASD in 1981, the CRD, which the NASD operates, is an on-line data base containing information pertaining to broker-dealers and their associated persons. Information contained in the CRD is provided by the NASD, SEC, some exchanges, the Commodity Futures Trading Commission, the National Futures Association, state securities commissions, and the Federal Bureau of Investigation. The CRD database includes about 5,500 broker-dealers and 460,000 active registered persons.
- ^{4/} An applicant for registration with an NASD member firm must complete Form U-4, pursuant to Article IV, Section 2 of the NASD By-Laws. Similarly, NYSE Rule 345.12 requires persons preparing to become associated with NYSE firms to file and keep current Form U-4.
- ^{5/} For example, the rule requires broker-dealers to report arrests for other than minor traffic incidents, and settlements of litigation or arbitration where the member firm paid a customer an amount in excess of \$25,000.
- ^{6/} The registered representative, however, is still required to amend the Form U-4 when the registered representative is the subject of a written customer complaint alleging compensatory damages in excess of \$10,000 or where the registered representative settles and is responsible for any amount in excess of \$5,000. See NYSE Rule 345.10-12.
- ^{7/} Members must file an Amended Form U-5 in the event that the member learns of facts or circumstances causing information in the Form U-5 termination notice to be inaccurate or incomplete. To be considered timely, members must file amendments not later than 30 days after the firm learns the facts or circumstances giving rise to the amendment. Thus, if the broker-dealer receives a customer complaint involving a former registered representative, the broker-dealer is required to file an Amended Form U-5.
- ^{8/} There are some matters which are not subject to a P.I. review but are immediately opened as an enforcement matter. These matters includes Market Surveillance and Member Firm Regulation referrals.
- ^{9/} In 1988 the NYSE completed 58 formal disciplinary actions. The Exchange completed 119, 191, 212, 194, and 189 enforcement actions in 1989, 1990, 1991, 1992 and 1993, respectively.

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- ^{10/} Shearson Lehman Bros., HPD 91-59 (May 14, 1991) \$750,000 fine; PaineWebber Securities, Inc., HPD 91-192 (November 15, 1991) \$900,000 fine.
- ^{11/} See Information Memo Number 90-17, "Timely and Complete Filings and Responses to Enforcement Inquiries" (April 30, 1990). Pursuant to NYSE Rule 345, entitled "Employees--Registration, Approval, Records", member firms are required to timely submit to the Exchange notices of termination of employment with a member (Form U-5). Pursuant to NYSE Rule 351, entitled "Reporting Requirements", members are required to report certain events to the NYSE on Form RE-3 such as the initiation or conclusion or settlement of certain proceedings. For example, members are required to report settlements of claims against a registered representative for over \$15,000 or against a member for over \$25,000, as well as certain firm, SRO, SEC or other governmental actions or sanctions.
- ^{12/} The Exchange may issue letters of caution or letters of admonition to the offending member for failing to file certain information with the Exchange in a timely manner. These letters are considered informal actions.
- ^{13/} NYSE Rule 476A, entitled "Imposition of Fines for Minor Violation(s) of Rules," is known as the "traffic ticket" rule. This rule permits the Exchange to summarily fine a member up to \$5,000 for not timely filing; certain employee registration or termination information with the Exchange (Forms U-4 and U-5 respectively); certain types of pending or final disciplinary proceedings; or pending customer complaint information. The Exchange is not required to hold a hearing to issue a traffic ticket and payment is considered a waiver of any rights to a hearing. If the firm or individual contests the ticket, then the matter becomes a disciplinary proceeding.
- ^{14/} Securities Exchange Act Release No. 25604 (April 20, 1988). 53 FR 14878 (April 26, 1988) (approving File No. SR-NASD-88-14).
- ^{15/} Pub. L. No. 101-429, 104 Stat. 931 (1990) (codified at 15 U.S.C. § 78q-3(i) (1988 & Supp. 1992)).
- ^{16/} The legislative history of the Penny Stock Reform Act provides that Congress expects that "the Commission, the state regulators, and registered securities associations will consult with one another to try and develop a common approach to this issue, one which fulfills the informational needs of the customers and assures the maximum level of investor protection." H.R. Rep. No. 617, 2d Sess. (1990) (emphasis added).
- ^{17/} Securities Exchange Act Release No. 30629 (April 23, 1992), 57 FR 18535 (April 30, 1992) (approving File No. SR-NASD-91-39).
- ^{18/} The term disciplinary action as used by the NASD includes, but is not limited to, the information provided in response to questions 7 B, C, D, E, and F on Form BD; and questions 22 C, D, E, F, and G on Form U-4.
- ^{19/} See Letter from Edward J. Markey, Chairman of the Subcommittee on Telecommunications and Finance, to Charles A. Bowsber, Comptroller General of the United States (July 17, 1992). Section 510 of the Penny Stock Reform Act directs the Comptroller General to conduct a review of the implementation of the Penny Stock Reform Act, and to submit a report to Congress with any recommendations.
- ^{20/} See GAO, Penny Stocks: Regulatory Actions to Reduce Potential for Fraud and Abuse (February 1993) at 48. ("GAO Report").

^{21/} See Letter from William Heyman, Director, Division of Market Regulation, SEC, to Richard Fogel, Assistant Comptroller General, General Accounting Office (November 27, 1992); GAO Report at 60 and 65; and Letter from John E. Pinto, Executive Vice President, Compliance Division, NASD, to R. Fogel, GAO (November 27, 1992).

^{22/} In addition to the information disclosed on Forms BD or U-4, all pending NASD initiated disciplinary actions, whether or not disclosed on Forms BD or U-4, are provided through the 800 Service.

^{23/} Securities Exchange Act Release No. 32568 (July 1, 1993), 58 FR 36723 (July 8, 1993) (approving File No. SR-NASD-93-26).

^{24/} Beginning July 1, 1993, the NASD began disclosing arbitration awards involving public customers rendered in its forum in two phases. Until September 1, 1993, the NASD disclosed arbitration awards reported on Form U-4 and those awards in its arbitration data base that date back to August 6, 1990. On September 1, 1993, the NASD expanded its disclosure to include arbitration awards in its data base that date back to May 10, 1989.

EXHIBIT 1

NYSE RULE 351.(a)

Rule 351. (a) Each member not associated with a member organization and each member organization shall promptly report to the Exchange whenever such member or member organization, or any member, allied member or registered or non-registered employee associated with such member or member organization:

(1) has violated any provision of any securities law or regulation, or any agreement with or rule or standards of conduct of any governmental agency, SRO, or business or professional organization, or engaged in conduct which is inconsistent with just and equitable principles of trade or detrimental to the interest or welfare of the Exchange;

(2) is the subject of any written customer complaint involving allegations of theft or misappropriation of funds or securities or of forgery;

(3) is named as a defendant or respondent in any proceeding brought by a regulatory or self-regulatory body, alleging violation of any provision of the Securities Exchange Act of 1934, or of any other Federal or state securities, insurance, or commodities statute, or of any rule or regulation thereunder, or of any agreement with, or of any provision of the constitution, rules or similar governing instruments of, any securities, insurance or commodities regulatory or self-regulatory organization;

(4) is denied registration or is expelled, enjoined, directed to cease and desist, suspended or otherwise disciplined by any securities, insurance or commodities industry regulatory or SRO or is denied membership or continued membership in any such SRO; or is barred from becoming associated with any member or member organization of any such SRO;

(5) is arrested, arraigned, indicted or convicted of, or pleads guilty to, or pleads no contest to, any criminal offense (other than minor traffic violations);

(6) is a director, controlling stockholder, partner, officer or sole proprietor of, or an associated person with, a broker, dealer, investment company, investment advisor, underwriter or insurance company which is suspended, expelled or had its registration denied or revoked by any agency, jurisdiction or organization or is associated in such a capacity with a bank, trust company or other financial institution which was convicted of, or pleaded no contest to, any felony or misdemeanor;

(7) is a defendant or respondent in any securities or commodities-related civil litigation or arbitration which has been disposed of by judgment, award or settlement for an amount exceeding \$15,000. However, when a member organization is the defendant or respondent, then the reporting to the Exchange shall be required only when such judgment, award or settlement is for an amount exceeding \$25,000;

(8) is the subject of any claim for damages by a customer, broker or dealer which is settled for an amount exceeding \$15,000. However, when the claim for damages is against a member organization, then the reporting to the Exchange shall be required only when such claim is settled for an amount exceeding \$25,000;

(9) is, or learns that he is associated in any business or financial activity with any person who is, subject to a "statutory disqualification" as that term is defined in the Securities Exchange Act of 1934;

(10) is the subject of any disciplinary action taken by the member or member organization against any of its associated persons involving suspension, termination, the withholding of commissions or imposition of fines in excess of \$2,500, or any other significant limitation on activities.
