

August 21, 1987

Richard G. Ketchum, Esq.  
Director  
Division of Market Regulation  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549

Dear Mr. Ketchum:

Your letter of July 22, 1987 to Mr. Phelan, concerning the Exchange's enforcement program, has received the immediate attention it warrants.

We want the Commission to know that the highest priority at the Exchange will be to correct the deficiencies noted in your letter relating to sales practice referrals from the Commission and customer complaints, and to assure that our Enforcement Division achieves the highest standards.

We would like to give you a brief history of our regulatory efforts during the past several years because we believe it demonstrates the Exchange's commitment to effective regulatory practices. In 1984, the Exchange embarked upon a five-year program to significantly improve and upgrade its regulatory capability. We added personnel, installed systems and substantially overhauled our operating procedures. These efforts have shown significant improvement in the Member Firm Regulation and Market Surveillance Divisions.

In order to respond to your criticisms as quickly as possible, we are taking the following initiatives:

- Twenty-two additional staff persons have been authorized for the Division of Enforcement; some positions have already been filled, and the remainder will be filled by the end of September. A special training program is being developed to assure that these employees will be integrated in the shortest timeframe possible.
- The number of enforcement units is being increased from four to six and a separate Sales Practice Department is being established to investigate and prosecute significant sales practice cases.
- Milbank, Tweed, Hadley & McCloy, outside counsel for the Exchange, with experience in these matters, has been engaged to review all Sales Practice cases that have been open for longer than one year to expedite the issuance of charges, settlements, and closing of investigations by the end of 1987. In addition, all prior recommendations made by the SEC in

earlier inspection reports will be reviewed to ensure that they are in place and are being implemented.

- All referrals made to the Exchange in 1987 by regional offices of the SEC are being reviewed to assure that they are being properly handled.
- New procedures will be applied to all cases opened in 1987 so that these matters do not “age” by inactivity as other cases have in the past.
- Senior management and Human Resources will accelerate a program to improve the quality and attitude of the Enforcement staff.
- Several significant management changes will be made.
- The Exchange’s Regulatory Quality Review Department and outside counsel will periodically review the adequacy of the Enforcement Division’s procedures and practices.

The recommendations made by your staff will be handled as follows:

Customer Complaint Department (“CCD”):

Recommendation 1 & 2

Specific steps should be taken to assure that CCD’s existing policies of investigating or referring cases notwithstanding pending litigation or arbitration and of referring matters to appropriate departments, are consistently implemented.

Response:

We agree that current policies should be carried out and the Manager and/or Managing Director will spot check such matters on a routine basis to assure implementation of these policies.

Recommendation 3:

CCD’s responses to complainants should be modified to enable them to understand the Exchange’s investigation process and that any disciplinary action which may result will be publicly announced by the Exchange. In addition, the staff recommends that CCD modify its form letters to inform the Commission when matters are referred to Enforcement and to modify procedures so that its logs are consistent with actual case disposition or status.

Response:

It is important that our responses to complainants properly explain the Exchange's investigatory process. In this connection, CCD has used the following language in form letters which involve a possible monetary dispute and are sales practice related:

“In handling of complaints, the Exchange seeks to create a mutual understanding between the complainant and the firm by affording both parties the opportunity of presenting their version of the facts to the other. Often this will lead to an amicable resolution to a problem or will provide the complainant with a satisfactory explanation of a situation. At the same time, the staff of the Exchange examines all customer complaints to determine whether a firm or its representatives committed any violations of Exchange rules or ethical business practices. However, findings of any violations are made only after a full investigation and an administrative hearing before an Exchange hearing panel. Any disciplinary actions taken are made public only through the news media.”

In the future, the language noted above will be included as part of all appropriate letters. CCD had modified its letters to the Commission to include notice when a referral is made to another department of the Exchange; i.e., Enforcement, Market Surveillance, etc. Further, the Manager will spot check internal logs to verify that they are consistent with actual case disposition or status.

Recommendation 4:

To assure the receipt of prompt responses from member organizations in the context of customer complaints, a specific range of steps should be taken, including, where appropriate, enforcement referrals. It also is recommended that CCD gain access to a CRD terminal so as to afford a direct opportunity to review the disciplinary and employment history of registered personnel.

Response:

We agree with your recommendations and CCD has taken the following steps to assure prompt responses from the membership:

- a. Creation of a tickler system to monitor responses following an initial request, so that follow-up letters are sent and telephone calls are made according to pre-existing procedures.

- b. We have filed an amendment to Rule 476A setting forth a penalty program to deal with member organizations not responding within the time period specified by the Exchange.
- c. Organizations which exhibit a pattern of delay in their responses beyond 45 days may be referred to the Enforcement Division for failure to cooperate.
- d. Form letters will be modified to notify the membership of the specific steps which will be taken when a complete response is not received within a specified time period.
- e. Two CRD terminals are expected to be installed for CCD during the fourth quarter of 1987.

The Enforcement Division ("Enforcement")

Recommendation 1:

Under previously existing "no-open" procedures, Enforcement did not have sufficient information to determine whether violations existed before deciding not to open an investigation. The staff has expressed the need to consistently implement the presently existing (revised) procedures.

Response:

We agree and will apply and implement the present "no-open" procedures. We also will review the eight "no-open" cases adversely commented upon in your letter using the new procedures.

Recommendation 2:

After opening an investigation, Enforcement failed to investigate referrals thoroughly in four out of six cases examined. Accordingly, Enforcement's written procedures should be modified to require that cause investigations thoroughly address the customer's allegations as well as issues raised during the course of the investigation.

Similarly, concern was expressed that Enforcement's Procedures and Policy Manual does not address the matter of adequate documentation when Enforcement defers an investigation to another SRO which is conducting a parallel investigation.

Response:

We will set forth in the Procedures and Policy Manual that investigations of sales practice matters should be expanded. The procedures will require additional accounts of a registered representative or additional accounts in a branch office to be reviewed if the violations indicate that the registered representative would likely engage in similar conduct in other accounts or that the violations could have taken place only in an environment in which supervision was inadequate. In addition, the procedures will set forth circumstances which require previous and subsequent employer reviews.

Moreover, the Exchange will review its procedures as they relate to on-site inspections. Finally, our procedures will also provide that when the Exchange no longer has jurisdiction over a matter a referral of the matter will be made to the Commission.

In instances where investigations are deferred to another SRO, the unit which is charged with maintaining liaison with other SROs will send a letter to that SRO or other regulatory body confirming our understanding that their investigation will cover all aspects of the matter, including supervision. A copy of this letter will be inserted in the file. (See Section XVA (3) of new manual).

In order to make sure these procedures are carried out, Enforcement Directors will be required to review each file before it is closed and sign the case folder to indicate that appropriate procedures have been followed.

Recommendation 3:

Serious delays were encountered in all phases of the enforcement process. This should be addressed in terms of increased staff, implementation of good supervisory techniques and a commitment to aggressively investigate cases.

Response:

We agree with your recommendations and as previously stated, the Exchange is substantially increasing the Enforcement staff thereby reducing the individual attorney case load, and increasing and strengthening management. It is also reviewing the "swing" category and will be establishing new procedures which will assure more expeditious handling of all matters.

We believe these steps will greatly reduce the time it takes to conclude investigations and permit a more aggressive enforcement policy in all areas of Exchange responsibility, particularly with respect to sales practice violations and member firm supervision.

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Recommendation 4:

Miscellaneous deficiencies in Enforcement documentation included failure to maintain chronological logs, as required by Enforcement's procedures, failure to maintain organized files and failure to produce all of the requested files (although significant improvements were noted in this area since the last inspection).

Response:

We are concerned with the lack of proper documentation in investigatory files. In order to assure that proper procedures are being followed, an Enforcement Director will be required to sign the case folder before it can be closed, indicating that he has reviewed the file and that it is properly documented and organized. A sample of open cases will also be reviewed to see that they are properly documented and organized.

The Exchange has made improvements in its central records retrieval procedures and will commit additional resources if necessary to achieve a 100% retrieval rate in the future.

The matters referred to in this letter will be implemented no later than October 21 and we will keep the Commission informed of our progress. Comments made in your letter about particular cases have, in some instances, been responded to and we will meet with your staff within the next two weeks to respond to all the Commission's comments relating to particular cases.

The Board of Directors has been advised of the deficiencies noted in your inspection and the steps we intend to take to correct such deficiencies.

Finally, we would like to reaffirm our commitment to investor protection and to the necessity for vigorously investigating and prosecuting sales practice violations.

If you or your staff have any questions, please contact me.

Sincerely,

Robert J. Birnbaum