"INVESTOR PROTECTION: THE ROLE OF THE SEC, THE SROs, AND THE INDUSTRY IN PREVENTING SALES PRACTICE ABUSES"

REMARKS OF
COMMISSIONER MARY L. SCHAPIRO
UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Before the
Twenty-Fifth Annual Rocky Mountain
State-Federal-Provincial Securities Conference

DENVER, COLORADO

OCTOBER 9, 1992

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Good afternoon. It is a real honor for me to have the opportunity to speak with you on the occasion of the twenty-fifth anniversary of this symposium. This conference has been, and will continue to be, a major event for the timely exchange of information and ideas among securities regulators and practitioners. I want to extend my congratulations to Bob Davenport, and to Lois Rice, for their work this year, in putting together a thoughtful and informative program.

In previous remarks at this conference, I spoke about the Commission's Task Force on Administrative Proceedings, which I have had the pleasure of chairing. The Task Force undertook a review of the Commission's administrative process, to determine if there were ways in which the process could be made more efficient and fair. In addition to examining all of the Commission's Rules of Practice, we are proposing a plan for exercising the Commission's recently acquired temporary cease-and- desist authority. I am not going to go into the details of the report today because I expect that it will be published and made publicly available soon. I just want to report that a great deal has been accomplished since the birth of the Task Force two years ago, and I am very grateful for input the Task

Force received from Bob Davenport and Bob Fusfeld, among others, and members of the securities bar.

The topic I would like to speak to you about today concerns something that goes to the very heart of the securities business. It is, in fact, the linchpin of the business. That something is integrity. In the United States, we are all very proud of having the deepest and most liquid markets in the world. I work frequently with regulators throughout the world, in emerging and developed markets. Without exception, they look with envy at our stock, options, and futures exchanges as models of capital formation and risk-shifting. There are many things that we do right, but it is the widespread investor participation that distinguishes our markets from all others. To ensure continued participation of large and small customers, maintaining investor confidence in the integrity of the marketplace should be our highest priority as regulators, as practitioners, as employees and managers of broker-dealer firms, and as members of self-regulatory organizations.

Two years ago, Judge Stanley Sporkin of the U.S. District Court for the District of Columbia, asked, in connection with his consideration of the Keating case, where were all the lawyers, where were the accountants? As usual, Judge Sporkin exhibited an unerring ability to get to the heart of the matter at hand. His question referred of course to the specifics of an alleged fraud perpetrated at a savings and loan institution, but I think a similar question can be asked in the context of examining the hiring and supervision practices of U.S. broker-dealer firms. When sales practice abuses arise, it seems to me that we have to ask: where were the branch office managers; where were the compliance officers; what were the management practices of a firm that permitted an individual with a past history of serious securities law violations or multiple customer complaints to become associated with yet another firm, and sell to the public?

The scenario in sales practice abuse cases reads like a bad novel. (For me, these are among the most disturbing cases the Commission sees because the victims are numerous, easily identifiable and often include persons whose lack of investment experience, or age, or ethnic affinity, makes them such easy targets.) Week after week, the Commission considers the following sort of scenario. A smooth talking registered representative cold calls his way into the unsuspecting hands - and bank account - of an investor with limited investment experience but a substantial nest egg.

Account opening statements are signed, and the investor instructs the representative to invest only in "safe" instruments, like conservative mutual funds or blue chip stocks. The investor, however, may list goals such as "income" and "growth potential" on the account opening statements without realizing how these objectives might be interpreted by the rep. Before too much time passes, the account is churned, unauthorized trading goes undetected, high risk investments are made, and perhaps a margin or options account is opened, all on an uninformed and unauthorized basis. The investor receives his account statement and discovers that his $100,000 nest egg now has a value of $25,000, if he is lucky, or perhaps the account has a negative net balance and he <u>owes</u> the firm, if he is not so lucky. In conversations with the rep, the customer is told to ignore the account statement, that it is wrong due to a "back-office screw-up" and he has in fact made money on his investment. According to the registered rep, the <u>minus</u> signs on the statement actually indicate a positive balance. Sometimes the registered rep simply "creates" new account statements to show an account with lots of profit. And so the investor is comforted, and the fraud goes undetected for a while longer.

Add to this basic scenario one of my favorite and all too common twists. The representative has a prior history of customer complaints but he happens to be a big producer for the firm, so his transgressions are largely ignored. In fact, he is such a money maker that, even if one firm lets him go, a competitor across the street will be only too happy to employ him. These practices may in fact become exacerbated during periods of bull markets and low interest rates, when small investors are looking for a way to get a better return on their investments, and firms are striving for a competitive edge.

If I sound a little cynical, it is because the scenario is all too familiar, and these practices threaten the small investors of this country in a manner that I find intolerable. What are we doing to combat these practices? What more can we do? How is it that brokers with seemingly bad track records keep getting hired by reputable firms?

There are four principal lines of defense against sales practice abuses: the broker-dealer firms, the self-regulatory organizations, the SEC and the state securities commissions, and the public investor. I am going to speak briefly today on the role each of these groups plays, and I'd like to suggest ways in which each can improve upon its performance.

Broker-dealers bear primary responsibility for the conduct of their employees, and for the tone that is set within the firm regarding how business should be conducted. Each firm is also responsible for ensuring that registered reps, and managers of the firm, <u>who are known by the firm to have engaged</u> in questionable sales practices, are in the future prevented from doing so. No firm, indeed no organization of any kind, can give an ironclad guarantee that none of its employees will ever engage in illegal practices. There will always be instances where the most astute branch office manager is taken in by a felonious broker, and fails to detect, for example, that the rep is selling away from the firm, or engaged in forgery. But broker-dealer firms have three principal compliance functions, which, if properly executed, would go a long way to curing the problem of abusive sales practices.

First, I would like to suggest a variation of the "know your customer" rule, and that is, the "know your rep" rule. No one is in a better position than the firms themselves to ensure, through careful hiring practices, that the individuals they employ are not likely to engage in thievery. Hiring procedures should be designed to uncover, and disqualify from employment, individuals whose disciplinary history or customer complaint file makes them bad candidates for positions of trust in the handling of customer funds. I would like to think that the hiring practices of every firm reflect an overriding concern for their customers, but there is troubling anecdotal evidence, such as that reported recently in the Los Angeles Times, that indicates a willingness of some firms to hire top producers in spite of problematic histories. The calculation that leads a firm to conclude that potential commissions generated by a big producer outweigh the liabilities that result from the producer's defalcations mystifies me. How do you factor in your firm's loss of reputation? How do you calculate the human suffering and anguish?

My second point is that firms must be scrupulous in setting up, and maintaining, policies and procedures designed to detect sales practice abuses. In order to be effective, these policies must set out, in clear and unambiguous terms, the lines of responsibility and supervision within each branch office, within each region, and within the top management of the firm. Employees who are charged with supervisory authority must be educated about their responsibilities and instructed to exercise their authority. The firm as a whole must adopt a philosophy that puts the best interests of its customers ahead of, rather than behind, its interest in profits. Let me add that, when firms hire persons who have a known history of customer complaints, arbitrations, private litigation or disciplinary problems, their supervisory responsibilities take on an added importance. A firm cannot hire someone with a bad track record and then argue in its defense that it was duped.

Third, having done all it can to prevent sales practice abuses through a careful hiring process and good compliance procedures, the firm must do what it can to ensure that the "bad apples" it discovers in its shop do not move with ease down the street, to another firm. The rules of all self-regulatory organizations require member firms to report the discharge or termination of employment of any registered representative or officer, with a statement of the reasons therefor, to the SRO on a U-5 form. In order to make this reporting requirement meaningful, the firms must act promptly, and they must provide a full and accurate description of the reason for termination. My sense is that in the past some firms have either (1) unintentionally filled out the form incorrectly, or (2) knowingly omitted information which, in the language of 10b-5, is necessary to make the disclosure not misleading. While I recognize that some firms have a concern about defamation actions based on their U-5 disclosure, I think the firms need to give renewed attention to the issue of providing appropriate disclosure on these forms. I would also urge that negotiation of dismissal terms not include a willingness by firms to be less than complete in their U-5 disclosure.

The issue of what is reported, and to whom, brings us to a discussion of the role played by SROs. In our system of self-regulation, the SROs are on the front-line of enforcement. Because of the reporting obligations of the firms, the SROs are alerted to certain types of disciplinary actions taken by the firms against their employees, and they are notified of instances in which a firm employee is the subject of a pending customer complaint or lawsuit involving claims in excess of a specified amount. The SROs of course also are made aware of potential disciplinary problems through customer complaints made directly to the exchange, through SEC referrals, through arbitration results, and through their own inspection programs. If SRO rules have been violated, the SRO may expel or suspend the individual or firm from its membership, or place limitations upon its business activities. The SROs are also empowered to fine, censure, suspend or bar any person from association with any member of the exchange. Clearly, SRO enforcement of their own rules - rules which generally require member firms to adhere to good business practice, and specifically require diligent supervision of all customer accounts -is crucial to achieving and maintaining compliance by the firms.

A large part of the enforcement burden falls on the shoulders of the New York Stock Exchange and the NASD, because they are the designated examining authorities for most firms dealing with the public. Each of these SROs must commit significant resources to its enforcement program, and be equally committed to bringing actions against their own members, and the members' employees.

There has been some criticism in the media concerning the speed with which disciplinary actions have been taken by the SROs against registered persons and firms, and the punishments that have been meted out. It has also been said that we are asking too much of the exchanges, to police the membership on whom they are built. Neither of these criticisms seem fair to me. As a regulator, I am acutely aware of the time it takes to develop a case, particularly where the facts are complex and no one is cooperating with you. That is not to say that we shouldn't be looking for ways to make the process more efficient, but we must be realistic in our expectations.

On the issue of whether the SROs are holding the line against their own members, a review of sales practice cases brought by the SROs in 1991 and to date this year, demonstrates that they are willing, and capable, of doing what needs to be done. For example, in 1991, the New York Stock Exchange brought a total of 212 disciplinary actions against members of the securities industry. More than seventy percent of these actions involved some type of sales practice abuse. By way of comparison, in 1988 the NYSE instituted only 58 disciplinary proceedings. The number of management officials charged by the NYSE with some kind of rule violation has increased almost fourfold during these years. Similarly, the number of actions brought by the NASD against its own members shows a strong commitment to enforcement of SRO rules. In 1990 and again in 1991, the NASD brought more than 1000 actions, with the majority of these cases involving sales practice abuses.

In terms of sanctions, the trend has been one of increased monetary penalties and more severe limitations on business. In 1991 the NASD fined a single registered rep two and-a-quarter million dollars, and levied other fines in excess of $1 million against member firms and individuals. In two important sales practice cases brought by the NYSE in the last year, fines of $750,000 and $900,000 were levied against Shearson Lehman Brothers Inc. and Paine Webber Inc., respectively. In both of these cases, the NYSE found that the firms, and individuals employed by the firms, had failed to reasonably discharge their supervisory responsibilities. These statistics demonstrate that SROs can and are bringing, an increasing number of disciplinary actions against firms with systemic sales practice problems, and against supervisory personnel, such as branch office managers. This focus on the firms and their supervisors is important and warranted, I think, because of the power of the firms to change the way they do business.

There are a number of other issues at the SRO level that deserve our attention. Once a registered rep has been found to have engaged in sales practice abuses, are we successfully communicating that message to other firms, to state and federal regulators, to the public? If the recent Los Angeles Times report is correct, then the answer for public investors is "maybe not." According to that series of articles, the investor hotline operated by the NASD does not always provide a complete profile of the disciplinary history of registered persons. Currently the hotline provides information on final SEC, SRO, and state regulatory actions against registered persons. But a very legitimate question is whether the hotline should also provide information regarding pending disciplinary charges, settlements of lawsuits or arbitration awards, civil judgments, and customer complaints. Collecting the information and inputting it into a central computer system does not appear to be part of the problem, because this information on reps is currently being retained by the Central Registration Depository, or "CRD" as it is commonly known.

How much information should be disclosed is not an entirely straightforward question. Disclosure via the hotline of pending actions against either firms or individuals may convey an unwarranted message of guilt, and may be particularly harsh when one acknowledges the considerable length of time an action can be pending. On the other hand, arbitration has replaced civil litigation to a large degree, and civil suits have always been a matter of public record. Certainly, concerns of unadjudicated guilt don't arise with respect to disclosing civil litigation judgements and final arbitration awards. The public ought to be told of these.

As regards criminal actions, the Commission recently proposed that indictments and informations against broker-dealer firms be disclosed promptly to the NASD. Since the NASD will have this information in its computer base, we need to consider whether this information should be disclosed on the hotline also. Additionally, I think there is merit in considering ways to disclose customer complaints. It may be advisable to limit the number and type of complaints disclosed by, for example, only disclosing complaints registered in the past five years, and only those having a certain monetary value, such as the $15,000 requirement now in place for RE-3 forms. I would like the SROs, in conjunction with the Commission, to consider these alternatives, because the hotline could be one of the most effective means for giving the investing public a profile of who they are buying securities from that is both up-to-date and accurate.

Like the SROs, the role played by state and federal regulators is chiefly one of enforcement. The focus of our enforcement efforts has evolved over time. My information is more anecdotal than statistical, but I believe that in the early to mid-1980s the Commission's sales practice abuse investigations largely focused on individual registered reps, and these matters were often referred to the SROs for action. Failure to supervise cases against branch office managers or firms were rare. Our focus has changed in the past several years, so that at present there is a greater emphasis on investigating, and addressing through sanctions, systemic supervisory problems.

In addition to our enforcement efforts, I think one of our most important jobs is to stimulate and facilitate communication among the SROs, the SEC, the firms, and state regulators. There are lots of questions that need to be resolved, ranging from topics like the adequacy of SRO and SEC sanctions, to questions concerning the re-entry of disqualified persons into the industry, and the disclosure of adverse information. We need to communicate with each other about the evolving trends in sales practice fraud and present a united front as we have done in the penny stock fraud area. As another example, it is clear to me that affinity fraud is on the increase. In order to detect these frauds before all the money has vanished, I recommended earlier this year that staff in the Commission's Enforcement Division review newspapers directed to specific ethnic groups to find out if potentially fraudulent investment schemes are being marketed through these publications.

Finally, I would like to say a few words about the role of the public investor. When I began this speech I noted that broker-dealer firms bear the primary responsibility for preventing sales practices abuses, but I could easily have begun by focusing on the role of the public investor. It would be a mistake to think that individual investors bear no, or even a minimal, responsibility, for what happens to their money. In fact, their ability to protect their own interests is a critical component of our system of regulation. But in order to protect themselves against fraud, small investors must have access to information and be educated about the ways in which sales practice frauds are perpetrated. We have seen, particularly here in the western United States, how successful a tool education can be. When stamping out abuses in the penny stock area became a state and federal priority, educating investors regarding the risks in that market became one of the most important means by which to reduce the fraudulent conduct.

What information sources do public investors have at their disposal? How can they stay on top of what is going on in their accounts? One of the most obvious ways investors can protect themselves is by paying close attention to their monthly account statements, but this also raises a bit of a problem. How many people do you know who really <u>understand</u> their statements? And if you called your broker to ask for a clarification, and he told you that the statement was wrong, in order to allay your concerns about losses, you might believe your broker, because the statement was so complicated that you didn't trust your ability to read it correctly. I think it's time for firms to consider ways that account statements can be made more comprehensible to the small investor. In addition, to combat the situation where brokers give false information to override the account statement, I think firms should include a written legend on the statement to the effect that: "This is a true and accurate statement of your account. If your broker informs you that any of the figures on this statement are incorrect, you are advised to contact your branch manager immediately or call the firm's 1-800-number." There are undoubtedly other means by which to get the word out to investors, and I would like to see them explored fully by the Commission, the states, the SROs and the firms.

In conclusion, I want to thank all of you for your attention. The good news about the problems I have touched upon today is that they are easily solvable. Accordingly, I believe that many of the abuses we now see in the sales practice area can be prevented through the combined efforts of the public, the industry, and the regulators.

Thank you.